

Audit Planning , Programme & Procedures

Explain Audit Procedures

Ans:

1. Defining the scope of the audit work, i.e. preparation of the audit engagement letter.
2. Obtaining the knowledge of the client's business and formulating the audit programme.
3. Evaluation of the accounting and internal control system existing in the auditee enterprise.
4. Determining the nature, timing and extent of audit procedures keeping in mind the audit risk and materiality involved.
5. Adequate documentation is also necessary, i.e. preparation of audit note book and working papers.
6. Formulation of opinion about the financial statements.
7. Issuance of audit report.

• Techniques to collect the necessary evidence:

1. Vouching.
2. Confirmations.
3. Physical examination and observation.
4. Analytical procedures.
5. Test checking.
6. Inquiry.
7. Electronic data processing.
8. Preparation of reconciliation statements.
9. Flow charting.
10. Scanning.

AUDIT PLANNING

Ans: SA 200 on 'Basic Principles Governing an Audit' issued by ICAI, mentions Audit Planning as one of the basic principles.

It states that the auditor should obtain the knowledge about client's business to determine the nature, timing and the extent of the audit procedures. The audit plans should cover among other things, obtaining knowledge about the client's accounting systems, policies and the internal control procedures and coordinating the work to be performed. Further plans should be flexible one so that these could be developed or revised as and when considered necessary.

SA 300 on audit planning further expounds the concept laid down in SA 200. SA 300 applies to the planning process of the audit of financial statements as well as to other financial information in context of recurring audits.

• Adequate planning helps to:

1. Ensure that appropriate attention is devoted to important areas of audit;
2. Ensure that potential problems are promptly identified;
3. Ensure that the work is completed properly and in time;
4. Utilize the assistants properly; and
5. Coordinate the work performed by others.

The auditor should consider the factors such as the complexity of audit, the environment in which the entity operates his previous experience with the client and knowledge of client's business, while planning his audit work.

A) Knowledge of the client's business

- It will enable the auditor to identify the events, transactions and practices that in his judgment may have a significant effect on the financial information. The auditor can obtain such knowledge from:
 1. The client's annual report to its shareholders;
 2. Minutes of meetings of shareholders, Board of Directors etc;
 3. Internal financial management reports;
 4. Previous year's audit working papers;

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5. Discussion with client;
6. The client's policy and procedures manual;
7. Consideration to the state of economy and its affect on client's business; and
8. Visit of the client's premises and plant facilities.

B) Development of an overall plan

The overall plan should cover the following:

1. Terms of audit engagement and statutory responsibilities;
2. Nature and timing of reports or other communication;
3. Nature and timing of reports or other communication;
4. Relevant legal and statutory requirements;
5. Accounting policies of client and changes therein;
6. Effect of new accounting or auditing pronouncements on the audit;
7. Identification of critical audit areas;
8. Conditions requiring special attention;
9. Degree of reliance as regards accounting system and internal control;
10. Possible rotation of emphasis on specific audit areas;
11. Nature and extent of audit evidence to be obtained;
12. Work of internal auditors and reliance to be placed on them;
13. Consideration to branch auditor's report;
14. Allocation of work between joint auditors and the procedures for its control and review; and
15. Establishing and coordinating the staff requirements

C) Audit Programme

An audit programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item and the financial statements and the estimated time required. To be more comprehensive, an audit programme is written plan containing exact details with regard to the conduct of a particular audit. It is a description or memorandum of the work to be done during an audit. Audit programme serves as a guide in arranging and distributing the audit work as well as checking against the possibility of the omissions.

As per SA 300, the auditor should prepare a written audit programme setting forth the procedures that are needed to be implemented while carrying out the audit plan. He may take into account the reliance to be placed on internal controls. The auditor has some flexibility in deciding when to perform audit procedures. But, sometimes he may have no discretion as to timing, such as, observing the stock taking by the client's personnel. The audit programme should consider previous year's audit programmes and these may be modified, if necessary.

• An audit programme may be classified into two categories:

1. Programme common to all types of audit. For example, checking of books of accounts; and
2. Special programme containing the work relating to a particular audit. For example, the audit programme for a partnership firm would be different from that of a company.

