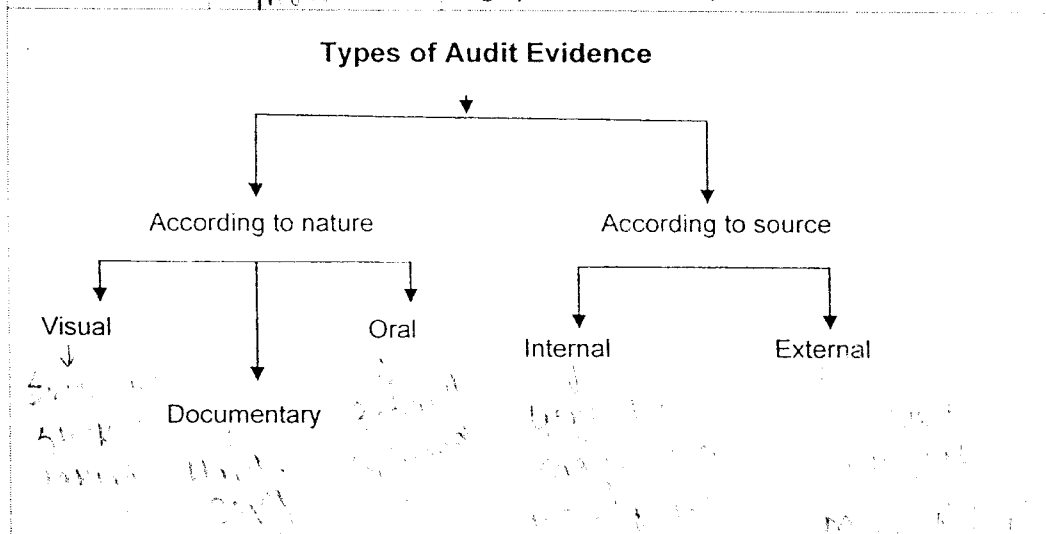


Basic concepts in Auditing

2.1 AAS 5-AUDIT EVIDENCE

Meaning	Audit Evidence refers to any information obtained by the auditor so that he can draw conclusions & express opinion on financial statements.		
Sufficiency	(a) Auditor should obtain sufficient & Appropriate evidences.		
Appropriateness	(b) Sufficiency refers to <i>quantum</i> of audit evidence.		
Evidence	(c) Appropriateness refers to <i>quality</i> of audit evidence.		
Factors affecting	(a) Degree of risk of misstatement.		
detection	(b) The result of audit procedures i.e. any fraud & error detected by auditor.		
Sufficiency &	(c) Materiality of item.		
Appropriateness	(d) Type of information available.		
	(e) Experience gained during previous audit.		
	(d) Trend shown by accounting ratios etc.		
Types of Audit Evidence	According to nature.	1. Visual .	E.g., observing stock taking conducted by client's staff.
		2. Documentary	E.g., Having a copy of loan agreement, sales bills.
		3. Oral	E.g., discussion with management regarding current trends in business.
	According to source	1. Internal	Which is created within client's organisation. For e.g., copies of bills given to customers, employee's wage sheets etc.
		2. External	This originates outside client's organisation. For E.g., purchase invoice, bank statement.



As per AS-2 "Objective & Scope of Audit of financial Statement" basic objective of audit is to express an view on the true & fairness of financial statements & for this he required Audit Evidence.

Difference between Internal & External Evidence

Basis	Internal	External
Meaning	Created & retained within client's organisation.	Originates outside client's organisation.
Example	Copies of sales invoice, wage sheet	Purchase invoice, bank statements
Source	Inside the entity.	Outside the entity
Reliability	Less reliable	More reliable

Reliability of Evidence

- (a) External evidence is generally more reliable than internal evidence.
- (b) Evidence obtained directly through auditor is more reliable than that obtained through client.
- (c) Written Evidence is more reliable than oral evidence.
- (d) Internal Evidence is reliable if related internal controls are good.

Consistency of Evidence

- (i) The audit evidences, obtained through different sources or of different nature should be consistent.
- (ii) If there is inconsistency among different evidences relating to a single item, auditor should perform **additional procedures** to resolve inconsistency.

Procedures to obtain Evidence

(i) Compliance Procedure	Compliance procedures are performed to check designing, operating effectiveness and continuity of I.C. system. Auditor performs compliance procedures in respect of the following assertions relating to internal control system :	
	Existence (design)	- that the internal control exists.
	Operating effectiveness	-that the I.C. system is operating effectively.
	Continuity	- that the internal control has been so operated throughout the period.
(ii) Substantive procedure	Substantive procedures are performed to check <u>completeness, accuracy and validity of transactions and balances</u> . Auditor performs substantive procedures in respect of following assertions relating to data produced by accounting system :	
	Measurement	That a transaction is recorded in the proper period at proper amount.
	Presentation and disclosure	An item is disclosed, classified and described as per recognized accounting policies and relevant statutory requirements, if any.
	Completeness	That there is no unrecorded asset or liability or transaction.
	Occurrence	That a transaction or event took place which pertains to the entity during the relevant period.
	Valuation	That an asset or liability is recorded at an appropriate carrying value.
	Existence	That an asset or a liability exists at given date.
	Rights and obligations	That an asset is a right of the entity and liability is an obligation of the entity at a given date.

Continuity & Design
 Design operation

Internal Control
 → exists
 → operative or effective
 → continuity

All transaction have been taken in account

Value ownership 7/4/6

AUDIT PROCEDURES

Compliance

Check

To test whether I.C. & existence, operation have been designed and operating effectively throughout the period.

Substantive procedure

To test completeness, accuracy & validity of data produced by accounting system. It consists of

Test of Details

Analytical review procedures
i.e., analysis of significant ratios & trends.

Ratio Analysis

testing procedures

testing balances

(verification)

(Votk P)

Value, Ownership, Title, Existence, Reserve of charge

Methods of audit

Compliance & substantive procedures are performed by following methods:

1. <u>Inspection</u>	Inspection consists of examining records, documents or tangible assets. Four types of documentary evidence are: (i) documentary evidence originating from and held by third parties; (ii) documentary evidence originating from third party and held by the entity; (iii) documentary evidence originating from the entity and held by third parties; and (iv) documentary evidence originating from and held by the entity
2. <u>Observation</u>	(i) Observation consists of witnessing a process or procedure being performed by others. (ii) For example, the auditor may observe the counting of inventories being performed by client's personnel.
3. <u>Inquiry and Confirmation</u>	(i) Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. (ii) Confirmation consists of the response to an inquiry. (iii) For example, the auditor requests confirmation of receivables by direct communication with debtors.
4. <u>Computation</u>	Computation consists of checking the arithmetical accuracy of records or performing independent calculations.
5. <u>Analytical Review</u>	Analytical review refers to studying significant ratios and trends and investigating unusual fluctuations.

