BASIC CONCETS IN AUDITING

1. Importance of audit by an independent professional auditor:

- The principal advantage of an independent audit is that the society is able to get an informed, objective and forthright opinion on financial statement of enterprise which are used by interested segment of society (e.g. – shareholders, trade payable, banker etc.) for significant economic decision making.
- Through audited accounts, shareholder of a company are assured that fund invested by them are safe and they are being used for only the purpose for which they raised and collected.
- State of affairs of enterprise can easily be understood through reliable/ audited financial statement.
- Management of business uses it for decision-making purpose.
- Investors are used for investment decision-making.
- Financial analysts can use the information to assess the performance of an entity.
- Worker are used to assess that reasonable share or revenue earned by the organisation has been paid them as bonus and distribution pattern has not violated the norms of social justice.

Auditor's Independence:

- In the context of the auditors, his independence is necessary so as to enable him to express his unbiased opinion on financial statement.
- The user of financial statement will rely on the opinion of the auditor only when he is convinced about his independence.
- Independence of the auditor has not only to exist in the fact, but should also appear to so exist to all reasonable persons.
- The chartered accountant is not known personally to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.
- The companies act, 2013, has therefore enacted specific provision to give concreate shape to this vital concept:
  - The provisions disqualifying certain types of persons from undertaking audit of limited companies.
  - Provision relating to celling on the number of audits that can be undertaken by a chartered accountant.
  - Provision requiring special resolution for appointing auditors in certain cases.
  - Other provisions on appointment, reappointment and removal of auditor, are designed with sufficient independence to carry out the audit.
  - Power to qualify his report is yet another weapon of the auditor to protect his independence.
  - Provision relating rotation of auditor/ audit firm.

2. Fundamental Accounting Assumption

- As per AS-1 on "Disclosure of accounting policies", accounting policies refers to –
  a) The specific accounting principal and,
  b) The methods of applying those principal adopted by enterprise in the preparation and presentation of financial statements.
- In the context of AS-1, there are certain fundamental accounting assumption underlie in preparation and presentation of financial statement. They are usually not specifically stated because their use and acceptance are assumed. Disclosure is necessary if they are not followed.
- The following have been generally accepted as fundamental accounting assumptions –
  - **i. Going Concern:**

- An enterprise is normally view as going concern i.e. it will continuing its operations for foreseeable future.
- It is assumed that enterprise has neither the intention nor the necessity for liquidation or of curtailing the scale of the operations.

ii. **Consistency:**

- It is assumed that accounting policies are consist form one period to another.

iii. **Accrual**

- Revenue and costs are accrued, that is, recognised as they are earned or incurred and recorded in the financial statement of periods to which they relate.

3. Audit Evidence

- As per the SA 500 “Audit Evidence”, it is the information used by the auditor in arriving at the conclusions on which the auditor opinion is based.
- Audit evidence includes both information contained in the accounting records underlying the financial statement and other information.

4. Audit procedure to obtain audit evidence

According to SA 500 “Audit Evidence”, the auditor may obtain evidence by one or more of the following audit procedure –

- **Inspection**
  - Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.
  - Inspection of records and documents provides audit evidence of varying degree of reliability, depending on their nature and source and, in case of internal records and documents, on the effectiveness of the control over their production.
- **Observation**
  - Observation consists of looking at a process or procedure being performed by other or of performance of control activities.
  - Observation provides audit evidence about the performance of a process or procedure, but limited to the point in time in which observation takes place.
- **External confirmation**
  - An external confirmation represent audit evidence obtained by the auditor as direct written response to the auditor from a third party, in paper form, or by electronic or other medium.
  - The confirmation request may be designed to ask if any modification have been made to the agreement and, if, so what the relevant details are.
  - External confirmation procedure also are used to obtain audit evidence about the absence of certain conditions. For example, the absence of a ‘side agreement’ that may influence relevance recognition
- **Recalculation**
  - Recalculation consist of checking the mathematical accuracy of documents or records.
  - Recalculation may be performed manually or electronically.

- **Reperformance**

- Reperformance involves the auditor’s independent execution of procedure or control that were originally performed as part of entity’s internal control.

