Audit And Assurance - Basics

Professional Skepticism

- Professional skepticism in auditing implies an attitude that includes a questioning mind and a critical assessment of audit evidence without being obsessively suspicious or skeptical.
- Auditors adopt an attitude of professional skepticism when they evaluate audit evidence.
- When the auditor adopts such an attitude, the auditor does not accept evidence gathered at its face value: rather, the auditor evaluates the evidence bearing in mind the possibility that, for example:

1. the evidence may be misleading,
2. the evidence may be incomplete, or
3. the person providing the evidence may be either incompetent or motivated to provide evidence that is misleading or incomplete.

Conducting Audit - Steps

Just Remember – I LOVE U

- I – Intent of Management
- L – Letter of Engagement
- O – Objective & Scope of Audit
- V – Vouching & Verification
- E – Evaluation of Evidence
- U – Unqualified (or Qualified or Adverse or Disclaimer) Opinion

Mis-statements

The misstatement can take place either:

- In a financial statement item; or
- In underlying account balance; or
- With class of transaction

of an entity.

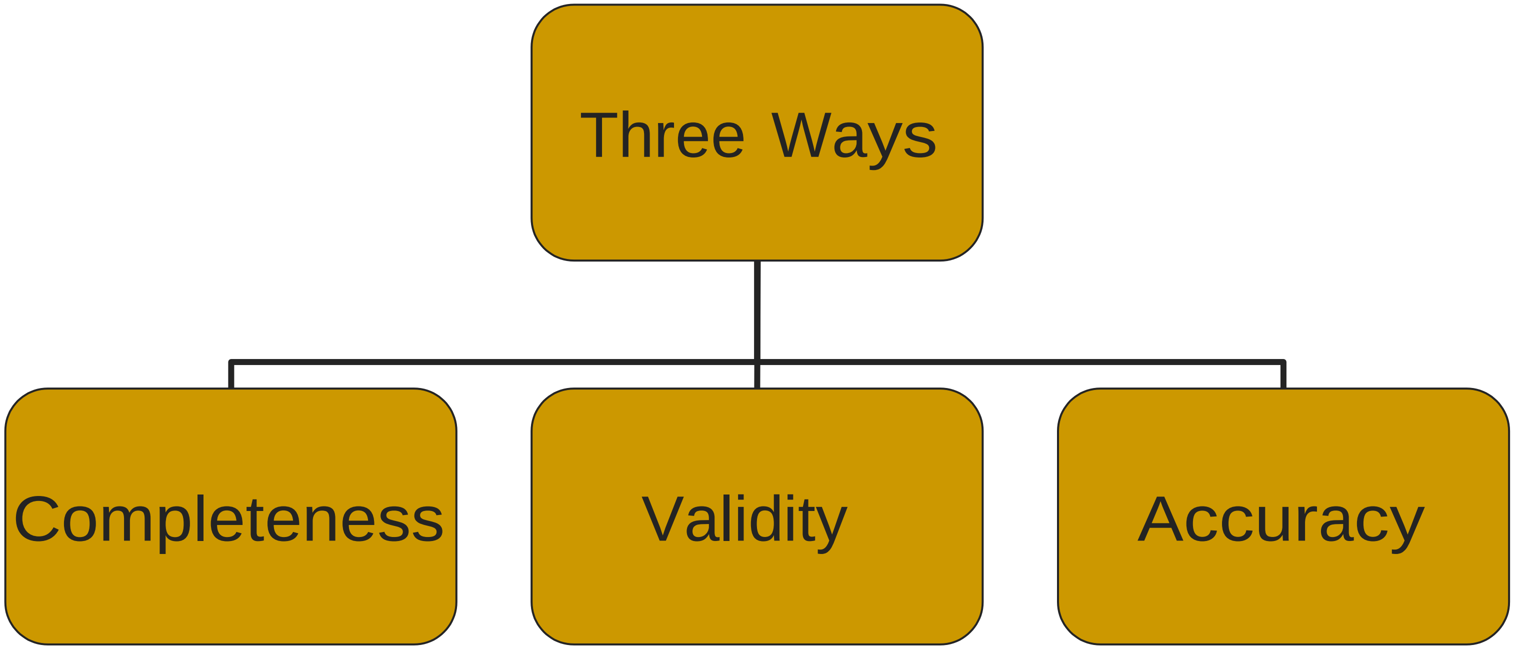
Mis-statements……contd.