Ratio Based Analysis

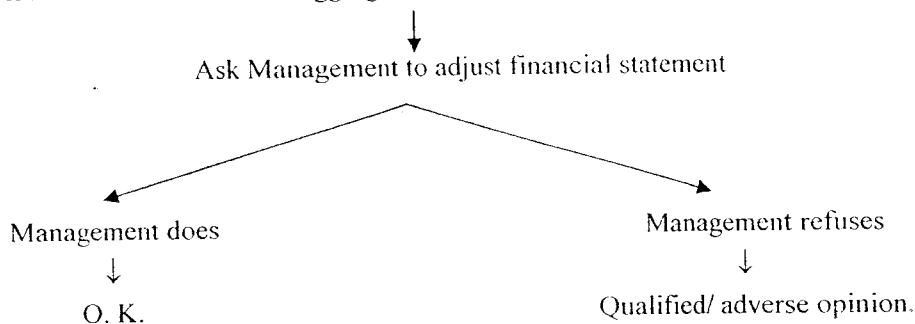
2.2 AAS 14 – ANALYTICAL PROCEDURES

Meaning	"Analytical procedures" means the analysis of significant ratios and trends, including the investigation of fluctuations.
Nature of Analytical Procedures	Analytical procedures include comparisons of the entity's financial information with following: - Comparable information for prior periods. [P.Y. C.Y. figures such as GP ratio] - Anticipated results such as budgets. [Budget expenditure] - Predictive estimates prepared by the auditor, such as estimation of depreciation - Industrial trend [Industries Ratio etc]
Use of ARP → Planning → Substantive Procedure → Overall Review	Analytical procedures are used – (a) In planning the nature, timing and extent of other audit procedures. NIS (b) as an overall review of the financial statements.
STAGE-1 In Planning the audit Nature, time & extent of Audit Process	- The auditor should apply analytical procedures at the planning stage for understanding the business and in identifying areas of potential risk. - It uses both financial and non-financial information.
STAGE-2 As Substantive Procedures Extra Qs. done	- He may use ARP at this stage as a mean to obtain extra evidence relating to an item. - When performing analytical procedures as substantive procedures, auditor will need to consider whether to rely on results of ARP or not.
STAGE-3 In overall review at the end of the audit Gen Expressive final view	- He should apply analytical procedures at or near the end of the audit while concluding as to whether the financial statements as a whole are consistent with his knowledge of the business. - In some cases, the auditor may identify areas where further procedures should be applied before reporting.
Extent of reliance on ARP	The application of analytical procedures is based on the assumption that relationships among data exist and continue. The extent of reliance on the results of analytical procedures depends on the following factors: (a) Materiality of the items involved. For example, when inventory balances are material the auditor does not rely only on analytical procedures in forming conclusions; (b) other audit procedures applied for the same audit objectives; (c) Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will place greater reliance in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and (d) assessment of inherent and control risks, for example, if internal control over sales order processing is weak, then auditor would consider adopting more substantive tests rather than ARP only.
Unusual fluctuations	When ARP identify significant fluctuations which are inconsistent with other information, the auditor should perform extended procedures.

2.3 13 - AUDIT MATERIALITY

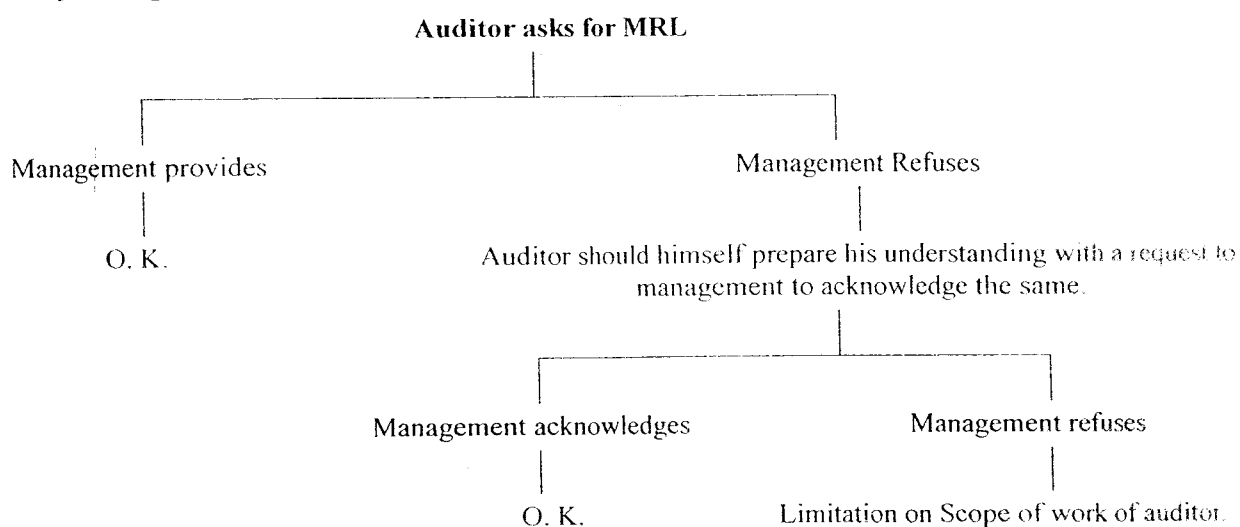
↳ Inclusion Presence or absence may effect the judgement of the financial statement	Meaning	- Material items are those which may affect the judgement of users of financial statements. - It may be quantitative / qualitative.
	<i>It depends upon</i>	- Size of item: (large amt) - Nature of item: (unusual, legal) - Statutory provisions, etc.
	Materiality to be considered	From both point of views – - Individual Account and - Overall financial statements.
	Auditor should consider materiality while	- Determining NTE of audit procedures; and - Evaluating effect of misstatements.
Relation between Materiality and Audit Risk	Relation	Inverse relationship between Degree of Audit Risk and Materiality level.
	Reason	Generally, management / employees don't commit fraud in high value items. Moreover, as a general practice, auditor examines high value items in detail. Thus, it is less risky that high value items and Error may not be detected. Thus high materiality level leaves audit risk at lower degree. Hence, inverse relation.
Considerations by Auditor		- Auditor decides upon materiality level during planning stage which may be <i>changed</i> during progress of audit. It may be increased/ decreased for specific account. - If ARP indicates misstatements, auditor should adopt other procedures to estimate it.
Aggregate uncorrected misstatement	Meaning	- Specific misstatements identified by Auditor + - Uncorrected misstatements (not identified) + - Net effect of uncorrected misstatements identified during previous year's audit

