

Audit Strategy, Planning and Programming

Question 1

You have been appointed the statutory auditor of a private limited company for the first time. Apart from adopting the conventional audit procedures such as posting, casting and vouching, what other auditing techniques would you employ for conducting the statutory audit?

Answer

A statutory auditor conducting audit of a private company for the first time would do well in case he obtains knowledge of the business of the company to understand and assess the kind of audit procedures to be employed by him as per SA 315 and 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". Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in:

- (i) Assessing risks and identifying problems.
- (ii) Planning and performing the audit effectively and efficiently.
- (iii) Evaluating audit evidence.

Such knowledge would enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. As far as adoption of conventional audit procedures is concerned, it would normally involve lot of time without commensurate benefits. In any case, if size of the business is large, the application of conventional procedure would involve extraordinary more time resulting into more cost and even then the auditor would not get the required satisfaction as to the figures contained in the financial statements. There may however, be some instances, say, where internal control systems are quite weak, it may perhaps be advisable to stick to conventional audit procedures such as vouching, etc. in detail. In any case, application of compliance procedure to evaluate the internal control systems in operations would enable the auditor to determine nature, extent and timing of substantive procedures.

Depending upon various factors including size of the business, it is advisable to reduce the extent of checking by adopting test check approach. Test-check approach is an accepted auditing procedure, which aims to test transactions on the basis of selection of samples from the entire population. Audit sampling means the application of audit procedures to less than

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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. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population. The auditor would also consider the specific audit objectives to be achieved and the audit procedures which are likely to best achieve those objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of control over an entity's purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

After performing vouching, it is necessary for an auditor to perform verification of balances contained in the financial statements. Verification and valuation of assets and liabilities contained in the balance sheet would involve obtaining evidence through methods like physical observations, confirmation, computation, inspection of documents and analytical reviews. Direct confirmation procedure provides an independent audit evidence to analyse the financial information contained in the accounting records. For example, confirmation may be done for debtors, creditors, investments lying with third parties, bank balances, etc.

Apart from conducting audit procedures like vouching and verification, it is quite useful to employ analytical review procedures; In fact, analytical review procedures would provide substantive audit evidence to support various assertions in the financial statements. Over a period of time, the analytical review as a method of obtaining evidence has emerged as a significant auditing procedures. As per SA 520, analytical procedures means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. The auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in

reducing detection risk for specific financial statement assertions. It further states that when analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

Therefore, a statutory auditor who has been appointed for the first time must resort to evaluation of internal control system through performance of compliance procedures based on the knowledge of the client's business following by vouching on a selected basis having regard to sampling. Physical observation and direct confirmation are also useful audit techniques in the verification of items contained in the financial statements. Ratio analysis or analytical procedures would also provide audit evidence as to various assertions contained in the financial statements.

Question 2

Write short notes on the following:

- (a) *Walk through Tests*
- (b) *Cut-off Procedures.*

Answer

- (a) Walk through Tests:** A walk through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands (1) the process flow of transactions, (2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and (3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk through also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

1. Be sure that the walk-through encompasses the complete process (initiation, authorization, recording, processing and reporting) for each significant process identified, including controls intended to address fraud risk.
2. Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.
3. Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.
4. Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff

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use, asking questions of different personnel at each significant stage and asking follow-up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of changes and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

(b) Cut-off Procedures: Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

- (a) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.
- (b) Goods sold have been excluded from the inventories and credit has been taken for sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

Question 3

Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.

Answer

Audit strategy is concerned with designing optimised audit approaches that seeks to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. The formulation of audit strategy as shall be evident from the process as explained in the following paragraphs in fact shall form the basis of audit planning to achieve the audit objectives in the most efficient and effective manner. Audit strategy generally involves the following steps:

1. **Obtaining Knowledge of Business:** SA 315 and 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" states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business

sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently. It also ensures that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. This would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and the other audit staff.

2. **Performing Analytical Procedures:** The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage. The use of the analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as the analytical techniques at the substantive stage.
3. **Evaluating Inherent Risk:** To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors such as quality of accounting system, unusual pressure on management, etc. 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.
4. **Evaluating Internal Control:** The auditor's assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes, the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This is done by:
 - (a) considering the results of gathering or updating information about the client; and
 - (b) making preliminary judgements about materiality, inherent risk and control effectiveness. These will include identification of the system(s) the auditor proposes to subject to an extended assessment of controls.

Thus, the audit strategy is evolved after considering the engagement objectives, the results of the business review, preliminary judgements as to materiality and identified inherent risks. Audit strategy also considers main points relating to planning and controlling the audit or comments on adequacy of the existing arrangements. Thus, the overall audit plan involving

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determination of timing, manpower, coordination and the directions in which the audit work has to proceed is dependent upon the audit strategy formulated by the audit firm.