Three ways of Mis-statements:

- not including in a financial statement item (or underlying account balance or class of transaction) an item that should be included;
- including in a financial statement item (or underlying account balance or class of transaction) an item that should not be included;
- including in a financial statement item (or underlying account balance or class of transaction) an item that should be included, but not including it accurately.

Mis-statements……contd.

Categorising Mis-statements:



Mis-statements……contd.

Examples of Mis-statements (category wise):

- Misstatement Of Completeness: the omission of a valid liability;
- Misstatement Of Validity: the inclusion of a fictitious asset;
- Misstatement Of Accuracy: the inclusion of a valid asset, but at an incorrect value or with an incorrect description

Note: Auditors classify misstatements as fraud (intentional), other illegal acts such as non compliance with laws and regulations (either intentional or unintentional) and errors (unintentional).

A misstatement may be material or immaterial. Where the auditor believes that the financial statements contain a material misstatement,

Mis-statements……contd.

the auditor issues a qualified audit opinion

Management’s Assertions

There are two categories of assertions by management that are of particular concern to auditors:

- Internal control assertions, and
- Financial statement assertions.

Internal Control Assertions

- Management is primarily responsible for the internal control procedures it establishes.
- There is an implied assertion by the management that such internal control procedures are effective as to both their design and operation.
- The auditor advises management of deficiencies in significant internal control procedures of which he becomes aware.

Financial Statements Assertions

- Auditors are not responsible for the preparation of the financial statements of an entity. This is the responsibility of management.
- The financial statements prepared by management for audit are a collection of assertions as to both the state of affairs of the entity at balance date and the results of its operations for the period ended on that date.
- Implied AssertionbyManagement: In broad terms, management is asserting to the auditor that the financial statements, and by implication the financial statement items and underlying account balances and classes of transaction, are free of (material) misstatement.
- Auditor's Role: That is, that the financial statement items, and underlying account balances and classes of transactions are, in all material respects, complete , valid and accurate . One of the principal objectives of the auditor is to add credibility to these assertions.

Financial Statements Assertions and Level of Aggregation

- Levels Of Aggregation?: In an accounting information system it refers to the various levels at which accounting related data and information is recorded and summarized.
- Each and every information is summarised in Financial Statements;
- Each financial statement item is comprised of one or more Account Balances;
- Each account balance is comprised of transactions of Various Classes;

Financial Statements Assertions and Level of Aggregation

- Level I – Financial Statement Level:
- Its a level at which the aggregated account balance data in the general ledger is summarized into a balance sheet and profit and loss statement;
- Each item in the financial statements is an aggregation of a number of account balances. For example, the financial statement item "Inventory" is an aggregation of a number of different inventory-related account balances.
- When management prepares the financial statements, it asserts that the financial statement items are complete, valid and accurate.
- Auditors, in forming their opinion on the financial statements, test these assertions by gathering and evaluating audit evidence that relate to each of these financial statement level assertions.

Financial Statements Assertions and Level of Aggregation

- Level II – Account Balance Level
- It is the level at which the aggregated transaction data contained in the various journals (e.g. cash receipts, sales and general journals) is recorded in, or 'posted to', the account balances in the general ledger to which the transactions relate.
- When management assert that the financial statements are complete, valid and accurate, it impliedly asserts that the underlying account balances are also complete, valid and accurate. For example, the assertion that "Inventory" in the financial statements is complete, valid and accurate, implies that underlying account balances such as "raw materials", "goods in transit", "finished goods", are also complete, valid and accurate.
- Auditors consider each account balance assertion individually. For example, the auditor gathers different evidence to test management's assertion that "raw materials" is complete, compared to the assertion that "raw materials is valid".

