Summary Notes of Chapter 1 – Nature of Auditing

SA 200 (AAS - 1)	Basic Principles Governing an Audit
SA 200A (AAS – 2)	Objectives and Scope of the Audit of Financial Statements
SA 240 (AAS – 4)	Auditor's Responsibility relating to Fraud in an Audit of Financial Statements.

General Purpose Financial Statements: Includes
- (a) Balance Sheet
- (b) Profit & Loss Account
- (c) Cash Flow Statement
- (d) Notes on accounts and Explanatory statements.

Accounting	Auditing	Investigation
Concerned with recording of Transactions and Preparation of Financial Statements	Independent Examination of financial information contained in financial statements.	Systematic, critical examination of records for a special purpose.

Types of Audit: (a) Statutory Audit (Required under Law)
(b) Voluntary Audit (Not required under law)

Qualities of Auditor:
(a) *Technical Qualities*: Sound knowledge of accountancy, auditing, taxation & corporate laws.
(b) *Personal Qualities*: Objectivity, integrity, independence, confidentiality, communication skills reliability and trust.

Types of Auditor: (a) Internal Auditor - Appointed by Management
(b) External Auditor (Statutory Auditor) - Appointed by Company

Objectives of Audit

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Primary Objective (SA 200A)
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Expression of Opinion on True & Fair view of Financial Statements

Secondary Objective (SA 240)
↓
Consideration of Risk of Material Misstatements resulting from Fraud and Error

Basic Principles Governing and Audit (SA 200):

1. Integrity, Objectivity and Independence	6. Planning
2. Confidentiality	7. Audit Evidence
3. Skills and Competence	8. Accounting Systems and Internal Controls
4. Work performed by others	9. Conclusion and Reporting
5. Documentation	

Scope of Audit (AAS – 2, SA 200A) determined by:
- The terms of the engagement
- The requirements of the relevant legislation
- The pronouncements of the Institute (ICAI)

Inherent Limitations of Audit: arises due to
- Use of judgement
- Use of Test Checking
- Weaknesses in internal control
- Persuasive nature of evidence

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Summary Notes of Chapter 2 – BASIC CONCEPTS IN AUDITING

AAS – 5 (SA 500) Audit Evidence

AAS – 13 (SA 320) Audit Materiality

AS – 1 Disclosure of Accounting Policies

AUDIT EVIDENCE (AAS – 5)

Meaning: any information, verbal or written obtained by the auditor on which he bases his opinion.

Objective: Audit evidence is one of the basic principles and requires that the auditor should obtain *sufficient and appropriate audit evidence* through the performance of *compliance and substantive procedures* to enable him to draw reasonable conclusions therefrom on which *to base his opinion* on the financial statements.

Sufficient and Appropriate Audit Evidence: Sufficiency of evidence refers to *quantum* of evidence; and appropriateness refers to *relevance and reliability*.

Types of Audit Evidence:

- *Depending upon its source*, may be classified as: Internal, and External.
- *Depending upon nature*, may be classified as: Visual, Documentary, and Oral Evidence

Reliability of Audit Evidence:

(a) External evidence is usually more reliable than internal evidence.

(b) Internal evidence will be more reliable, when related internal controls are satisfactory

(c) Evidence obtained by the auditor himself is more reliable than evidence obtained from entity.

(d) Documentary evidences are more reliable than oral representations.

Audit procedures

Compliance
(*Existence, Effectiveness & Continuity* of the control system)

Substantive
(Completeness, Accuracy & Validity of data produced by the accounting system)

Vouching & Verification

Analytical Review Procedures

Methods of Obtaining Audit Evidence: Inspection, Observation, Inquiry and confirmation, Computation and Analytical Review:

AUDITOR'S INDEPENDENCE: independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him. It stipulates that the independence is a condition of mind and personal character and should not be confused with the visible standards of independence.

Visibility: "*Independence of auditors must not only exist infact, but should also appear to exist to all reasonable persons*".

Objective: The main objective of an independent audit is to lend credibility to financial information contained in financial statements by expressing an independent opinion.

MATERIALITY: AS-1 - Material items are "items, the knowledge of which might influence the decisions of the users of the financial statements. As per AAS-13 information is material if its mis-statement could influence the economic decisions of users taken on the basis of the financial information.