- **Analytical procedure**
  - Analytical procedure consist of evaluation of financial information made by a study of a plausible (Good & Fair) relationship among both financial and non-financial data.
  - Analytical procedure also encompasses the investigation of identified fluctuation and relationship that are inconsist with other relevant information or deviate significantly from predicated amount.
- **Inquiry**
  - Inquiry consist of seeking information of knowledgeable person, both, financial and non-financial, within the entity or outside the entity.
  - Inquiry is used extensively throughput the audit in addition to other audit procedure.
  - Inquiry may range from formal written inquiries to informal oral inquiry.
  - Response to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, response might provide information that differ significantly from other information that the auditor has obtained.
  - In respect of some matters, the auditor may consider it necessary to obtain written representation from management and where appropriate, those charged with governance to confirm response to oral inquiries.

5. Reliability of Audit Evidences:

- SA 500 on “Audit Evidence” provides that the reliability of information to be used as audit evidences, and therefore of the audit evidences itself, is influenced by its source and its nature and the circumstances under which it is obtained, including the control over its preparation and maintenance where relevant.
- When the information to be used as audit evidence is obtained from sources external to the entity, circumstances may exit that could affect its reliability.
- Following are generalisations about the reliability of audit evidences may be useful:
  - The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
  - The reliability of audit evidences that is generated internally is increased when related control, including those its preparation and maintenance, imposed by the entity are effective.
  - Audit evidence obtained directly by the auditor is more reliable then audit evidence obtained indirectly or by interface.
  - Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than audit evidence obtained orally.
  - Audit evidence provided by original document is more reliable then audit evidence provided by photocopies, or document that have firmed or other transformation, reliability of which may depend on controls over their preparation and maintenance.

6. Difference between Internal Evidences and External Evidences

No.	INTERNAL Evidences	EXTERNAL Evidences
1	Evidences which are originates within the client’s entity are internal evidences.	Evidences which are originates outside the client’s entity are external evidences.
2	Internal evidences are less reliable because there are possibilities of manipulation and creation of false and misleading evidences to suit the client or his staff.	The external evidences is generally considered to be more reliable as they are come from third parties who is not normally interested in

		manipulation of accounting information of others
3	Examples: Sales invoice, copies of sales challan and forwarding note, good received note, inspection report, copies of cash memo etc.	Examples: Purchase invoice, supplier's challan and forward note, debit notes & credit notes, quotations confirmations etc.

7. Sufficient Appropriate Audit Evidence:

- SA 500 "Audit Evidence" requires that auditor shall design and perform audit procedure to obtain sufficient and appropriate audit evidence.
- Sufficiency is a measure of quantity of audit evidence.
- The quantity of audit evidence needed is affected by auditor's assessment of risk of misstatement and also by quality of such evidences.
- Appropriateness is a measure of quality of audit evidence, i.e., its relevant and its reliability in providing support for conclusion on which the auditor's opinion is based.
- Reliability of audit evidence is influenced by its source and nature, and is dependent on individual circumstances under which it is obtained.
- In general, the various factors which may influence the auditor's judgement as to what is sufficient and appropriate audit evidence are as under –
  - The materiality of the item.
  - The experience gained during previous audit.
  - The result of auditing procedure, including fraud and error which may have been found.
  - The type of information available.
  - The trend indicated by accounting ratios and analysis.
  - The degree of risk of misstatement which may be affected by the factors such as adequacy of internal control, nature and size of business and financial position of the entity.

8. Analytical procedure:

- Analytical procedure means evaluation of financial statement of an enterprise, made by the study of plausible relationship among both, financial and non-financial data.
- Analytical procedure are also encompasses with investigation of identified fluctuation and relationship that are inconsist with other relevant information or differ significantly from predicated amount.
- Analytical procedure are also includes the consideration of comparison of entity's financial information with –
  - Anticipated result of the entity, such as budgets or forecasts, or expectation of the auditor,
  - Similar industry information,
  - Comparable information of prior period.
- Analytical procedure are also includes consideration of comparison of relationship. For example – relationship among different elements of financial statement.
- Various methods may be used to perform analytical procedures. These methods range from performing simple comparison to performing complex analysis using advanced statistical technique.
- **Analytical procedure are used for following purposes:**
  - To obtain relevant and reliable audit evidences when using substantive analytical procedure, and

- To design and perform analytical procedure near to the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statement are consist with the auditor's understanding of the entity.