Financial Statements Assertions and Level of Aggregation

- Level III – Class of Transaction
- It is the level at which the source documents (e.g. cash receipt advices, delivery advices, journal vouchers) are processed as transactions.
- An implied assertion that an account balance is complete, valid and accurate is also an implied assertion that classes of transaction underlying the account balance are also complete, valid and accurate.
- For example, the assertion that "raw materials" account balance is complete, valid and accurate also implies that underlying classes of transactions (e.g. purchases and sales transactions) are also complete, valid and accurate.

Financial Statements Assertion vis-à-vis Level of Aggregation

LEVEL OF AGGREGATION	ASSERTIONS		
	Completeness	Validity	Accuracy
Financial statement item level	All valid account balances are included in the financial statement item.	All account balances included in the financial statement item (i) do exist and (ii) do pertain to the entity as at balance date.	All valid account balances included in the financial statement item are accurate as to (i) valuation and (ii) presentation and disclosure.

Financial Statements Assertion vis-à-vis Level of Aggregation

Account balance level	All valid assets, liabilities, equities, revenues and expenses are included in the account balance.	Balance sheet account balances: All assets, liabilities and equities included in the account balance (i) do exist and (ii) are owned (controlled) by, or owed by, the entity as at balance date. Income statement account balances: All income and expenses included in the account balance (i) do pertain to the entity and (ii) have occurred during the relevant period.	All valid assets, liabilities, equities, revenues and expenses included in the account balance are accurate as to (i) valuation and (ii) classification.

Financial Statements Assertion vis-à-vis Level of Aggregation

Class of transaction level	All valid economic events are included in the class of transaction.	All economic events included in the class (i) do pertain to the entity and (ii) have occurred during the relevant period.	All valid economic events included in the class are accurate as to (i) value and (ii) description.

Audit Procedures

- Compliance Procedures;
- Substantive Procedures

Nature, Timing & Extent of Audit Procedures

- The nature timing and extent of planned audit procedures is a way of describing the contents of the audit program for an audit engagement.
- Nature: The nature of a planned audit procedure refers to both the type of procedure and method used to gather the evidence.
- The greater the risk of material misstatement [RMM] the more reliable the planned method used in substantive testing. In this regard, tests of detail are considered to gather more reliable evidence than analytical procedures;

Audit stage	Type of procedure	Manual methods of gathering evidence include:
Substantive testing	Test of detail	Physical examination, recalculation, confirmation, vouching, cut-off test, inquiry.
	Analytical procedure	Reasonableness test, ratio analysis, scanning, roll-forward procedure.

Nature, Timing & Extent of Audit Procedures……..contd.

- Timing: The timing of a planned audit procedure refers to when the audit procedure is to be performed.
- Audit procedures may be performed prior to balance date (e.g. during interim visits), on balance date or after balance date (e.g. during final visit).
- The greater the RMM relating to a particular account balance assertion, the more critical is the timing of the substantive testing procedure.
- For example, if the RMM relating to the validity of inventory is high, the auditor will plan substantive procedures relating to the validity [existence] of the account balance assertion (for example, inventory counts) to be performed on balance date, but not before or after balance date. If this risk is not high, then the timing of these procedures is not as critical.

Nature, Timing & Extent of Audit Procedures……..contd.

- <u>Extent:</u> The extent of planned audit procedures simply refers to the extent of the nature of the procedures.
- For example,
- How many purchases invoices require vouching?
- How many computations (e.g. quantity on hand x unit cost) should be checked?
- The greater the RMM the more extensive the planned evidence gathered.