Factors influencing materiality: Materiality may be influenced by

- Legal and regulatory requirements
- Considerations which may have a significant bearing on the financial information, and
- Considerations relating to individual account balances and relationships.

TRUE AND FAIR VIEW

- 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 results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.
- What constitutes "true and fair" has not been defined in the legislation.
- In specific terms to ensure truth and fairness, an auditor has to see:
  (i) that the assets and liabilities are neither undervalued or overvalued;
  (ii) the charge on assets, if any, is disclosed;
  (iii) accounting policies have been followed consistently;
  (iv) all unusual, exceptional, non recurring items have been disclosed separately;
  (v) accounts have been drawn as per requirement of Schedule VI to the Companies Act & AS.

DISCLOSURE OF ACCOUNTING POLICIES AS – 1)

Meaning of Accounting Policies: Specific accounting principles and the method of applying those principles in the preparation & presentation of financial statements.

Factors affecting accounting policies: *Prudence,Substance over form and Materiality*

Fundamental Accounting Assumptions: *Going Concern, Consistency and Accrual*

Areas in which different accounting policies may be encountered: Method of depreciation, Treatment of expenditure during construction Valuation of inventories, Treatment of goodwill, Valuation of investment etc.

Disclosure requirements: AS–1 recommends as under:

(i) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

(ii) The disclosure should form part of financial statements and should normally be at one place.

(iii) If the fundamental accounting assumptions are followed, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Summary Notes of Chapter 3– Preparation for an Audit

AAS 3 (SA 230)	Documentation
AAS 6 (SA 400)	Risk Assessments and Internal Control
AAS 8 (SA 300)	Audit Planning
AAS 11 (SA 580)	Representations by Management
AAS 15 (SA 530)	Audit Sampling
AAS 17 (SA 220)	Quality Control for Audit Work
AAS 20 (SA 310)	Knowledge of Client Business
AAS 26 (SA 210)	Terms of Audit Engagement

AUDITOR'S ENGAGEMENT: The auditor should send an engagement letter to the client, before the commencement of the engagement, to help avoid any misunderstanding with respect to the engagement. It generally include reference to:

(a) Objective of audit of financial statements.
(b) Management's responsibility regarding the followings:
(c) Scope of Audit
(d) Test nature of audit and inherent limitations of non-detection of some material misstatement resulting from fraud.
(e) Unrestricted access to records, documentation and other information required.

AUDIT PROCESS Sequence of audit activities in an established order. Classified in four phases

Phase I - Proposal for Audit ***Phase III - Execution of Audit***
Phase II – Planning ***Phase IV - Reporting***

AUDIT TECHNIQUES *methods and means* adopted by an auditor for collection and evaluation of audit evidence in different auditing situations. For Example: physical examination, confirmation, inquiry, calculation of ratios; etc.

AUDIT PLANNING :

Scope of Audit Planning: Plans should be made to cover, among other things the followings:

- Acquiring knowledge of client's business;
- Establishing the expected degree of reliance to be placed on internal control;
- Determining the nature, timing and extent of the audit procedures to be performed;
- Coordinating the work to be performed.

Objectives of Audit Planning: Adequate audit planning facilitates:

- Devoting appropriate attention to important areas of the audit;
- Prompt identification of potential problems;
- Expeditious completion of work;
- Proper utilization of assistants;
- Coordination of work done by other auditors & experts.

Documentation of Audit Plan: The auditor should document his overall plan. And develop the audit Programme.

KNOWLEDGE OF CLIENT BUSINESS Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. The auditor can obtain knowledge of the industry and the entity from a number of sources. For example:

- Previous experience with the entity and its industry,
- discussion with people with the entity (for example, directors & operating personnel),
- discussion with internal audit personnel; and
- review of internal audit reports, etc.

AUDIT PROGRAMME

An Audit programme is a detailed plan of work, prepared by the auditor for carrying out an audit. It is comprised of a set of techniques and procedures, which the auditor plans to apply in the given audit for forming an opinion about the client's statement of account. It not only constitutes the plan of the work but also provides a basis for the supervision and control of the audit work.

CONTINUOUS AUDIT: Concurrent audit, thus, aims to examine transactions almost instantaneously as soon as the transaction occurs leading to shortening of the time interval between a transaction and its examination by an independent person not involved in its documentation.