If Auditor concludes that aggregate uncorrected misstatement are material



2.4 AAS 11 – MANAGEMENT REPRESENTATION

Management Representation	<i>Meaning</i> Written / oral confirmation by them w.r.t. items affecting financial statements. <i>Example</i> ▪ For Financial Statement as a whole. ▪ For Accounting Policies. <i>adopted by mgt.</i> ▪ Intention to hold Investments. ▪ Provision for claims, etc. <i>Provision for liabilities etc.</i>
Types of MRL	▪ Letter issued by management. ▪ Letter from auditor containing his understanding which is duly acknowledged and confirmed by the management.
Elements of MRL	▪ It should be addressed to Auditor. ▪ It should be dated and signed by proper authority. ▪ Date of MRL should be earlier than/same as date of audit report. ▪ For specific transaction, there may be separate management representation letters (For e.g. For Investment)
Management Representation as Audit Evidence	▪ He should use his <i>professional judgement</i> to decide the areas in which MRL is required. ▪ Management Representation should be <i>in writing</i>. ▪ Auditor should <i>seek corroborative</i> evidences. ▪ Evaluate its <i>reasonableness and consistency</i>. ▪ Management Representation should be provided by well <i>informed persons</i>. ▪ Management Representation Letter <i>can't be substituted</i> for other audit evidences. ▪ However, sometimes it may be <i>only</i> evidence.
Documentation	Of both types of Management Representation Letters.

Refusal by Management :

2.5 AS 30 – EXTERNAL CONFIRMATIONS

Definition	It is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item.	
Methods	▪ Selecting the items for which confirmations are needed. ▪ Designing the form of the confirmation request. <i>Request letter</i> ▪ Communicating the confirmation request to third party. ▪ Obtaining response from third party. ▪ Evaluating the information or absence of confirmation.	
Where confirmations may be used	▪ Debtor balances; ▪ Creditor balances; ▪ Terms of agreement or transactions with third parties; ▪ Bank Balance and other information from bankers; ▪ Stock held by third parties; ▪ Property title deeds held by third parties; ▪ Investments purchased but delivery not taken; & ▪ Bank loans.	
Timing of External Confirmations	External confirmation may be requested either at the balance sheet date or as at any other date close to the balance sheet date. Respondents will be more willing to a confirmation request containing management authorization.	
Use of Positive and Negative Confirmation Request	Positive confirmation request	It asks the respondent to <u>reply</u> to the auditor in all cases either by indicating the respondent's agreement/ disagreement with the given information, or by asking the respondent to fill in information.
	Negative confirmation request	It asks the respondent to <u>reply only in the event of disagreement</u> with the information provided in the request. Negative confirmation request should be used when: ▪ inherent and control risk is low; ▪ a large number of small balances is involved; ▪ a substantial number of errors is not expected; and ▪ it does not appear to the auditor that respondents will disregard these requests.
Characteristics of Respondents	Respondent's competence and independence affect the reliability of evidence. Thus, the confirmation request should be addressed to appropriate individual.	
The external confirmation process – considerations by auditor	▪ The auditor should maintain control over selection of third parties to whom a request will be sent, the preparation and sending of requests and the responses to those requests. ▪ He should ensure that he directly sends out the confirmation requests, the requests are properly addressed and that all replies and the undelivered confirmations are delivered directly to him. ▪ He should perform alternative procedures if no response is received to a positive external confirmation request. ▪ The auditor should consider whether external confirmations appear to be unreliable. ▪ He should also consider the causes of inconsistency revealed by external confirmation, if any.	

Management Requests	Meaning	If auditor wants to confirm certain information and management requests the auditor not to do so, he should consider validity of grounds for such a request. He should ask the management to submit its request in a written form , alongwith the reasons for such request. He should maintain documentation of the request made by the management along with the reasons given by the management.
	If he agrees	If he agrees to management request not to seek external confirmation regarding a particular matter, then apply alternative procedures to obtain sufficient appropriate evidences.
	If he doesn't agree	If the auditor does not accept the validity of management's request and is prevented from obtaining confirmations, there is a limitation on the scope of the auditor's work. He should consider the possible impact on the audit report.

OBJECTIVE TYPE QUESTIONS

Comment on whether following are True or False

- (1) **Evidence should be sufficient and appropriate.**
TRUE ⇒ Auditor should obtain *sufficient & Appropriate* evidence. Sufficiency refers to quantum of audit evidence. Appropriateness refers to quality of audit evidence.
- (2) **Auditor should consider consistency of evidence.**
TRUE ⇒ The audit evidences obtained through different sources or of different nature should be consistent. If there is inconsistency among different evidences relating to a single item, auditor should perform additional procedures to resolve inconsistency.
- (3) **Compliance procedure is undertaken to check transactions & balances.** *Internal Control.*
FALSE ⇒ Compliance procedure is undertaken to check designing, operating effectiveness and continuity of internal control systems.
- (4) **Substantive procedures are carried out to check data produced by accounting system.**
TRUE ⇒ Substantive procedures are undertaken to check completeness, accuracy and validity of data produced by accounting system *i.e.*, transactions and balances.
- (5) **Auditor may use analytical review procedure at planning stage.**
TRUE ⇒ The auditor should apply analytical procedures at planning stage for understanding the business and in identifying areas of potential risk. It uses both financial and non- financial information.
- (6) **Material items are only quantitative in nature.** *quality also*
FALSE ⇒ Material items are those which may influence the judgement of users of financial statements. It may be quantitative and qualitative as well.
- (7) **There is inverse relation between materiality & audit risk.**
TRUE ⇒ Generally management /employees don't commit fraud in high value items. Moreover, as a general practice, auditor checks high value items in detail. Thus it is less risky that high value fraud and error may not be detected. So, high materiality level leaves audit risk at lower degree.
- (8) **Management representation letter can be of two types.**
TRUE ⇒ (i) Letter issued by management
(ii) Letter from auditors outlining his understanding, which is duly acknowledged and confirmed by the management.

