

PREPARATION FOR AN AUDIT

Question 1

State with reasons (in short) whether the following statements are true or false.

- (i) *Components of Audit Risk does not includes sampling risk.*
- (ii) *Test checks refers to the out of routine checks that are carried out in the normal course of audit.* (2 Marks each)(May 2007)

Answer

- (i) **True:** Three components of audit risk are Inherent risk, Control risk and Detection risk.
- (ii) **False:** Test checks refers to an audit procedure wherein only a part is checked to form an opinion instead of checking all the transactions.

Question 2

Explain the following in brief:

Relationship between materiality and audit risk. (5 Marks) (May 2007)

Answer

Relationship between materiality and audit risk: SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

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Question 3

Explain in brief, the utility of Working Paper to an auditor.

(3 Marks) (May 2007)

Answer

Utility of Working Paper: Audit working papers are very useful to the auditor in the following way:

- (i) It provides guidance to the audit staff with regard to manner of checking the schedules.
- (ii) The auditor is able to fix responsibility on the staff members who signs each schedule.
- (iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.
- (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

Question 4

Write short notes on the following:

(a) Management Representations.

Or

Audit Techniques.

(b) Supervision of Audit work.

(5+5=10 Marks) (May 2007)

Answer

(a) Management Representations: SA-580 on 'Representation by Management' establishes standards on the use of management representations as audit evidence, the procedure to be applied in evaluating and documenting management representations and the action to be taken if management refers to provide appropriate representations.

Management Representation is of great use to the auditor when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Representation by management sometimes may constitute only evidence with the auditor where matter is principally of intention.

It cannot be substitute for normal audit procedure. Auditor should seek the corroborative audit evidence supporting representation by the management. Auditor should evaluate the representation as to its reasonability.

Cases where management representation is normally obtained includes accounting policies, cost and physical existence of assets, investments, compliance of relevant laws, capital commitments etc.

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OR

Audit Techniques: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following:

1. Posting checking
2. Casting checking
3. Physical examination and count
4. Confirmation
5. Inquiry
6. Year-end scrutiny
7. Re-computation
8. Tracing in subsequent period
9. Bank reconciliation

The two terms, procedure and techniques often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve technique of inspection and checking computation of documentary evidence. As per SA 500 on Audit Evidence, basically audit procedures are broadly of two types viz, compliance procedures and substantive procedures. Substantive procedures are further comprised of tests of details and analytical review procedures. Vouching is a substantive audit procedure which involves audit techniques like casting, cross-casting, checking of posting, etc. On the other hand, verification of assets and liabilities is a substantive audit procedure which involves application of audit techniques like physical examination, confirmation from third parties etc.

(b) Supervision of Audit work: SA 220 on quality control for audit work requires that personnel carrying out the supervisory responsibility should perform the following functions during the audit:

- (i) Monitor the progress of the audit to consider whether the assistants have the necessary skills and competence, understanding of the audit directions and are discharging their work as per audit programme;
- (ii) Collect and address significant audit questions raised during the audit and based on their significance modifying the overall audit plan and programme and
- (iii) Resolve any difference of professional judgment with appropriate consultation.

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Question 5

Comment on the following situations/statements:

- (a) *Auditor of AAS Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence. (8 Marks)*
- (b) *M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year. (6 Marks) (Nov 2007)*

Answer

- (a) As per SA 580 on “Written Representations” in the course of audit, an auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. In such a situation he may rely on the submission by the management but he should seek corroborative audit evidence from sources inside or outside the entity and evaluate the representation made by management.

Management representation is not a substitute for other audit evidence. The auditor should seek and apply normal audit procedure. Mere possession of a certificate does not absolve the auditor from his liability. He should not seek or accept certificates when subject matter is such that it is capable of verification from internal and/or external evidences.

In the instant case, the stock of imported material lying with the transporter can be easily verified with purchase order, invoice, bill of entry, custom document, payment of F.C. etc.

Therefore the auditor in this instant case has not used available evidences. He should not have rested with the certificate obtained from the management and could have evaluated other evidences. He may be held liable for negligence and professional misjudgment.

- (b) As per SA 230 on “Audit Documentation” the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor's exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can't insist upon the auditor to handover the working papers of the previous year.

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Question 6

Explain the following in brief:

Precautions to be taken in applying test check technique. (6 Marks)(Nov 2007)

Answer

The following precautions may be taken in applying test check techniques:

- (i) Transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of same kind.
- (ii) Study and evaluation of internal control system should be exercised for its efficiency, soundness and capability for producing reliable accounting and financial data.
- (iii) System of authorization, documentation, recording and evidencing of transaction should be examined.
- (iv) A properly thought - out test check plan should be prepared to match with the audit objective and avoid mix-up in the objective.
- (v) Selection of transactions should be made in such manner so that bias cannot enter in the selection.
- (vi) Identification of the area where the check may not be done.
- (vii) The number of transaction to be selected for each test check plan should be predetermined based on degree of reliance that should be placed on test check result and confidence that can be placed.
- (viii) Materiality of the error as a result of test check must be pre-determined and criteria be fixed to judge the same. Only the material errors may be properly and thoroughly investigated.