AUDIT WORKING PAPERS

Meaning of Working Papers: Working papers are written records prepared /kept by the auditor for:

(i) aiding in the planning and performance of the audit;

(ii) aiding in the supervision and review of the audit work; and

(iii) providing evidence of the audit work performed to support the auditor's opinion.

Working Papers

Permanent Audit File	Current Audit File
a) Memorandum and Articles of Association. b) Copies of important legal documents c) Details of study & evaluation of internal controls in the form of narrative record, questionnaires or flow charts etc. d) Copies of audited statements of previous years. e) Analysis of significant ratios and trends. f) Copies of management letter, if any g) Record of communication with the retiring auditor. h) Notes regarding significant accounting policies. i) Significant audit observations of earlier years.	a) Correspondence relating to acceptance of annual reappointment. b) Copies of m4inutes of Board Meetings and General Meetings as are relevant to audit. c) Audit Programme d) Analysis of transactions and balances. e) Record of the nature, timing, and extent of audit procedures. f) Evidence to show that the work performed by assistants was supervised and reviewed. g) Copies of communication with other auditors, experts and other third parties. h) Matters discussed with client i) Letters of representation.

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 are recorded. Audit note book form part of audit working papers and for each year a fresh audit note book is maintained.

QUALITY CONTROL FOR AUDIT WORK

AAS-17, "Quality Control for Audit Work" requires that the audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with Statements on Auditing and Assurance Standards (AASs).

APPROACHES OF QUALITY CONTROL: two approaches - first, at the ***firm level*** and secondly, at the ***individual audit level***.

TEST CHECKING: Audit procedure wherein an audit is conducted on the basis of a part checking.

Precautions in the application of test-checking techniques:

(i) Appropriate classification and stratification of the transactions.

(ii) Sequential study of transactions from beginning to end

(iii) Evaluation of efficiency and soundness internal control system

(iv) Biasness should not enter into the selection.

(v) Identification of the areas where test check may not be done.

(vi) The number of transactions to be selected should be predetermined.

Items not suitable for test-checking:

(i) Opening and closing entries.

(ii) Bank reconciliation statement.

(iii) Balance sheet items.

(iv) Matters involving estimation as well as computation, e.g., depreciation, royalty, etc.

(v) Transactions which may be small in number but may be important and material.

(vi) Transactions which are recognised by law to be looked into by the auditor carefully, e.g., managerial remuneration, etc.

(vii) In case of seasonal industry, the auditor should not resort to test checking on annual basis.

(viii) Transactions of non-recurring nature or exceptional transactions may not be conducive for test checking.

AUDIT SAMPLING (AAS- 15): The application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

Methods of Sampling: 3 - ***Random Sampling, Systematic Sampling and Haphazard Sampling.***

AUDIT RISK: Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated.

COMPONENTS OF AUDIT RISK: three - ***Inherent risk, Control Risk and Detection Risk.***
The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptable low level.

RELATIONSHIP BETWEEN MATERIALITY AND AUDIT RISK

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.

SURPRISE CHECK: Surprise checks are mainly intended to ascertain whether the internal control system is working effectively, and whether all accounting and other records are kept up to date and as per the statutory regulations. Such checks and surprise visit can exercise good moral checks on the client's staff.

REPRESENTATION BY MANAGEMENT Management representation constitutes audit evidence furnished by management to auditor in respect of any transaction entered into by the entity. Management Representation is of great use to the auditor when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

Summary Notes of Chapter 4 – Internal Control

AAS 6 (SA 400)	Risk Assessments and Internal Control
AAS 7 (SA 610)	Relying upon the work of Internal Auditor
AAS 10 (SA 600)	Using the work of Another Auditor

INTERNAL CONTROL: System of internal control may be defined as the plan of organization, and all the methods and procedures adopted by the management of an entity to assist in achieving management's objective

Review of Internal Control by Management: It is required to ascertain:

(a) whether the prescribed management policies are being properly interpreted by the employees and are faithfully implemented.

(b) Whether the prescribed procedures need a revision because of changed circumstances or whether they have becomes obsolete or cumbersome.

(c) Whether effective measures are taken promptly when the system appears to break down.

Review of Internal Control by Auditor: The auditor's objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive audit procedures.

Methods of collecting information: Narrative record, Check List, Internal Control Questionnaire, Flow-chart

Testing of Internal Control System: It may include:

(a) Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly.