• Advantages of audit programme

The main advantages of an audit programme are as follows:

1. It serves as a ready check list of audit procedures to be performed.
2. The audit work can be properly allocated to the audit assistants or the article clerks.
3. The auditor may easily know the extent of work done at any point of time. Thus, the progress of work done can be under the supervision and control of the auditor.
4. Audit programme would not only be useful for the audit assistants in carrying the audit work but for the principal too as he would be in a position to account for the individual responsibilities.

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5. A uniformity of the work can be attained as the same programme would be followed from time to time.
6. It is a useful basis for planning the programme for the following year.
7. It may be used as evidence by the auditor in the event when any charge is brought against him. He can prove that there has no negligence on his part and he exercised reasonable care and skill while performing the task.

- **Disadvantages of Audit Programme**

The main disadvantages of an audit programme are as follows:

1. The auditor's task becomes mechanical and the auditors may lose interest and initiative.
2. Drawing up of an audit programme may be unnecessary for a small concern.
3. Though audit programme helps in fixing responsibilities but inefficient staff may defend themselves by stating that the matter was not contained in the audit programme.
4. Rigid programmes cannot be laid down for each type of business.
5. Though an audit programme may suffer from the above disadvantages but these can be removed by taking some initiatives such as consulting the audit assistants, modifying the programme on the basis of experience gained during audit, etc.



CONTINUOUS AUDIT

Ans: Continuous audit involves the detailed examination of all the transactions by the auditor continuously throughout the year or at regular intervals, say fortnightly or monthly. A continuous audit is one which is commenced and carried on before the close of the financial year to which it relates. It involves the constant engagement of auditor's staff at the client office throughout the period under review. Continuous audit is suitable in cases where the final accounts are desired to be presented soon after the close of the financial year or there is great volume of transactions or the system of internal check is weak.

- **Advantages**

1. A close and extensive examination of accounts is possible as the auditor gets full year for the purpose.
2. The errors and frauds can be detected and rectified soon.
3. A regular supervision by the auditor brings increased efficiency and accuracy in the accounts of the enterprise.
4. Better MIS system because of availability of updated and accurate accounts.
5. Continuous audit create more check on the client's staff.
6. The auditor can have much better understanding of the client's business and thus he can suggest the client the ways to improve operational efficiency.
7. The final accounts can be prepared and reported upon soon after the end of the financial year.
8. It also facilitates auditor to schedule his work in convenient manner and avoid the pressure that may mount at the close of financial year.

- **Disadvantages**

1. The auditor checks the books of accounts in several visits. The items or figures or books of accounts may be tampered by the client's staff after the auditor has checked them during previous visits.
2. The technique of continuous audit is not suitable for small concerns.
3. Auditor's frequent visits may cause inconvenience to the client's staff.
4. Further, friendly ties may develop between client's staff and the auditor's staff. This may lead to collusion among them.
5. The work become too mechanical as it continues throughout the year.

- **These disadvantages can be avoided by taking the following measures:**

1. An audit programme should be prepared in a systematic manner.
2. The auditor should use secret ticks and use different colours to denote the specific ticks during the course of checking the different entries.
3. Specific instructions should be given to the client's staff not to alter or correct the audited figures.
4. The visits should be at irregular intervals so that the staff of the client may not be able to prepare in advance against the possible queries.
5. Adequate documentation, i.e., working papers should be maintained so that the thread of work is not lost.

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FINAL AUDIT

Ans: A final audit is also called as Completed Audit or Periodical Audit. Final audit is done after the close of the financial year, i.e. after the books of accounts have been closed and the final accounts are drawn up. In this type of audit, the client gives the possession of books of accounts to the auditor for audit and routine checking and other audit procedures begin only after that.

Advantages

1. The work can be carried on at a stretch. Thus the thread of work is not lost.
2. As the audit work commences only after the year end, there is no dislocation of client's work.
3. Collusion among audit staff and client's staff can be avoided.
4. Periodical audit is also suitable for small size concerns.

Disadvantages

1. Accounts cannot be subjected to detailed checking. Some of the errors or frauds may remain undetected.
2. Periodical audit is not advisable for large concerns because they have voluminous transactions.
3. There is a delay in presentation of final accounts.