9. Audit Working Papers

- As per SA 230 "Audit Documentation", audit working papers are the records of the audit procedure performed, relevant audit evidences obtained and the conclusion the auditor reached.
- Audit working paper constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and clients' record.
- Working papers are the –
  a) Evidences of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and
  b) Evidence that audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.
- **Advantages of Audit Working Papers-** The working papers if properly maintained, can be used as defence in case of need. The audit working papers are found very useful in the following aspects as they –
  i. Assisting the engagement team to plan and perform of the audit;
  ii. Assisting the members of engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220;
  iii. Provide evidence of the work performed to support the auditor's opinion;
  iv. Act as evidence in court of law when charge of negligence is brought against the auditor;
  v. Enabling the engagement team to be accountable for its work.
  vi. Retaining a record of matters of continuing significance to future audits.
  vii. Enabling the conduct of quality control reviews and inspections in accordance with SQC1.
  viii. Enabling the conduct of external inspection in accordance with applicable legal, regulatory or other requirements.
- **Retention of working papers**
  - Working papers should be retain long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention.
  - The retention period for audit engagement ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.
- **Ownership of Working Papers**
  - Working papers are the property of the auditor.
  - The auditor should adopt reasonable procedure for custody and confidentiality of his working papers.
  - An auditor is not required to provide the clients or other auditor access to his working papers.
  - Main auditor is not required to provide the clients or other auditor access to his working papers.
  - In case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor may not be comply with the request of the principal auditor to give a photocopies of working paper
  - The main auditor of the company does not have right to access to the working papers of branch auditor.

10. Test of Controls

- According to SA 330 "The Auditor's Responses to Assessed Risks", 'test of controls' means an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatement at assertion level.
- The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when;
  - The auditor's assessment of risk of material misstatement at the assertion level includes an expectation that the controls are operating effectively.
  - Substantive procedure alone cannot provide sufficient appropriate audit evidence at the assertion level.

11. Substantive procedure

- These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion.
- In other words, substantive procedure test the validity and propriety of the accounting treatment of the transaction.
- Substantive procedure comprise:
  - Tests of details (of classes of transactions, account balances, and disclosures), and
  - Substantive analytical procedure.
- Irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedure for each material class of transaction, account balance, and disclosure.
- **Assertions while Obtaining Audit Evidences from Substantive Procedure:**
  - i. **Existence** – that an asset or liability exists at a given date.
  - ii. **Rights and obligations** – that an asset is a right of the entity and a liability is an obligation at a given date.
  - iii. **Occurrence** – that a transaction or event took place which pertains to the entity.
  - iv. **Completeness** – that there are no unrecorded assets, liabilities or transaction.
  - v. **Valuation** – that an asset or liability is recorded at an appropriate carrying value.
  - vi. **Measurement** – that a transaction is recorded in the proper amount and revenue or expenses are allocated to proper period.
  - vii. **Presentation & disclosure** – that an item is disclosed, classified and described in accordance with recognised accounting policies, practices and statutory requirements.

12. True and Fair

- The concept of true and fair is a fundamental concept in auditing.
- The phrase " true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the result of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.
- This requires that the auditor should examine the accounts with a view to verifying that all asset and liabilities, income and expenses are stated at the amount which are in accordance with accounting principal and policies, and no material item has been omitted.

13. Accounting Estimate

- According to SA 500, accounting estimate means an approximation of an amount in the absence of a precise means of measurement.
- This term is used for an amount in the measured at fair value where there is an estimation uncertainty as well as for other amount that requires estimation.

- Because of the uncertainty inherent in business activities, some financial statement items can only be estimated.
- Further, the specific characteristic of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item.
- Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatement, for example:
  - Accounting estimate arising in entities that engage in business activities that are not complex.
  - Accounting estimate that are frequently made and updated because they relate to routine transactions.
- For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:
  - Accounting estimate relating to the outcome of litigation.
  - Allowances for doubtful accounts.
  - Inventory obsolescence.
  - Warranty obligations.
  - Depreciation method or asset useful life.
  - Outcome of long term contracts.
  - Financial obligations.