Question 4

As a chartered accountants firm draft an engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.20XX.

Answer

Engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.20XX

To

The Board of Directors

XYZ Ltd.

.....

You have vide your letter datedrequested that we compile the Balance Sheet of XYZ Ltd. as at 31.3.20XX and the related Profit and Loss account for the year ended on that date.

We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As Management, you are responsible for :

- (a) The accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.
- (b) Preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.
- (c) Safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.
- (d) Ensuring that the activities of the entity are carried on in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable accounting standard(s), issued by the Institute of Chartered Accountants of India and other recognized accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide written confirmations of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is (specify purpose)

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documents and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

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 compilation of your financial statements.

XYZ & Co.
Chartered Accountants
Firm Registration No.
S/d

Question 5

M/s PQR & Company, Chartered Accountants have been appointed Statutory Auditors of a listed Company for the year ended 31st March, 20XX. Draft an appropriate engagement letter to be sent to the Board of Directors for the same.

Answer

Draft of an Engagement Letter

To the Board of Directors

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 20XX 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 firm 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

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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 judgements 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 controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us 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.

PQR & Co.
Chartered Accountants

.....
(Signature)

Firm's Registration No.
(Name of the Member)

(Designation)

Date :

Place :

Acknowledged on behalf of
_____ Company by

.....

(Signature)

Name and Designation

Date

Question 6

X Ltd., paid Rs.25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.10 with delivery instructions to deliver the same in the last week of June, 10. Further on 2.2.10 X Ltd. purchased two diesel generator sets from Y Ltd. for Rs.30 lakhs on 90 days Credit term. In the accounts for 2009-10, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of Rs.5 lakhs as due from them. As the statutory auditor, how would you deal with this?

Answer

Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Revised Schedule VI to the Companies Act, 1956 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will cancel the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd., to show these two items separately. If X Ltd., does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

Question 7

Answer the following:

- (a) *What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?*
- (b) *You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure.*

Answer

(a) As per "SA 520 (Revised) Analytical Procedure", when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:

1. Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
2. Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

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3. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
4. Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
 - (i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
 - (ii) Performing other audit procedures as necessary in the circumstances.

(b) Audit Programme of Multiplex

1. Peruse the Memorandum of Association and Articles of Association of the entity.
2. Ensure the object clause permits the entity to engage in this type of business.
3. In the case of income from sale of tickets:
 - (a) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
 - (b) Verify the system of relating to on line booking of various shows and the system of realization of money.
 - (c) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.
4. Verify the internal control system and its effectiveness relating to the income from cafes shops, pubs etc., located within the multiplex.
5. Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
6. Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.
7. In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
8. Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

9. Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

Question 8

What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?

Answer

The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

1. Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework
2. The nature of the entity, including:
 - (a) its operations;
 - (b) its ownership and governance structures;
 - (c) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (d) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
3. The entity's selection and application of accounting policies.
4. The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
5. The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 9

XYZ Ltd. appoints you as the auditor of the company. You observe that previous auditors A & Co., resigned. Also Balance Sheet as at 31-03-2010 shows an audit fee payable of ₹ 25,000. What precautions you will take before commencing the audit work?

Answer

Precautions before Commencing the Audit Work: In the instant case the auditor before accepting the appointment as well as commencing the audit work, the auditor should see the

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following:

1. When a previous auditor resigned, the auditor should verify that the resolution appointing him as the auditor at the general meeting was duly moved and approved by the shareholders.
2. The auditor should refer to the resignation submitted by the previous auditor.
3. The auditor should communicate with him so as to ascertain.
 - (i) The circumstances which led up to his resignation.
 - (ii) Whether there existed any circumstances on account of which he should not accept the appointment.
 - (iii) Whether the requirements of section 224(6) in respect of such an appointment have been complied with.

Further, Clause (9) of part I of the First Schedule to Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he 'accepts' an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956, in respect of such appointment have been duly complied with.

Question 10

A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?

Answer

Development of an overall plan - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit.

- (i) Terms of his engagement and any statutory responsibilities.
- (ii) Nature and timing of reports or other communications.
- (iii) Applicable Legal or Statutory requirements.
- (iv) Accounting policies adopted by the clients and changes, if any, in those policies.
- (v) The effects of new accounting and auditing pronouncement on the audit.
- (vi) Identification of significant audit areas.
- (vii) Setting of materiality levels for the audit purpose.

- (viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- (ix) Degree of reliance to be placed on the accounting system and internal control.
- (x) Possible rotation of emphasis on specific audit areas.
- (xi) Nature and extent of audit evidence to be obtained.
- (xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.
- (xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.
- (xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.
- (xv) Establishing and coordinating staffing requirements.

(Note : Student may also refer SA 300)