AUDIT WORKING PAPERS

Ans: Audit working papers are the record of the planning and execution of the audit engagement. Auditors retain a set of working papers for each audit engagement for each year. The audit working papers for the current year are referred to as the current working papers. Working papers that are relevant to more than one audit engagement are often kept separately in a file referred to as permanent working papers. The audit working papers (current and permanent) for a client audit engagement are sufficiently detailed to enable another appropriately experienced and competent auditor that is not familiar with the client to obtain an overall understanding of the engagement.

- SA 230 on '**Documentation**' issued by ICAI deals with the 'working papers'. As per this SA, documentation refers to the working papers prepared or obtained and retained by the auditors for his audit work. Working papers (or documentation) serve three purposes
 1. Aid in planning and performance of the audit;
 2. Aid in supervision and review of the audit work; and
 3. These papers serve as an evidence of the audit work performed by the auditor to support his opinion.
- The form and content of working papers vary from audits to audits, but they are affected by the following matters:
 1. Nature if engagement;
 2. Form of audit report;
 3. Nature and complexity of client's business;
 4. Nature and condition of client's records
 5. Degree of reliance of internal controls;
 6. Supervision of work performed by assistants.

Types of working paper files

Ans: In case of recurring audits, some working papers files may be classified into permanent audit files and current audit files: while the former is updated with the Information of continuing importance, the latter contains information relating to audit of a single period.

- Title Permanent Audit File Current Audit File**

Title	Permanent Audit File	Current Audit File
1. Structure :	Legal and Organizational structure of the entity.	Correspondence relating to acceptance of annual reappointment.
2. Documentation :	Facts or copies of legal documents, agreements and minutes relevant to the audit.	Extracts of important matters in the minutes of Board Meetings and General Meetings relevant to the audit.

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3. Records :	A Record if study and evaluation of internal controls.	Copies of management letters.
4. Analysis :	Analysis of significant ratios & trends.	Analysis of transactions and balances.
5. Audit Evidence :	Copies of the audited financial statements of previous year(s).	Copies of communication with other auditors, experts and third parties.
6. Preparation :	Notes regarding significant accounting policies.	Audit programme.
7. Significance :	Significant audit observations of the earlier years.	Conclusions reached on significant aspects of audit.

- Working papers are the **property of the auditor**, the portions or extracts of which can be had at his discretion. These working papers should kept in **safe custody and in confidential manner** for such time as is sufficient to meet the requirements of his practice or to satisfy any related legal or professional requirement of record retention. However, if required by some legislation, the auditor has to make working papers available to the regulatory authority.
- ICAI has prescribed that the **members have to retain the working papers for a period of 7 years**. Otherwise, the member is guilty of professional misconduct.

Audit Note Book

Ans: An audit book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. The audit note book is a permanent record of the auditor. For each individual audit, the auditor usually maintains a separate audit note book. The audit note book should be maintained clearly, completely and systematically. In case of City Equitable Fire Insurance Company, the auditors were relieved because they have maintained record of the audit work performed at each stage.

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| 1. Contents of Audit Note Book | 8. Accounting methods, internal control systems followed by the enterprise, applicable laws etc. |
| 2. Name of the business enterprise. | 9. Key management personnel. |
| 3. Organisation structure. | 10. Errors and fraud discovered. |
| 4. Important provisions of MOA of Association. | 11. Matters requiring explanations or clarifications. |
| 5. Communication with the previous auditor, if any. | 12. Special points that need attention in the audit report and for subsequent audits. |
| 6. Management representations and instructions. | |
| 7. List of books of accounts maintained by the enterprise. | |

Quality control for Audit work

Ans: As per SA 220 "Quality control as to the policies and procedures of an audit firm for audit work generally, and procedures regarding the work delegated to assistants on an individual audit."

- Auditor** : As the person with final responsibility for the audit,
- Audit firm** : As a partnership firm or sole practitioner providing audit service,
- Personnel** : As all partners and professional staff engaged in the audit practice of the firm,
- Assistants** : As personnel involved in an individual audit other than auditor.