14. Concept of materiality

- Financial reporting frameworks may discuss materiality in different terms, they generally explain that:
  - Misstatement, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decision of users taken on the basis of the financial statements;
  - Judgement about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information need of users of financial statement, and by the size of nature of a misstatement, or a combination of both; and
  - The auditor's determination of materiality is a matter of professional judgement, and is affected by the auditor's perception of the financial information needs of users of financial statement. In this context, it is reasonable for the auditor to assume that users:
    a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statement with reasonably diligence;
    b) Understand that financial statement are prepared, presented and audited to levels of materiality;
    c) Recognised the uncertainties inherent in the measurement of amounts based on the use of estimates, judgement and consideration of future events; and
    d) Make reasonable economic decision on the basis of the information in the financial statement.
  - The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatement on the audit and of uncorrected misstatement on the audit and of uncorrected misstatements, if any, on the financial statement and in forming the opinion in the auditor's report.

15. External confirmation

- As per SA 505 "External Confirmation" is an audit evidence obtained as a direct written response to the auditor from a third party, in paper form, or by electronic or other medium?

- Following are examples of situations where external confirmations may be useful –
    - Bank balances and other information from bankers
    - Account receivable balances
    - Inventory held by third party.
    - Account payable balances.

16. Responsibility of Joint Auditor

The main feature of SA 299 are as under –

- **Division of work**
  - Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas.
  - Certain areas of work, due to their importance or due to the nature or work involved would not be divided and would be covered by all the joint auditors.
  - Such a division made by joint auditors should be adequately documented and preferably communicated to the auditee.
- **Coordination**
  - Where in the course of his work, a joint auditor come across matter –
    - Which are relevant to the areas of other joint auditor and
    - Which require joint discussion

He should communicate the same to all the other joint auditor in writing before the finalisation and preparation of the audit report.

- In respect of work divided amongst the joint auditor, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him.
- Joint auditor are jointly and severally responsible in respect of the audit conducted by them as under –
  - In respect of the audit work which is not divided among the joint auditor and is carried out any of them.
  - In respect of decision taken by all of the joint auditors concerning the nature, timing or extent of the audit procedure to be performed by any of the joint auditor.
  - In respect of matters which are brought to the notice of the joint auditors by any of them and on which there is an agreement among the joint auditor.
  - For examining that the financial statement of the entity comply with the disclosure requirement of the relevant statute.
  - It is separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquires to be made in the course of his audit.
  - The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditor
  - Each joint auditor is entitled to assure that the other joint auditor have carried out their part of the work in accordance with the generally accepted audit procedure and therefore, it would not be necessary for joint auditor to review the work performed by other joint auditor.
- Where the joint auditors are in disagreement with the regard to any matter to be covered by the report, each one of them should express their opinion through a separate report.
- A joint auditor is not bound be the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

PREPERATION FOR AN AUDIT

1. Audit Sampling

"Audit Sampling" means the application of audit procedure to less than 100% of the item within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusion about the entire population.

Selection of audit sample on Random Basis-

- Selection of audit sample on random basis ensure that all items in population have an equal chance of selection.
- This method is consider as appropriate, provided the population to be sampled consist of reasonably similar units and fall within a reasonable range.
- In fact, selection of an audit sample on a random basis is the pre-requisite for application of statistical technique.
- Whenever, audit sample selection has been done on a random basis, no statistical process for selection of sample is need to be followed.

2. Methods of selecting samples

i. **Random Selection-**
  - This method is applied through random number generator. Example – random number table.
  - Stratified sampling is one of the methods of random sampling.
  - This method involves dividing the whole population, to be tested, in a few groups call strata and taking a sample from each of them.
  - Each stratum is treated as if it were a separate population and if proportionate items are selected from each of the stratum.
  - The groups into which whole population is divided is determined by the auditor on basis of his judgement. e.g. – entire expense vouchers may be divided into –
    a. Vouchers above ₹100000.
    b. Vouchers between ₹25000 and ₹100000.
    c. Voucher below ₹25000.
  - The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these difference. This is achieved by selecting different proportions from each strata.

ii. **Systematic selection**
  - In this method, the number of sampling units in the population is divided by sample size to give a sampling interval, for example – 50, ad having determine a starting point within first 50, each 50th sampling unit thereafter is selected.
  - When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in population.