Chapter 3

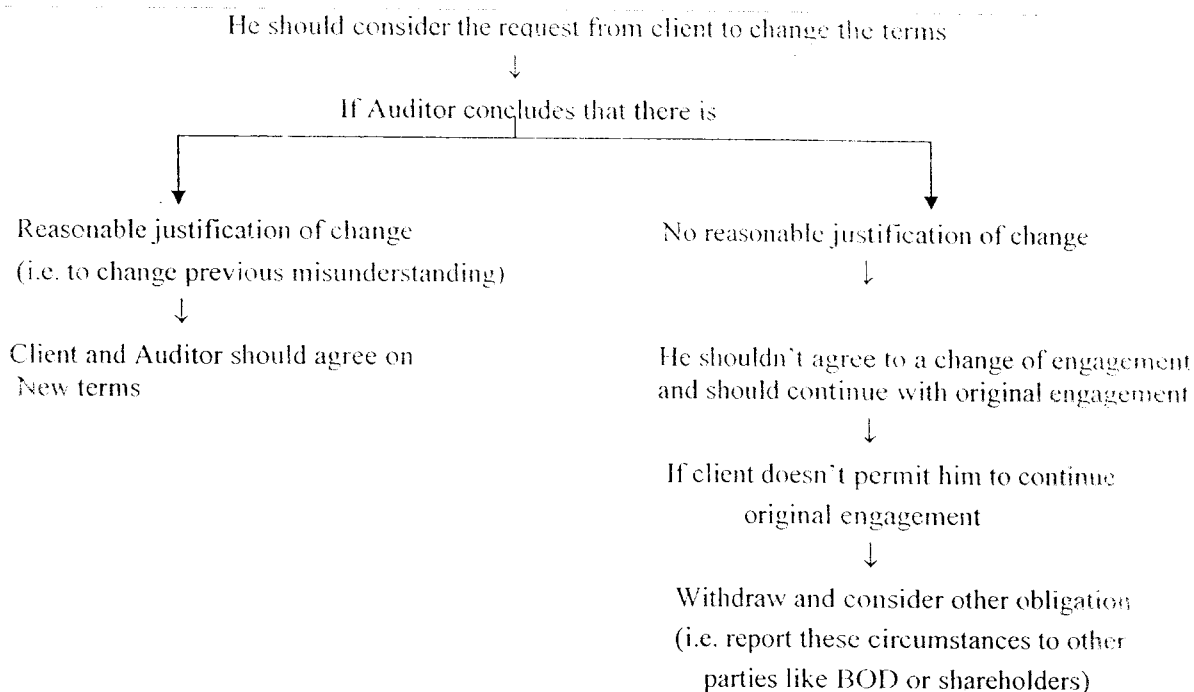
Preparation for an Audit

3.1 AUDIT PROCESS

(1) Audit Process at a glance	1. <u>Engagement</u> of Auditor. 2. Auditor Obtains <u>knowledge of client's Business</u>. 3. Formulation of <u>audit plan & program</u>. 4. Determining <u>NTE</u> of substantive procedures. 5. On the basis of results of <u>compliance procedures</u>, performing <u>substantive Procedures</u>. 6. Maintaining working papers. 7. Formulation of opinion regarding financial statements. 8. Issuance of Audit Report.	
(2) Audit Process (stage wise) <i>→ Compliance Procedures</i> <i>→ Substantive Procedures</i> <i>→ Vouching</i> <i>→ Verification</i> <i>→ Reporting</i> <i>→ DRP</i>	(i) Stage 1: Planning	(i) Formulating overall plan based on knowledge of client's Business. (ii) Preparing detailed audit programs for every aspect to be covered in Audit.
	(ii) Stage 2: Performing procedures & obtaining evidences there from	(i) Examining system of internal controls by performing compliance procedures. (ii) Based on above, determining NTE of substantive procedures. (iii) Conducting vouching of transactions. (iv) Performing verification of balances. (v) Ensuring appropriate disclosure of information. (vi) Examining form & content of financial statements. (vii) Analysing significant ratios & trends.
	(iii) State 3 : Concluding & Reporting	(i) Forming conclusion on the basis of evidences. (ii) Providing report on Truthfulness & Fairness of financial statements on the basis of conclusions. (iii) Ensuring that report complies with the statutory requirement, if any. (iv) Communicating the Report to the appropriate authority.

3.2 AAS 26 – TERMS OF AUDIT ENGAGEMENT

Engagement	1. Client and Auditor should agree on terms of engagement by way of an audit engagement letter, to avoid any misunderstanding. 2. Auditor should send an engagement letter, preferably before commencement of engagement.
Principal contents: of Engagement Letter The Engagement Letter must state that the it is management responsibility to prepare financial statements by using various accounting policies & estimates and that auditor's responsibility is just to report on whether or not such financial statements	✓ The objective of the audit: i.e. Statutory, cost audit, Interim audit ✓ The scope of the audit: → lower or as per terms of Engagement ✓ Management's responsibility for the financial statements; ✓ Management's responsibility for selection and consistent application of appropriate accounting policies; i.e. <u>Consistency</u> ✓ Management's responsibility for preparation of the financial statements on a going concern basis; ✓ Management's responsibility for making reasonable judgments and <u>estimates</u>; ✓ Management's responsibility for the maintenance of adequate accounting <u>records</u> and <u>internal controls</u>; ✓ Unrestricted access to records and <u>documentation</u>; ✓ The fact that due to (1) the test nature of an audit, (2) persuasive rather than conclusive nature of audit evidence, (3) involvement of judgement and (4) inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undetected; & ✓ The fact that the audit process may be subjected to peer review. ✓
Additional Matters	✓ Planning of the audit. ✓ Expectation of <u>receiving</u> MRL. AAS-11 ✓ Requesting client to confirm the terms of the engagement. <i>External Confirmation. A 32</i> ✓ Description of any other letters the auditor expects to issue to the client. ✓ Fees and billing arrangements. (AAS-11) ✓ Arrangements w.r.t. the involvement of other auditors and experts and internal auditor. ✓ Arrangements to be made with the predecessor auditor.
Audit of Component	When the auditor of a parent entity is also the auditor of its subsidiary, branch or division, Auditor should consider Legal requirements, independence of the management etc. to decide whether to send a separate engagement letter to the component.
Recurring Audits	The auditor should consider whether circumstances require revision in terms of engagement or if there is need to remind existing terms of engagement to the client.
Change in Engagement	If before completing the engagement, client requests the auditor to change the engagement to one, which provides a lower level of assurance, he should consider the reasonableness of such a request.



3.3 SAMPLE ENGAGEMENT LETTER

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 2XXX and the related profit and loss account and the (cash flow statement) for the year ended on that date.

We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements. We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems, which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal control for safeguarding of the assets of the company and for the preventing and detecting fraud or other regularities. As part of the audit process, we will request from management written confirmation concerning representations made to management in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit. Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded. Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.

Date

Chartered Accountants

Place

.....
(Signature)

(Name of the Member)

(Designation)

Acknowledged on behalf of ABC Company by

.....
(Signature)

Name and Designation

Date

3.4 AUDIT TECHNIQUES

Meaning	Audit techniques refer to certain means & methods for collecting evidences.		
Example	1. Posting checking	2. Casting checking	3. Physical verification
	4. Inquiry	5. Re-computation	6. <u>ARP</u>
	7. Year end scrutiny	8. Bank reconciliation	8.5
Difference Between Audit Procedures & Audit Techniques	Basis	Procedures	Techniques
	(i) Meaning	Basic way to handle audit work.	Methods are employed for conducting procedures.
	(ii) Types	Two types – Compliance and substantive.	Many (refer to examples given above)
	(iii) Nature	A specific procedure may require a number of techniques.	In verification of Assets, many techniques such as physical examination, inquiry and computations are needed.