Question 7

Write short note on Quality control for audit work at firm level. (5 Marks) (Nov 2007)

Answer

Quality control for audit work at firm level: SA 220 on Quality Control For Audit Work requires that the audit firm should implement quality control policies and procedures to ensure that audits are conducted in accordance with SA. The requirements are:-

- (i) **Professional requirement:** Firms personnel should adhere to the principle of independence, integrity, objectivity, confidentiality and professional behaviour.
- (ii) **Skill & competence:** Personnel should have attained and maintain technical standard and professional competence.
- (iii) **Assignment:** Audit work is to be assigned to personnel who have degree of technical training as per the requirement.
- (iv) **Delegation:** Direction, supervision and review of work at all level to meet standard of quality.

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- (v) **Consultation:** Consultation within or outside the firm with experts wherever necessary.
- (vi) **Acceptance and retention of clients:** Evaluation of prospective clients and review of existing to accept or retain a client based on firm's independence and ability to serve.
- (vii) **Monitoring:** Adequacy and operational effectiveness of quality control policies to be continuously monitored.

Question 8

State with reasons (in short) whether the following statements are True or False.

- (i) *When inherent and control risks are low, an auditor can accept a lower detection risk.*
- (ii) *Audit procedure and Audit technique are not one and same thing.*

(2 Marks each) (May 2008)

Answer

- (i) **False:** When inherent and control risk are low, an auditor can accept a higher detection risk and still reduce risk to an acceptable lower level.
- (ii) **True:** The two terms, procedure and technique are often used interchangeably. In fact, however, a distinction does exist. Procedure represents the broad frame of the manner of handling audit work and the technique stands for the methods employed for carrying out the procedure.

Question 9

What does SA 230 say about utility, ownership, custody and retention of working papers?

(4 Marks) (May 2008)

Answer

Utility of working papers: According to SA 230 on 'Audit Documentation' working papers helps in planning and performance of the audit, supervision and review of the audit work and provide evidence of the audit work performed to support the auditor's opinion.

Ownership of working papers: Working papers are the property of the auditor and he may, at his discretion, make portions of or extracts from his working papers to his client.

Custody of working papers: The auditor should adopt reasonable procedures for safe custody and confidentiality of his working papers.

Retention of working papers: Working papers should be retained, 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.

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Question 10

Mention, any four, areas where surprise check can significantly improve the effectiveness of an audit.
(4 Marks) (May 2008)

Answer

Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are:

- (i) Verification of cash and investments.
- (ii) Inventory
- (iii) Internal control and internal checks
- (iv) Books of prime entries and statutory registers.

Question 11

Write short notes on the following: (Answer any two)

- (a) *Advantages of Statistical sampling in Auditing.*
- (b) *Contents of Audit Note-book.* (5 + 5 = 10 Marks) (May 2008)

Answer

(a) Advantages of statistical sampling in Auditing:

The advantages of using statistical sampling technique in auditing are:

- (i) Sample size does not increase in proportion to the increase in the size of population.
- (ii) Sample selection is more objective and based on law of probability.
- (iii) This provides a means of estimating the minimum sample size associated with a specified risk and precision level.
- (iv) It also provides a means for deriving a calculated risk and corresponding precision.
- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistake are not large.

(b) Contents of Audit Note book: Audit note book contains large variety of matters observed during the course of audit. Significant matters observed during audit which should be recorded in audit note book are normally the following:

- (i) Audit queries not cleared immediately.
- (ii) Mistakes or irregularities observed during the course of audit.

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- (iii) Unsatisfactory book-keeping arrangements, costing method.
- (iv) Important information about the company which is not apparent from the accounts.
- (v) Special points requiring consideration at the time of verification of annual accounts.
- (vi) Important matters for future reference.

Question 12

State with reasons (in short) whether the following statements are True or False.

- (i) SA 580 is related to Audit Materiality.
- (ii) Audit Working Papers to be kept at least for 3 (three) years.
- (iii) When the auditor uses more Professional Judgement, the Degree of Inherent risk is lower. (2 marks each) (Nov 2008)

Answer

- (i) **False:** SA 580 is related to the Written Representations. Materiality in Planning and Performing an Audit is discussed in SA 320.
- (ii) **False:** Audit working papers are to be kept at least 10 years.
- (iii) **True:** The auditor uses his professional judgment to assess inherent risk by evaluating different factor relating to the organization. On this basis he tries to ensure lower level of inherent risk.

Question 13

What points in relevance to SA 230 should be kept in view while preparing an Audit Programme? (6 Marks) (Nov 2008)

Answer

Audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statement. For the purpose of programme construction, the following points should be kept in view:

1. Stay within scope and limitation of the assignment.
2. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

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Question 14

State with reasons (in short) whether the following statements are True or False.