iii. **Monetary Unit Sampling**
  - This method is a type of value-weighted selection in which sample size, selection and evaluation result in conclusion in monetary amount.

iv. **Haphazard Selection**
  - In this method, the auditor selects the sample without following a structured technique.
  - Although, no structured technique is used, it ensure that all item in the population have a chance of selection.
  - Haphazard sampling is not appropriate when using statistical sampling

v. **Block Selection**

- This method involves selection of a block or blocks of contiguous items from within the population.
- Block selection cannot ordinarily be used in audit sampling because most population are structure such that item in a sequence can be expected to have similar characteristic to each other, and items of different characteristic elsewhere in the population.

3. Sampling Risk

- When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatement may cause the financial statement to be materially misstated and provide a margin for possible undetected misstatements.
- The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subject to the same audit procedure.
- Sampling risk can lead to two types of erroneously conclusions –
  - In case of a test of control, that controls are more effective than they actually are, or in the case of a substantive procedure i.e. test of details that a material misstatement does not exist when in fact is does. The auditor is primarily concerned with this type of erroneously because it affects audit effectiveness and more likely to lead to an inappropriate audit opinion.
  - In the case of a test of control, that controls are less effective than they actually are, or in case a substantive procedure i.e. test of details, that a material misstatement exits when in fact it does not. This type of erroneously conclusion affect audit efficiency as it would usually lead to additional work to establish that initial conclusion were incorrect.

4. Audit Note Book

- An audit note book is usually a bound book in which a large variety of matters observed during the course of audit is recorded.
- Audit note book form part of audit working papers and for each year a fresh audit note book is maintained.
- In case an auditor classifies his working papers into permanent and current, then audit not book form part of the current file.
- The audit note book also provides a valuable help to auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily.
- It is also used for recording of various queries raised in the course of the work and their state of disposal.
- In respect of disposed quarries, explanations obtained and evidences seen would be recorded in said book, while queries remaining undisposed of would be noted for fellowship.

5. Continuous Audit

- A continuous audit is one in which the auditor's staff is engage continuously in checking the accounts of the clients, when for the purpose, the staff attends at quit frequent intervals say weekly basis during the financial period.
- **Purpose of continues audit –**
  - Errors are discovered earlier with result that there is adequate time for making the necessary rectification.
  - Because of frequent attendance of the auditor, the opportunities of committing frauds are reduce.
  - Fraud, if committed, is detected sooner with result that size of fraud is limited and also chances of recovering the amount lost are improved.
  - The attendance of audit staff acts as a moral check of client's staff.

- The client's accounts are always kept up to date.
- Since audit can be carried on throughout the year, there is more time for detailed checking of the accounts when the audit is taken up closer of the year.
- If the auditor carries on a continuous audit, he remain constantly in touch with the client's affairs, thereby able to carry out his duties efficiently.

- **Drawbacks/ Disadvantage of continuous audit –**
  - Due to audit carried out in several installments, the audit staff may fail to keep track of things which they had not checked on their last or earlier visit, as a result whereof some of the transaction may escape audit scrutiny.
  - There is a danger that the records of transactions after they have audited may be altered either innocently or fraudulently.
  - The examination of an item left incomplete on a visit for being undertaking on the next visit may be overlooked.
  - A continuous audit may involve a good deal of waste of time and efforts if the size of concern is small.

6. Letter of Engagement

- The audit engagement letter is sent by the auditor to his client which specifies –
  - The objective and scope of audit, and
  - The extent of his responsibilities to the client, and
  - The form of report.
- Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax returns, checking the sales tax return, etc. beside audit.
- In such cases, there may be misunderstanding about the exact scope of the work; the auditor may think that he is merely required prepare accounts while the client may think audit of accounts is also covered.
- It is, therefore, of the greatest importance, both for the accountant and client, that each party should be clear about the nature of the engagement.
- It must be in writing and should exactly specify the scope of the work.
- It is in the interest of the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduce to a great extent.
- SA -210 lays down the standard on agreeing the terms of engagement with the client and the auditor's response to a request by client to change the terms of an engagement to one that provides a lower level of assurance.
- **Change in terms of Engagement –**
  - According to SA 210 "Agreeing the terms of Audit Engagement", an auditor –
    - Who is required to change the engagement,
    - Which is require lower level of assurance,
    - Before the completion of engagement,
    - Should consider the appropriateness of doing so.
  - But when the engagement are changed, both the auditor and client should agree on new terms.
  - However, the auditor should not agree to a change in terms where there is not reasonable justification for doing so.
  - If the auditor is unable to agree to a change of terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