3.5 AAS – 8 – AUDIT PLANNING

Planning	1. The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. 2. It should be based on knowledge of the client's business.
Applicability	1. The Statement is framed in the context of recurring audits. 2. In a first audit, the auditor may extend his planning process beyond the matters discussed herein.
Contents	Planning should be continuous, involving ▪ Developing an overall plan for scope and conduct of the audit; and ▪ Developing an audit programme.
Usefulness	Audit planning helps to ensure that: ▪ appropriate attention is devoted to important areas of the audit; ▪ potential problems are promptly identified; ▪ the work is complete in time; NOTE ▪ assistants are utilised properly; and ▪ the work done by other auditors and experts is duly co-ordinated.
Knowledge of the clients Business	The auditor can obtain such knowledge from - (i) Previous Experience. (ii) Discussion with people within entity. (iii) Discussion with internal auditor. (iv) Discussion with other auditor. (v) Discussion with knowledgeable people outside entity. (vi) Publication relating to industry in which entity operates. (vii) Legislation and Regulation. (viii) Visits to entity/plant. (ix) Documents produced by entity (minutes, manuals, plans) etc. (x) Client's annual report to shareholders. (xi) Client's policy and procedure manual. (xii) Minutes of meeting of shareholders, BOD etc. (xiii) Internal periodic reports. (xiv) Consideration of state of economy and its impact on client's business.
Discussion with Client	Discussions with the client may include following: ▪ Changes in management organizational structure, and activities of the client. ▪ Current Government legislation, regulations and directives affecting the client. ▪ Current business developments. ▪ Current or impending financial difficulties or accounting problems. ▪ Existence of related parties with whom transactions are likely. ▪ New or closed premises and plant facilities. ▪ Recent or impending changes in technology. ▪ Significant matters arising from previous year's financial statements, audit report and management letters. ▪ Changes in the accounting practices and in the system of internal control. ▪ Scope and timing of the examination. ▪ Assistance of client personnel in data preparation. ▪ Relevance of any work to be carried out by the client's internal auditors.

Development of an overall audit plan (outline of plan)

- ↳ Statutory Responsibility
- ↳ Requirement
- ↳ Acc Policies
- ↳ Audit area
- ↳ IC system & reliance
- Nk

- The terms of engagement and any statutory responsibilities.
- Nature and timing of reports or other communication.
- Applicable legal or statutory requirements.
- Accounting policies adopted by the client and changes in those policies.
- Effect of new accounting or auditing pronouncements on the audit.
- Identification of significant audit areas.
- Setting of materiality levels for audit purposes.
- Conditions requiring special attention such as the possibility of material error or fraud.
- Reliance to be placed on accounting system and internal control.
- Rotation of emphasis on specific audit areas.
- Nature, timing and extent of audit evidence.
- Work of internal auditors and the extent of their involvement.
- Involvement of other auditors.
- Involvement of experts.
- Allocation of work between joint auditors.
- Establishing and coordinating staffing requirements.

Documentation

The auditor should document his overall plan. Form and extent of the documentation will vary depending on the size and complexity of the audit.

Developing the audit program

- Identification of work required
- Nature Timing
- Control
- Timing for each of audit

1. Auditor should prepare a written audit programme listing the procedures required to implement the audit plan.
2. The programme should have sufficient details so that it can be used as a set of instructions for the assistants.
3. The auditor should consider the
 - (i) Timing of the procedures;
 - (ii) The coordination of any assistance required from the client and the availability of assistants; and
 - (iii) The involvement of other auditors or experts.
4. Auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing. *For example* observing stock taking conducted by client.

3.6 ADVANTAGES OF AUDIT PROGRAM

(i) Selection of Assistants	The program helps selecting assistants as per their capability.
(ii) Instructions for staff	It contains instructions for staff as to work to be done.
(iii) Ready check list	It provides ready checklist of all the procedures and techniques to be adopted.
(vi) No ignorance or overlooking	Due to properly written program, there is no chance of forgetting /overlooking some important matter.

(v) Responsibility fixation	Program clearly set out as to who is required to do a particular work. Thus responsibility can be fixed.
(vi) Progress of work done	The progress of work can be determined on the basis of entries on the program.
(vii) Supervision	Work by assistants can be easily supervised by referring the program.
(viii) Timely completion	Time to time, compliance with program is checked so as to complete the work on timely basis.
(ix) Basis for reporting	Program easily sets out procedure - evidence - conclusions chain, to enable the auditor to express opinion.
(x) Future Audits	It serves as a guide for audits to be carried out in succeeding years.
(xi) Safeguard for auditor	In case, auditor faces some case for negligence, he can defend himself by showing it.

3.7 LIMITATIONS OF AUDIT PROGRAM

(i) Mechanical Approach	Assistants may carry out work mechanically without understanding the whole concept.
(ii) Inflexibility	The program often becomes rigid & inflexible. Assistants are not able to change it as per requirements of specific case.
(iii) Lack of initiative	Hard & fast program hurts the initiative & judgmental skills of hard working assistants.
(iv) Monotonous	Talented & efficient staff becomes frustrated due to anonymity in programs.
(v) Shelter for inefficient assistants	They think that it contains exhaustive matters. They don't even think of any unusual matter, which is not listed in program even if its presence can change audit approach.

3.8 WAYS TO CARRY OUT SYSTEMATIC & EFFICIENT AUDIT

1. Regularity	Audit must be carried out regularly.
2. Record of time	If arrival & departure time of assistants are recorded, it will act as a moral check for them.
3. Completeness	Specific portion of work should be completed on daily basis.
4. Documentation	Working papers should be maintained regarding all the work done.
5. Confidentiality	Audit staff should not discuss the client's affairs with outsiders.
6. Stamping	After examination, all vouchers must be stamped.
7. Colour differentiation	Colored pen/pencils & different ticks should be used to indicate different audit procedures.
8. Supervision	Audit team manager must periodically review & supervise the work done.
9. Regular meetings	During audit, there should be continuous interaction among the members of audit team to discuss latest findings.
10. Flexibility	If need arises, audit program should be revised during the course of audit.

