

SPECIAL AUDIT TECHNIQUES

Question 1

“An auditor while analysing the errors in a sample need not consider the qualitative aspects of errors detected.” Please comment.

Answer

Characteristics of Sampling Errors: SA 530, “Audit Sampling”, requires that while evaluating sample results, the auditor should analyse any errors detected in the samples having regard to appropriateness of the audit objective. An auditor while evaluating the errors detected in a sample selected by him from the total audit population, should analyse the nature of the errors, the projected errors in the total population and the sampling risk attached to it. While designing an audit sample, the auditor would also need to define the conditions that constitute the error keeping in view the audit objectives.

Flowing from the above, the auditor, therefore, would also need to consider the qualitative aspects of the errors detected by him. This will include the nature and reasons for the error and its possible effect on other phases. In case a repetitive pattern emerges from such analysis, for example, type of transaction, location, product line or period of time, the auditor would need to identify all items in the population, which contain such errors, resulting in a total population. The auditor would then need to carry out a separate analysis based on the examination carried out by him for each such sub-population. Accordingly, the auditor cannot be satisfied by detecting errors only but also would need to consider the qualitative aspects of such errors.

Question 2

The auditor “should take into account the aggregate of all uncorrected misstatements including those involving estimates in his assessment of materiality in audit

Answer

SA 320 (Revised) “Materiality in Planning and Performing an Audit” requires that in forming his opinion on the financial information, the auditor should consider all material aspects, either individual or in aggregate which are relatively important for true and fair view of financial statements. In this context, the auditor should consider whether the effect of aggregate uncorrected misstatements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the misstatements are material.

As per SA 320, the aggregate of uncorrected misstatements comprises: (a) specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and (b) the auditor's best estimate of other misstatements which cannot be specifically identified (that is, projected errors). The analytical procedures employed by the auditor may give him some indication about the existence of misstatements, which can be further substantiated by him through estimates process.

When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known misstatements identified by him in his sample to the items in the balance or class from which his sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate misstatement in the balance or class.

Impact of Misstatements: If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected misstatements causes the financial information to be materially misstated, he should consider requesting the management to adjust the financial information or extending his audit procedures. In any event, the management may want to adjust the financial information for known misstatements. The adjustment of financial information may involve, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate.

Question 3

"Obtaining audit evidence in performing compliance and substantive procedures." Comment.

Answer

Obtaining Audit Evidence: In performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods:

- (i) **Inspection:** It consists of examining various records, documents and tangible assets. Examination of these records and assets provides evidence of varying degree of reliability depending upon their nature, source and effectiveness of internal control over their processing. Inspection of tangible assets provides reliable evidence regarding their existence. Four major categories of documentary evidence, which provide different degree of reliability are:
 - (a) documentary evidence originating from and held by third parties;
 - (b) documentary evidence originating from third party and held by entity;
 - (c) documentary evidence originating from the entity and held by third parties;
 - (d) documentary evidence originating from and held by the entity.

Inspection of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

- (ii) **Observation:** It consists of witnessing a process or procedure being performed by others. Observation of physical verification of inventories by the auditor will help in gathering reliable evidence as to their existence, physical condition and control.
- (iii) **Inquiry and confirmation:** Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors.

- (iv) **Computation:** It consists of checking the arithmetical accuracy of source documents and accounting records and doing calculation to arrive at facts and figures.
- (v) **Analytical review:** It consists of studying significant ratios and trends and investigating unusual fluctuations in results.

Question 4

What is Haphazard Sampling?

Answer

Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

Question 5

Explain the concept of Audit risk:

- (i) *At the level of financial statements*
- (ii) *At the level of account balance and class of transactions.*

Answer

- (i) **Audit risk at the financial statement level:** Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such an assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessment can be made at the individual account balances or class of transactions level. For assessing inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:
- (i) The integrity of management
 - (ii) Management experience, knowledge and changes during the period (e.g. the inexperience of management may affect the preparation of the financial statements of the entity)
 - (iii) Unusual pressure on management
 - (iv) The nature of entity's business (e.g. its technological obsolescence of products and services, complex capital structure, significance of related parties and the number of locations and geographical spread of its production (facilities), factors affecting the industry in which the entity operates (e.g. economic and competitive conditions, changes in technology).
- (ii) **Audit risk at the account balance and class of transactions level:** Majority of audit procedures are directed to, and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level. To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:
- (i) The complexity of underlying transactions which might require the use of the work of an expert;
 - (ii) Susceptibility of assets to loss or misappropriation;
 - (iii) The completion of unusual and complex transactions, particularly at or next year end, and
 - (iv) Transactions not subjected to the normal processing mode.

Question 6

Write a short note on - Audit Risk.

Answer

Audit Risks: As per "SA 200 (Revised) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", audit risk is a function of the

risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Three components of audit risk are:

- ◆ Inherent risk (risk that material errors will occur);
- ◆ Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
- ◆ Detection risk (risk that any remaining material errors will not be detected by the auditor).

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

Control risk - Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

Detection risk - For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For

example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

Question 7

“Surprise Checks” help the auditors to ascertain whether the internal control system is operating effectively in a Company or not. Discuss.

Answer

Surprise Checks: SA 315 & SA 330 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment” and “The Auditor's Responses to Assessed Risks” prescribe that “the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.” The understanding of the accounting and internal control system can be obtained in several ways including inspection of documents making inquiries of appropriate management, observation of activities, etc. It is in this context, surprise checks intend to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. Particularly, the observation of the entity's activities and operations including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing on a surprise visit would reveal the exact manner in which the activities are being performed in the manner prescribed by the management. It has often been found that manipulations and frauds are facilitated under a system of book-keeping, which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors

exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

The Guidance Note issued by the Institute on the subject specifies that surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit. If this surprise check reveals any weaknesses in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Thus "surprise checks" help the auditors, during the course of their audit, to ascertain whether the internal control is operating effectively in a company or not.

Question 8

Write short notes on the following:

- (a) Factors relevant in evaluation of Inherent Risk*
- (b) Inquiry.*

Answer

- (a) Relevant Factors in evaluation of inherent risk:** While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence, dealing with large number of related parties etc.
- (b) Inquiry:** "SA 500 Audit Evidence" mentions inquiry as one of the methods of collecting evidence by seeking appropriate information from knowledgeable persons, both financial

and non- financial, within the entity or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information, which he did not possess earlier or may not provide him with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

The need for inquiry may arise at every stage of auditing. Evaluating responses to inquiries is an integral part of the inquiry process.

Auditor has to make a statement in his report whether he has obtained all information and explanation that he considered necessary for audit. This is possible through inquiry, as one of the methods of obtaining information.