  - Withdraw from the audit engagement where possible under applicable law or regulation; and
  - Determine whether there is any obligation, either contractual or otherwise, to other parties, such as those charged with governance, owner or regulations.
- In instant case, the auditor was unable to obtain sufficient evidence regarding receivable. The client requested him for a change in the terms of the agreement to avoid qualified/ adverse opinion. Hence, there is no reasonable justification for change in the terms of engagement.
- Thus, the auditor should not agree for change in terms of engagement letter. He may withdraw from the engagement if possible under law; and determine any obligation to report accordingly.

7. Obtaining knowledge of the Business

- The auditor need to obtain a level of knowledge of client's business that will enable him to identify the events, transactions and practices that, in his judgement, may have significant effect on financial information among other things.
- As per SA 315 – "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its environment" the auditor shall obtain an understanding of following –
  a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
  b) The nature of entity, including -
     - Its ownership and governance structures,
     - Its operations, the type of investment that the entity is making and plans to make,
     - The way that the entity is structured and how it is financed,

     To enable the auditor to understand the classes of transaction, account balances, and disclosure to be expected in the financial statement.
  c) The entity's selection and application of accounting policies, including the reason for changes thereto.
  d) The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consist with the applicable financial reporting framework and accounting policies used in relevant industry.
  e) The entity's objective and strategies, and those related businesses risk that may result in risk of material misstatement.
  f) The measurement and review of entity's financial performance.
- In addition, knowledge about client's business in performing the audit is important in respect of following aspects-
  - It help auditor to identify areas of special audit consideration.
  - To evaluate the reasonableness of -
    - Accounting estimates, and
    - Management representation.
  - To make judgement about the appropriateness of accounting policies and disclosure.

8. Inherent Risk

- Inherent risk is –
  - The susceptibility of an account balance or class of transactions to misstatement,
  - That could be material either individually or,
  - When aggregate with misstatement in other balances or classes,

  - Assuming that there were no related internal controls.
- As per SA 315, "identifying and Assessing the risk of Material Misstatement through understanding the Entity and its Environment" for this purpose, the auditor shall:
  - Identify risks throughout the process of obtaining an understanding of entity and its environment including –
    - Relevant control that relate to the risks and
    - By considering the classes of transactions, account balances, and disclosure in the financial statement.
  - Assess the identified risks, and evaluate whether they relate more pervasively to the financial statement as a whole and potentially affect many assertion.
  - Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test, and
  - Consider the likelihood of misstatement including the possibility of multiple misstatement, and whether the potential misstatement is of a magnitude that could result in material misstatement.

9. Management Representation

- SA 580, "Written Representation" deals with the auditor's responsibility to obtain written representation from management and, where appropriate, those charge with governance.
- Written representation are necessary information that the auditor requires in connection with the audit of entity's financial statement.
- Accordingly, similar to response to enquiries, written representation are audit evidence.
- In certain instances, such as where knowledge of facts is confide to management or where matter is principally of intention, a representation by management may be only audit evidences which can reasonably be expected to available.
- For example, intention of management to hold a specific investment for long term.
- However, it cannot be a substitute for other audit evidences expected to be available.

10. Audit Programme

- An audit programme is -
  - A detailed plan of applying,
  - The audit procedure in given circumstances,
  - With instruction for the appropriate technique to be adopted,
  - For accomplishing the audit objectives.
- It is designed with keeping in view –
  - Nature, size and composition of business,
  - Dependability of the internal control,
  - Given scope of work.
- An audit programme provides sufficient details to serves as a set of instruction to the audit team and also help to control the proper execution of the work.
- An audit programme is flexible i.e. it can be change according to requirement of situation or circumstances.
- There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidences about the transactions.
- For the purpose of framing an audit programme the following points should be kept in view –
  - Audit objective
  - Audit procedure to be applied

   - Extent of check
   - Timing of check
   - Allocation of work amongst team members
   - Special instruction based on post experience of the auditee.