3.9 CLASSIFICATION OF AUDIT ACCORDING TO TIME OF ASSURANCE

Financial Audit	Meaning	Audit that begins after the books have been closed at end of accounting period & thereafter carried on continually till completion.
	Advantages	(i) Work is carried out in single continuous sitting. (ii) Suitable for small client. (iii) No manipulation in accounts, once closed. (iv) No interruption in regular workflow of client.
	Limitations	(i) Excessive workload on auditor at end of accounting year. (ii) May not be suitable for big enterprise. (iii) Misstatements cannot be determined on an early basis. (iv) Less time for detailed examination.
Continuous Audit	Meaning	➤ When audit is conducted during the financial year <i>i.e.</i>, accounts are examined the whole year round; it is termed as continuous audit ➤ Audit staff is present at clients site almost during entire accounting period.
	Advantages	(i) Earlier discovery of misstatements. (ii) Presence of audit staff acts as moral check on client. (iii) Client's accounts are always kept up to date. (iv) Auditor has more time for detailed checking. (v) Auditing work can be completed on a timely basis. (vi) Helpful for client as auditor can provide useful suggestion after detailed checking. (vii) Routine checking is completed in advance. (viii) Less pressure at year-end.
	Limitations	(i) Records may be altered after being examined by auditor. (ii) Not suitable for small organisation. (iii) Audit staff may overlook a matter not completely examined on last visit. (iv) Sometimes, client feels that regular presence of auditor interrupts his working. (v) It is very time consuming.
	Precautions to avoid limitations	(i) Work should be completed up to definite stage during each visit. (ii) Important balances should be noted down at end of each visit & compared at next visit so that any alteration can be detected. (iii) Visits should be on random basis (surprise visits). (iv) Special attention should be given to altered figures, if any. (v) Auditor should try at his level best not to interfere in client's day to day work.

3.10 AUDIT WORKING PAPERS (DOCUMENTATION)

AA5-3

Meaning	➤ Documentation refers to working papers kept by the auditor in connection with performance of his audit work. ➤ It is the record of <u>planning</u>, <u>procedure performed</u>, <u>evidence obtained</u> & <u>conclusions drawn</u>. ➤ It shows that audit work has been conducted as per requirement.				
Basic requirements	(i) W.P. should be designed & organised according to <u>circumstances</u> of each audit (ii) As far as possible, working papers should be kept in <u>standardised</u> form. (iii) Documentation should be sufficiently complete, <u>dated</u> & <u>signed</u>. (iv) All significant matters involving <u>judgment</u> should be documented. (v) As per ICAI, documentation is the property of auditor & he should maintain it at least upto <u>10 years</u> from date of signing of audit report. (vi) If it is in electronic /magnetic media, he should take proper <u>care</u> for its storage & retrieval (vii) He should maintain <u>confidentiality</u> (should not show his W.P. to outsiders).				
working paper files	In case of recurring audit, two type of files are maintained to avoid duplicity of documentation. These are as follows: <table> <tr> <td> 1. Permanent audit file ↳ MOA/AOA ↳ Legal documents ↳ P/L Financial St. ↳ Engagement letter ↳ Discussion with Previous Auditor ↳ Overall Plan ↳ Audit observation ↳ Accounting policies. </td><td> It contains matters which don't change very often. This file is updated during each audit. Its contents are as follows:- ▪ Information regarding the legal and organizational structure of the entity. For e.g. in case of Company, this includes MOA & AOA. ▪ Legal documents, agreements and minutes relevant to the audit. ▪ A record of the study and the evaluation of the internal controls. ▪ Copies of audited financial statements for previous years. ▪ Analysis of significant ratios and trends. ▪ Copies of management letters issued by the auditor, if any. ▪ Record of communication with the retiring auditor. ▪ Notes regarding significant accounting policies. ▪ Significant audit observations of earlier years. </td></tr> <tr> <td> 2. Current audit file ↳ Annual Reappointment ↳ Audit prog ↳ Copies of expert, ↳ Copies of external Confirmation. </td><td> It contains matters relating to audit of single period. Its contents are as follows:- ▪ Correspondence relating to acceptance of annual reappointment. ▪ Important matters in the minutes of Board Meetings and General Meetings as relevant to audit. ▪ Evidence of the planning process of the audit and audit programme. ▪ Analysis of transactions and balances. ▪ A record of the nature, timing and extent of auditing procedures. ▪ Evidence that the work performed by assistants was supervised and reviewed. ▪ Copies of communication with other auditors, experts and third parties. ▪ Letters of representation or confirmation received from the client. ▪ Conclusions reached by the auditor concerning significant aspects of the audit. ▪ Copies of the financial information being reported on and the related audit reports. </td></tr> </table>	1. Permanent audit file ↳ MOA/AOA ↳ Legal documents ↳ P/L Financial St. ↳ Engagement letter ↳ Discussion with Previous Auditor ↳ Overall Plan ↳ Audit observation ↳ Accounting policies.	It contains matters which don't change very often. This file is updated during each audit. Its contents are as follows:- ▪ Information regarding the legal and organizational structure of the entity. For e.g. in case of Company, this includes MOA & AOA. ▪ Legal documents, agreements and minutes relevant to the audit. ▪ A record of the study and the evaluation of the internal controls. ▪ Copies of audited financial statements for previous years. ▪ Analysis of significant ratios and trends. ▪ Copies of management letters issued by the auditor, if any. ▪ Record of communication with the retiring auditor. ▪ Notes regarding significant accounting policies. ▪ Significant audit observations of earlier years.	2. Current audit file ↳ Annual Reappointment ↳ Audit prog ↳ Copies of expert, ↳ Copies of external Confirmation.	It contains matters relating to audit of single period. Its contents are as follows:- ▪ Correspondence relating to acceptance of annual reappointment. ▪ Important matters in the minutes of Board Meetings and General Meetings as relevant to audit. ▪ Evidence of the planning process of the audit and audit programme. ▪ Analysis of transactions and balances. ▪ A record of the nature, timing and extent of auditing procedures. ▪ Evidence that the work performed by assistants was supervised and reviewed. ▪ Copies of communication with other auditors, experts and third parties. ▪ Letters of representation or confirmation received from the client. ▪ Conclusions reached by the auditor concerning significant aspects of the audit. ▪ Copies of the financial information being reported on and the related audit reports.
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Audit note <i>Meaning</i>	Meaning	It is generally a bound book which records large variety of matters observed during audit.
↳ Compile ↳ Audit queries. ↳ Making ↳ Audit queries not solved.	Examples of contents	(i) Audit queries not solved immediately. (ii) Irregularities observed during audit. (iii) Important information regarding entity not appearing in accounts. (iv) Important matters for future reference.
	Features /usefulness	(i) It is permanent record of auditor, which can be referred to later on. (ii) It contains all details of work carried out. This work can be linked, if concerned assistant is away. (iii) It contains all workflow of audit in detail. (iv) It can be important defence for auditor if action for negligence is brought against him subsequently. (v) It shows weakness in clients system, thus helpful in formulating audit programs in future. (vi) It helps in follow up of work done.
Important advantage of working papers	(i) Provides <u>guidance</u> to audit staff. (ii) <u>Responsibility</u> of work can be fixed as documentation kept is signed and checked by appropriate personnel. (iii) Act as a <u>defence</u> if charge of negligence is brought against him. (iv) Important for <u>future</u> planning. (v) Contains <u>basis</u> for forming an opinion. (vi) Helps the senior to <u>review</u> work done by assistants.	
Guidance note on auditors right, if client & other seek access to his document	Auditors property	Ownership & custody of working papers rests with auditor. Thus, it is auditor's property.
	Rule of confidentiality	As per AAS-1 auditor should not disclose any confidential matter relating to client to any 3 rd party unless it is
	Permitted by client or his legal /Professional duty to disclose	
Can he show working papers to	3rd parties including other auditors	No, otherwise it will violate rule of confidentiality as above.
	Client	(i) Client doesn't have any right to access audit W.P. kept by auditor. (ii) But auditor may, at his discretion, show some/ complete W.P. to client. (iii) If he shows W.P. to client itself, rule of confidentiality does not arise at all.