(b) Inquiries about and observation of internal controls which leave no audit trail.

(c) Re-performance of internal controls.

(d) Testing of internal controls operating on specific computerised applications.

Examination in Depth: It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods.

INTERNAL CHECK

Meaning: Internal check has been defined by the Institute of Chartered Accountants in England and Wales, as the

- checks on day-to-day transactions;
- which operate continuously as part of the routine system;
- whereby the work of one person is proved independently or complimentary to the work of another,
- the object being the prevention or earlier detection of error or fraud".

General considerations in framing a system of Internal Check:

(i) No single person should have an independent control over any important aspect.

(ii) The duties of members of the staff should be changed from time to time.

(iii) Persons having physical custody of assets must not be permitted to have access to the books.

(iv) Budgetary control would enable the management to review from time to time the progress of trading activities.

(v) The financial and administrative powers should be distributed very judiciously.

(vi) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

INTERNAL AUDIT: Independent appraisal activity within an organisation, for the review of operations as a service to the organisation. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls.

Scope	***Appraisal***
(i) Review of accounting system & related internal controls (ii) Examination for management of financial and operating information (iii) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation (iv) Physical examination and verification	(i) Organisational status: (ii) Scope of function (iii) Technical competence (iv) Due professional care (v) Follow up of recommendations

Relationship between the Statutory Auditor and Internal Auditor: is a professional relationship wherein both can benefit from each other.

Reliance on the Work of Internal Auditor: It is a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor.

Summary Notes of Chapter 4 – Audit in an CIS Environment

Distinction between computer-based system of accounting and conventional nature:

(i) *Absence of Input documents*

(ii) *Design*

(iii) *Complexity & Reliability*

(iv) *Organisational structure*

(v) *Lack of Visible Audit Trail*

Problems encountered while shifting from manual based accounting records to computer based accounting records:

(i) *Difficulty in Visual Observation.*

(ii) *Inability to observe the processing due to internal storage*

(iii) *Making changes in Programmes* without the auditors knowledge.

(iv) *Disappearance of Audit Trail*:

(v) *Use of High-level languages*:

OBJECTIVE AND SCOPE OF AUDIT IN CIS ENVIRONMENT: The overall objective and scope of an audit does not change in an CIS environment but the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control.

INTERNAL CONTROL IN A COMPUTER-BASED SYSTEM

A. GENERAL CIS CONTROLS: The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. These controls may include:

(a) *Organisation and management controls*

(b) *Application systems development and maintenance controls*

(c) *Computer operation controls*

(d) *Systems software controls*

(e) *Data entry and program controls*

B. CIS APPLICATION CONTROLS: The purpose of CIS application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. These include:

(a) *Controls over input*

(b) *Controls over processing and computer data files*

(c) *Controls over output*

AUDIT TRAIL It refers to a situation where it is possible to relate, on a "one-to-one" basis, the original input with the final output.

COMPUTER AIDED AUDIT TECHNIQUES (CAATs): Techniques with the help of which auditor carried out the work of audit are known as CAAT. The auditor can use the computer to test:

(a) the logic and controls existing within the system, and

(b) the records produced by the system.

System characteristics resulting from the nature of CIS processing that demand the use of Computer Aided Audit Techniques (CAAT) are:

a. *Absence of input documents*

b. *Lack of visible transaction trail*

c. *Lack of visible output*

d. *Ease of Access to data and computer programmes*

Advantages of CAAT: *Audit effectiveness, Savings in time, Effective test checking and examination in depth*:

APPROACHES TO AUDIT IN CIS ENVIRONMENT

Two approaches - "auditing around the computer" and "auditing through the computer".

Auditing Around the computer vs. Auditing through the computer

	Auditing around the computer	Auditing through the computer
Recognition of computers	Computers are recognised as mechanical aids for book keeping only.	Computers are recognised as targets of auditing and are used live for auditing.
Focus of Audit	Compare input vouchers with system outputs to obtain audit assurance.	To peruse the accounting systems and software used to provide audit assurance on various aspects of control.
Use of computers	Computers are used as Black Box only.	Computers are used to check calculations, comparing the contents, analysing the accounting ratio by comparing them etc.
Use of CAATs	CAAT's are not used.	CAAT's and other audit software tools are used for auditing.