- **The role of audit programme in audit plan and performance-**
  - The audit programme is helpful both in planning and performance stage of audit –
    1. The audit programme list down the areas of audit before commencement.
    2. The audit timing is specified therein; thereby it becomes a schedule of audit plan.
    3. The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of firm.
    4. It specifies the procedure to be checked during the audit.
    5. As the audit work is split into various elements of procedure to be performed, the audit programme act as guiding chart or check list during the performance of audit.
    6. The working paper of the audit staff can reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting the financial statement.
    7. It is also help in preparing a diary of performance and plan and also base for billing the clients.
    8. Chance of duplication of work is eliminated.
    9. Evidences of work done is available when auditor is to defend his performance against charge of negligence.
    10. It serves as a guide for audit to be carried out in the succeeding year.

11. Permanent Audit File and Current Audit File

i. **Permanent Audit File:** It includes –
  - Information related to organisational and legal structure of the entity –
    - In case of a company, this includes memorandum of association and article of association.
    - In case of a statutory corporation, this includes the act and regulation under which corporation is operate.
  - Copies of important legal documents, agreements and minutes relevant to the audit.
  - Details of the study and evaluation of the internal control related to the accounting system in form of narrative records, questionnaires or flow chart, or some combination thereof.
  - Copies of audited financial statement of precious years.
  - Analysis of significant ratios and trends.
  - Copies of management letter by auditor, if any.
  - Records of communication with retiring auditors, if any, before acceptance of the appointment as auditors.
  - Notes regarding significant accounting policies.
  - Significant audit observation of earlier year.

ii. Current Audit File:
  - Correspondence relating to acceptance of annual appointment.
  - Copies of important matters in minutes of board meeting and general meetings.
  - Evidence of planning process of the audit and audit programme.
  - Analysis of transaction and balances.
  - A record of the nature, timing and extent of audit procedures performed and the result of such procedure.

- Evidences that work performed by assistant was supervised and reviewed.
- Copies of communication with other auditor, exports and other third parties.
- Letters of representation or confirmation received from client.
- Conclusion reached by auditor concerning significant aspects of the work.

12. Surprise checks

- Surprise checks are a part of normal audit procedure.
- An element of surprise can significantly improve the audit effectiveness.
- The element of surprise in an audit may be -
  - In regard to time of audit, e.g. selection of date of visit;
  - In regard of selection of area of audit.
  - Surprise checks are mainly intended to ascertain –
    - Whether the internal control system is working effectively, and
    - Whether the accounting and other records are kept up to date as per the statutory requirements.
  - Surprise checks can exercise good moral checks on the client's staff.
  - It help in determining whether errors and frauds exists and if they exists, bring the matters in notice of management, so that corrective action can be taken.
  - Surprise checks are very effective in –
    - Verification of cash and investment,
    - Test checking of inventory,
    - Verification of accounting records,
    - Statutory register and internal verification of accounting records,
    - Statutory register and internal control system.
    - The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in course of audit.
  - It is not necessary in all cases for the results of the surprise checks to be include in the auditor's report on accounts. They should, however, be included opinion of the auditor they are material and effect a true and fair view of the accounts on which he is reporting.

13. Test Checking in System Based Audit

- System based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit test.
- Depending upon size and nature of the business concerned, an accounting system will incorporate necessary internal controls to provide assurance that-
  - All the transaction and information have been recorded,
  - Frauds and errors, if any, in preparing the accounts will be identified.
  - All the assets and liabilities recorded in the books of accounts do exists and are shown at correct amount.
  - There is compliances with statutory regulations.
- After the auditor has ascertained the clients accounting system, he should assess it to satisfy the above mention requirements.
- The auditor, therefore, after evaluating internal control system, test the same to ascertain whether it is actually in operation.
- This is does on a selection basis i.e. he adopts test checking technique.
- He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test or by auditing in-depth.