3.11 TEST CHECKING / SAMPLING - BASICS

Meaning	Test checking means examining less than 100% of items in the population.	
Why it is required	(i) Auditor usually doesn't have enough time for detailed 100% examination. (ii) Number of transactions / Balances are generally very high. (iii) Mostly items are identical. (iv) If, on basis of compliance procedures, it is concluded that internal control system is very effective, there is no need for detailed 100% examination.	
Examples where it may not be suitable	(i) Checking bank reconciliation statement. <i>BR S</i> (ii) Few transactions, very high in amount. <i>Material items</i> (iii) Few transactions with related parties. (iv) Few transactions, having unusual nature. <i>Unusual nature</i> (v) Disclosure requirement of accounting standards. (vi) Compliance with statutory provision. (vii) Significant entries near/ at year-end. (viii) Few transactions involving foreign exchange. (ix) When internal controls are very weak. <i>Cut off procedure</i> <i>Weak</i>	
Precautions while conducting test checking (how to make sampling effective)	(i) <i>Thorough study of accounting system</i>	The flow of transactions should be completely studied before adopting sampling.
	(ii) <i>Thorough study of I.C. System.</i>	Proper study of internal control system helps the auditor to devise further test check plans.
	(iii) <i>Areas not suitable for sampling</i>	Auditor should take care to ensure that detailed complete checking is done for required items (as above).
	(iv) <i>Proper planning</i>	Proper plan for test checking should be devised & explained to audit staff.
	(v) <i>Classification</i>	Transactions & Balances should be classified & stratified, if required.
	(vi) <i>Sample size</i>	The number of items in a sample should be appropriately determined.
	(vii) <i>No bias</i>	Sample should be chosen in unbiased way.
	(viii) <i>Analysis of misstatement</i>	Errors found in sample should be analysed properly.
Type-I Judgmental sampling <i>Sampling based on Auditor's Judgment</i>	Meaning	- Sample size & composition are decided on basis of auditor's experience. - This is a traditional method of sampling.
	Example	He may decide to check entries in July, November & February and March during audit of certain year & out of remaining months in next year (Rotation of Emphasis).
	Advantages	- Simple to operate. - Traditional approach thus understandable by audit staff with the little expertise. - Rotation of emphasis is done. - Normally year end transactions are checked in detail to ensure whether cut off procedures are adequate.
	Limitations	(i) Unscientific method. (ii) There may be personal bias. (iii) Sample may not be true representative of population. (iv) Not suitable if situations changes materially (due to inadequacy of experience of auditor in that particular area).

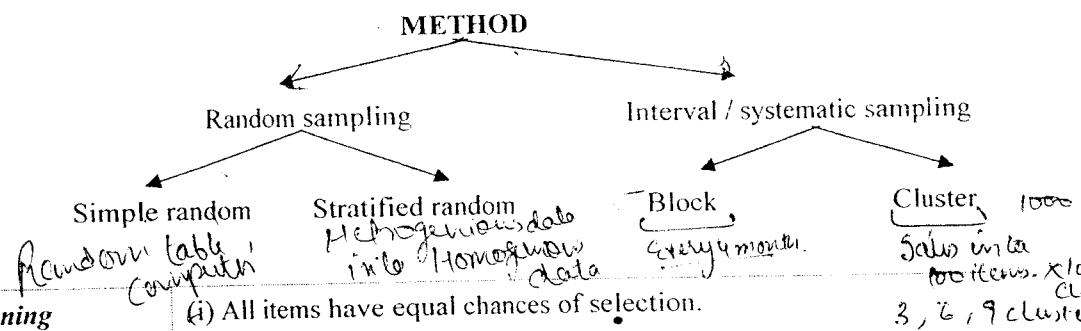
Application of statistical & mathematical methods.

Meaning	- Sample is chosen by applying certain mathematical & statistical devices. - It is generally based on probability theory.
Advantages	(i) <u>More scientific.</u> (ii) <u>No personal bias.</u> (iii) Results of sample can be evaluated & projected in more reliable way. (iv) Widely accepted way of sampling.
Limitations	(i) Complex to operate. (ii) Not suitable for audit staff having no knowledge of statistical technique. (iii) It may be time consuming exercise.

3.12 METHOD FOR SELECTING THE SAMPLE

Meaning

- Method means the way in which sample is chosen.
- Method should be such that sample can be expected to be true representative of population.
- For this, it is necessary that each item in population have equal chance of being chosen.
- There are basically two methods by which sample can be selected.



Method-I

Random Sampling

Meaning

- (i) All items have equal chances of selection.
- (ii) It may involve use of random number table.
- (iii) It can be of two types i.e. simple random or stratified random.

(I) Simple Random Sampling

- (i) Each item of population (for Eg. :- each debtor) has equal chance of selection.
- (ii) It can be chosen by
 - use of random number table.
 - help of computer.
 - Picking up number in a random way.
- (iii) Suitable for Homogeneous population (population having similar items). For example:- Debtors ranging from Rs. 5,000 to 15,000.

→ Equal chance
→ Number Table
↓
Simple Random

(2) *Stratified Random Sampling*

- Stratification means dividing a heterogeneous population into more homogeneous sub populations.
- Sample is taken from each sub population (stratum)
- It is useful for diversified population.
- For Eg.:- Debtor in range of 20 Rs. to 5,00,000 Rs. where it can be divided into stratum as following.

Upto 10,000	A	10,001 - 1,00,000	B
3,00,001 - 5,00,000	D	1,00,001 - 3,00,000	C

- Now, random sample is chosen from each stratum.
- Its results are more appropriate in case of population having different characteristics.
- It is simply an extension of simple random sampling.
- However, it requires special attention to judge contents of each stratum.