- (i) *Auditing in-depth implies that the auditor vouches almost all transactions in a manner that the chances of not checking any transaction are left at minimum.*
- (ii) *Taking management representation is a convenient, economical and equally acceptable auditing method even where the direct access by auditor to audit evidence is possible.* (2 Marks each) (June 2009)

Answer

- (i) **False:** Auditing in depth does not mean cent percent or near cent percent vouching. It is checking selected transactions from beginning to end to understand and vet the system within which the transaction passes through.
- (ii) **False:** Where it is possible for auditor to check the transaction by himself through direct access, it is not fair for him to merely rely the management representation as prime audit evidence.

Question 15

Write short note on Knowledge of Client's business.

(5 Marks) (June 2009)

Answer

Knowledge of client's business - Auditor can obtain this information from:

- (i) Clients annual report to shareholders
- (ii) Minutes of shareholders/board of directors
- (iii) Internal financial management reports of current & previous year
- (iv) Previous year audit working papers
- (v) Discussion with client
- (vi) Clients policy and procedure manual
- (vii) Publications like trade journals, magazines, news papers and
- (viii) Visit to client's premises

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Question 16

State with reasons (in short) whether the following statements are true or false.

- (i) *While auditing the accounts of a company, it is obligatory that the auditor must adopt sampling technique.*
- (ii) *The auditee firm has no right to compel the auditor to provide copies of the working papers.*
(2 Marks each) (Nov 2009)

Answer

- (i) **False:** It is not obligatory that the auditor must adopt sampling technique in auditing the accounts. But he should ensure that the relevant standards on auditing have been followed. It is in the interest of the auditor if he decides to form his opinion on the basis of audit sample using standards and techniques which are widely followed and recognised.
- (ii) **True:** Working papers are the property of the auditors. Auditee has no right to compel the auditor's firm to provide it with the copies of working papers. However, the auditors may at their discretion make portions of or extracts from their working papers available to the auditee.

Question 17

- (a) *Explain concept of materiality and factors which act as guiding factors to this concept.*
(6 Marks)
- (b) *Describe a set of instructions, which an auditor has to give to his client before the start of actual audit.*
(4 Marks)

Answer

- (a) **Concept of materiality:** SA 320 "Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.

The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

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 is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the

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risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Factors to be considered for determining materiality

- (i) Item of materiality may be determined individually or in aggregate.
- (ii) The materiality depends on the regulatory or legal considerations.
- (iii) Materiality is not often reckoned with respect to quantitative details alone. It has qualitative dimensions as well.
- (iv) Even insignificant items in terms of quality may be material in special circumstances.
- (v) Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule VI requires disclosure of items of expenditures which are in excess of one percent or Rs.500, whichever is less.
- (vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

(b) Following instructions are given by the auditor to the client before the start of audit:

- (i) The accounts should be totalled up and trial balance and final accounts be kept ready.
- (ii) Vouchers should be serially arranged.
- (iii) Schedule of debtors and creditors should be prepared.
- (iv) Schedule of outstanding expenses, prepaid expenses and accrued income to be kept ready.
- (v) A list of bad and doubtful debts should be prepared.
- (vi) Schedule of investments should be prepared.
- (vii) Certified list of goods returned to be prepared.
- (viii) Statement of permanent capital expenditure to be prepared.
- (ix) Schedule of deferred revenue expenditures to be prepared.
- (x) Names and addresses of managers and other officers should be kept ready.

Alternative answer

- (1) It is the responsibility of the management to prepare the financial statements, to select and consistently apply the appropriate accounting policies
- (2) Management is responsible for the maintenance of adequate accounting records and internal controls for safeguarding assets of the company
- (3) Unrestricted access to whatever records, documentation and other information required in connection with the audit.

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- (4) Management's responsibility for making judgements of estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity.
- (5) Management's responsibility for preparation of the financial statements as a going concern.

Question 18

- (a) *X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the Company. In the course of audit of the company, the auditor was unable to obtain appropriate sufficient audit evidence regarding receivables. The client requested for a change in the terms of engagement.*
- (b) *Write short note Audit risk at the account balance level and at the class of transactions level.* (5 Marks each) (Nov 2009)

Answer

(a) Change in terms of engagement

1. An auditor who is required to change the engagement which requires lower level of assurance before the completion of engagement should consider the appropriateness of doing so.
2. But when the terms of engagement are changed, both the auditor and the client should agree on the new terms.
3. However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.
4. In the instant case, the auditor was unable to obtain sufficient evidence regarding receivables. 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.
5. Thus the auditor should not agree for change in the terms of engagement letter.

(b) Audit risk at the account balance level and at the class of transactions level

Majority of audit procedures are directed to and carried out at the account balance level and the class of transactions level. At these levels, the auditor uses professional judgment to evaluate numerous factors to assess inherent risk:

- (i) Financial statement of accounts likely to be susceptible to mismanagement.
- (ii) The complexity of underlying transactions which might require the use of the work of an expert.
- (iii) The amount of judgment involved in determining account balances.
- (iv) Susceptibility of assets to loss or misappropriation.
- (v) The completion of unusual and complex transactions, particularly at or near year end.