- This approach is adopted in system based audit which is Morden audit approach.
- The system based audit begin with evaluating the accounting system and internal control and then by testing them to ascertain their reliability.
- By this, auditor first established how reliable the system is and then decides how much detailed checking of transaction and verification of assets and liability he must undertake.
- If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detail checking would be necessary.

14. Concept of Materiality

- SA 320 "Materiality in planning and performing an Audit" establishes standard on the concept of materiality and its relationship with audit risk.
- The concept of materiality is fundamental to the process of accounting.
- It covers all the stages from recording to classification and presentation.
- It is very important for the auditor who has constantly to judge whether a particular item is material or not.
- There id inverse relationship between materiality and degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa.
- Factors to be consider for determining materiality -
  - Items of materiality may be determined individually or in aggregate.
  - Items of materiality depends on the regulatory or legal consideration.
  - Even insignificant items in terms of quality may be material in special circumstances.
  - Sometimes the materiality of an item in terms of quantity is described in law itself. For example – Schedule III require disclosure of item of expenditure which are in excess of one percent of the revenue form operation or ₹100000, whichever is higher.
  - An item whose impact is insignificant at present, but in future it may significant, may be material item.

15. Audit risk at the Account Balance Level and at the Class of Transaction Level

- At these levels, the auditor uses professional judgement to evaluate numerous factors to assess inherent risk –
  - Financial statement of accounts likely to be susceptible to mismanagement.
  - The complexity of judgement involved in determining account balances.
  - Susceptibility of asset to loss or misappropriation.
  - The amount of judgement involved in determining account balances.
  - The completion of unusual and complex transactions, particularly at or near end.

16. Extent on Reliance on Analytical Procedures

- the extent of reliance that the auditor places on the result of analytical procedures depends upon the following factors –
  - Materiality of the item involved, for example – when inventory balances are material, the auditor does not rely only on analytical procedure in forming conclusions.
  - Other audit procedure directed toward the same audit objectives,
  - Accuracy with which the expected results of analytical procedure can be predicated. For example - the auditor will ordinarily expected greater consistency in comparing gross profit margins form one period to another than in comparing discretionary expenses, such as research or adverting.
  - Assessment of inherent risk and control risk.

- The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such control are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the result of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting related controls.

17. Reliability of external confirmation

- As per SA 505 "External Confirmation", the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external procedures, and evaluating the result of the external confirmation procedure.
- SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability.
- All responses carry some risk of interception, alternation or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium.
- Factors that may indicate doubts about the reliability of a response that it –
  - Was receive by the auditor indirectly; or
  - Appeared not to come from the originally intended confirming party.
- If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implication on the assessment of the relevant risk of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

18. Factors governing modes of communication of Auditor with those charged with governance

- As per SA 260, "Communication with Those charged with Governance", the form of communication may be affected by the such factors as –
  - Whether the matter has been satisfactory resolved.
  - Whether management has previously communicated the matter.
  - The size, operating structure, control environment, and legal structure of the entity.
  - In case of an audit of special purpose financial statement, whether the auditor also audit the entity's general purpose financial statement.
  - Legal requirements. In some jurisdictions, a written communication with those charged with Governance is required in a prescribed form by the local law.
  - The expectations of those charged with Governance, including arrangements made for periodic meetings or communications with the auditor.
  - The amount of ongoing contact and dialogs the auditor has with those charged with Governance.
  - Whether there have been significant changes in the membership of a governing body.

19. Procedure to be performed by the Auditor In Expressing Opinion on 'Going Concern' Assumption

- As per SA 570, "Going Concern", the following are the relevant procedure that are relevant in this connection –
  - Analyse and discuss cash flow, profit and other relevant forecasts with management.
  - Analyse and discuss the entity's latest available interim financial statement.
  - Read the terms of debenture and loan agreement and determine whether any have been breached.
  - Read minutes of meetings of shareholders, the board of directors and important committees for reference to financial difficulties.

- Inquire the entity's legal counsel regarding the existence of litigations and claims.
- Evaluate the entity's plan to deal with unfilled customer orders.
- Perform audit procedure regarding subsequent event to identify those that either mitigate or otherwise affect the entity's ability to continue as going concern.
- Confirm the existence, terms and adequacy of borrowing facilities.
- Obtain and review reports of regularity actions.
- Determine the adequacy of support for any planned disposal of assets.