Method-2
Interval /
systematic
sampling*Meaning*

- Items are chosen in such a way that there is constant interval between selections.
- The first interval has random start.
- Interval may be based on
 - (i) Certain number (Eg. :- every 10th sales invoice).
 - (ii) Monetary total (Eg. every increase of Rs. 10,000 in cumulative wage summary)
- It is used in case when population does not correspond to a particular trend.
- It can be of two types - block & cluster.

(1) *Block Sampling*

- Selection of a definite block of consecutive items.
- For Eg. :- first 50 purchase invoice for month of November.
- This is a simple method like judgemental sampling.
- However, it may be biased at times.

(2) *Cluster sampling*

- (1) Population is divided into groups called Cluster.
- (2) A number of clusters are selected on random basis.
- (3) For Eg. :- 1000 sales invoices are divided into 10 clusters having 100 items each, then 3rd, 6th & 9th clusters are chosen.
- (4) Less effective than random sampling since each item is not randomly chosen.

3.13 FACTOR AFFECTING SIZE OF SAMPLE

Factor	(i) Tolerable Error (ii) Expected Error (iii) Sampling Risk	
1. Tolerable Error	⇒ Maximum Error in population that auditor is ready to accept for a given sample size. ⇒ If smaller tolerable error, big sample size is needed.	
	<i>In compliance procedure</i>	Maximum rate of deviation from established procedure of I.C.
	<i>In substantive procedure</i>	Maximum monetary error.
2. Expected Error	⇒ If auditor expects possibility of error in population, larger sample size is required. ⇒ If population is expected to be free of misstatement, smaller sample size is needed.	
3. Sampling Risk	1. It arise from possibility that ⇒ Auditor's conclusion based upon sample, ⇒ May be different from, ⇒ Conclusion that would have been reached, ⇒ If same audit procedures were applied on entire population. 2. It is always in sampling. 3. If acceptable sampling risk is low, large sample is needed. 4. It arises in both compliance procedures & substantive procedure.	
	<i>In compliance procedure</i>	<i>Risk of under reliance</i> Based upon sample, auditor concludes that I.C. system is not adequate, however actually it is not so. <i>Risk of over reliance</i> Based upon sample, auditor concludes that I.C. are very effective & thus decides to rely on them, however it is not so in reality.
	<i>In substantive procedure</i>	<i>Risk of incorrect Rejection</i> Based upon sample, auditor concludes that transactions/ balances are materially misstated, whereas in fact these are not. <i>Risk of incorrect Acceptance</i> Based upon sample auditor concludes that transactions/ balances are not materially misstated while in fact these are misstated.

Sampling Risk (at a glance)

In Compliance Procedure	Risk of Under reliance	Risk of over reliance
In Substantive Procedure	Risk of incorrect rejection	Risk of incorrect acceptance
Effect	↓ These both lead to more work to be performed by auditor. However audit report is not erroneous.	↓ These both may lead to erroneous opinion by auditor.

3.14 DIFFERENCE BETWEEN TEST CHECKING AND ROUTINE CHECKING

Basis	Test Checking	Routine Checking
1. Meaning	Examining less than whole population <i>< 100%</i>	Detailed checking of all aspects of a transaction such as casting, posting, carry forward, calculation, balancing etc. <i>= 100%</i>
2. Objective	To form an opinion on financial statements on the basis of examination of selected items only.	To ensure arithmetical accuracy of entries in original books & ensure their correct posting.
3. Nature	It May be judgemental or statistical device.	It is a mechanical process, which becomes monotonous at times.
4. Level of Function	The extent of sampling is chosen by higher level of audit staff.	This work is delegated to junior audit staff.
5. Time element <i>It less</i>	It saves time of audit staff. <i>Saves</i>	It is more time consuming. <i>BRS</i>

3.15 AAS 15 - AUDIT SAMPLING

Audit Sampling	Meaning – Application of audit procedures on <i>Less</i> than 100% of items. → It may be statistical or non-statistical. → It requires skill and competence on part of auditor. → Auditor should try his level best to choose sample, which should be true representative of population. → Choosing all items above certain amount is not sampling.
Design of Audit Sample	It depends on following : Audit Objective – Specific objective and procedures. Population – It should be appropriate. Stratification – Dividing heterogeneous (different characteristics) populations in more homogeneous (similar characteristics) sub-populations. For getting same level of assurance, it results in smaller sample size.
Sampling Units	Individual units constituting the population.
Size of Sample	Auditor should consider overall population, tolerable error, expected error and sampling risk.
Method of Sampling	Each item in population should have equal chances of being chosen. Thus – (1) Random Sample – Use of random number table. Each sampling unit has equal probability of being selected. (2) Systematic Sample – Having fixed interval between any consecutive units selected. However, it can be adopted only when population is not structured in a way that it corresponds to a particular trend. (3) Haphazard Selection – No intention to include/exclude a particular item. It is equivalent to random sample.
Expected Error	If auditor expects error in population, then take larger sample size, otherwise smaller sample size is appropriate.
Tolerable Error	Maximum Error in population that auditor is ready to accept for a given sample size.

SAMPLE TWO METER

	Ist Step – Analysis of Error in Sample	– Judge whether an item is error or not. – If sufficient and appropriate evidence can't be obtained regarding a specific item, it could be an error. – Auditor should to check (1) cause of error, and (2) its impact on other phases of audit. – If there is common trend in error, he should perform extended procedures.
	IInd Step – Projection of Error	– Project it to entire population by appropriate method. – Consider both quantitative and qualitative aspects of error found while projecting.
	IIIrd Step – Reassessing Sampling Risk	– If error in population exceeds tolerable error then auditor should extend audit procedure.
Sampling Risk		→ It arises from possibility that auditor's conclusion based upon sample may be different from conclusion that would have been reached if complete population were subjected to same audit procedure. → If auditor is willing to accept less risk, then large size of sample should be taken. → It is always there in sampling.

SURPRISE CHECKS

Basics of surprise checks system	1. The element of surprise in an audit can be both with regard to the items and time of the audit, that is the selection of the date at which the auditor visits the client's office to carry out the audit and the selection of the items, which are subjected to audit. 2. Surprise checks are useful methods of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management 3. Surprise checks are also particularly relevant in respect of certain items, for example, cash, investments. 4. Wherever feasible, a surprise check should be made at least once in the course of an audit.
Recommendations by ICAI Cash stock Bank & Pgt AR	1. Surprise checks should be considered as a desirable part of each audit. 2. The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include: (a) Verification of cash and investments; (b) Test-verification of stores and stocks and the records relating thereto; (c) Verification of books of prime entry and statutory registers. 3. The frequency of surprise checks may be determined by the auditor in the circumstances. 4. The results of the surprise checks should be communicated to the management. 5. The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him. 6. It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor, they are material and affect a true and fair view of the financial statements.