Factors to be considered for incorporating quality control in audit work :

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|------------------------------|--|
| 1. Professional Requirements | 5. Consultation |
| 2. Skills and competence | 6. Acceptance and Retention of clients |
| 3. Assignment | 7. Monitoring |
| 4. Delegation | 8. Effectively communication |

Levels for Audit Work-Audit Firm and Individual Audit

- Direction** : Audit assistants should be informed of the nature of business and possible accounting or auditing problems. They should be explained of what is expected of them and how to achieve it. They should be informed about the importance of audit programme, time budgets and overall audit plan.

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2. Supervision :

- ✓ Persons carrying out supervisory responsibilities should
- ✓ Monitor the progress of audit;
- ✓ Become informed of and address significant accounting and auditing questions raised during the audit;
- ✓ Resolve the differences of professional judgment and consider the level of consultation as appropriate.

3. Review :

- ✓ Review of work of audit staff should be carried out to ensure that the
- ✓ Work has been performed as per the audit programme;
- ✓ Work performed has been adequately documented;
- ✓ All significant matters have been resolved or are reflected in audit conclusions;
- ✓ Objectives of the audit procedures have been achieved; and
- ✓ Conclusions expressed are consistent with the work performed.

Delegation and Supervision of audit work

Ans:

✓ Delegation of Audit work

1. An auditor only delegates work/authority to persons (i.e. delegates) with the appropriate experience and competence.
2. This applies to all levels of organization within the audit firm. Thus, a senior staff member to whom work/authority has been delegated only further delegates work/authority to other staff members that have the appropriate experience and competence.
3. An auditor or staff member delegating work/authority ensures that the person to whom the work/ authority has been delegated (i.e. the delegatee) completely understands the nature of the work that the person is required to perform as well as the limits of any delegated authority.

✓ Supervision of Audit work

1. Auditors and audit staff members supervise the work delegated by them to others so as to minimize the risk of a lessening of the standard of care.
2. The more complex the nature of the work delegated and the less experienced or competent the staff member to whom the work has been delegated, then the greater the degree of supervision.
3. Auditors supervise work while it is being performed by the delegatee. This contrasts with the review of work which auditors carry out after the delegatee has performed the work.
4. The purpose of supervision is to provide the supervisor with a degree of assurance that the work of the delegatee is being performed (as opposed to was performed) in accordance with the instructions given and with the appropriate standard of care.

✓ Review of Audit work

1. Work performed by the auditor and his audit staff is reviewed. Work performed by the auditor (the engagement partner) is reviewed by a person not personally involved with the client (the review partner and/or personnel from quality control).
2. Work performed by the auditor's staff members is usually reviewed by the person that delegated the work to those staff members.
3. The purpose of this quality review is to ensure that the work was performed in accordance with instructions given, with the appropriate standard of care, and in accordance with any delegated authority.
4. In relation to work performed in the control testing, substantive testing and opinion formulation stages, the reviewer ensures that audit procedures performed conform with the audit programs, that audit procedures required to be performed have been properly performed, that the evidence obtained has been properly documented and that conclusions reached are consistent with the evidence obtained.

Audit Sampling

Ans: As per SA 530 on "Audit Sampling", it means 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.

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✓ Test Checking :

It is concerned with selecting and examining a representative sample from a large number of similar items.

While test checking the following aspects need to be considered:

1. Presentation and disclosure.
2. Adherence to the generally accepted accounting practices.
3. Compliance with the statutory requirements.
4. Existence of errors and frauds.
5. Arithmetical accuracy.
6. Materiality of the items involved.

• Precautions before applying test checking :

The auditor must take the following precautions before he applies test checking for auditing:

1. The auditor must review the system of internal controls existing in the enterprise. Test checking should be avoided in case the internal control system is weak or ineffective.
2. The sample selected for test checking should be representative in character and the transactions should be of homogeneous nature.
3. The number of transactions to be selected for test checking should be predetermined depending upon the extent to which the reliance can be placed on the results of test checking.
4. The auditor should identify those areas where test checking is not suitable, for example, opening and closing entries, bank reconciliation statement, non-recurring items, transactions of a seasonal industry, other areas where the compliance with the applicable law is required such as managerial remuneration under Companies Act, etc.
5. No element of bias should be present in selecting a sample.
6. The system of test checking should be reviewed from time to time so that necessary improvements, if any, can be made.

• Methods of statistical sampling

There are two main methods for determining the size of sample viz. Judgmental Sampling and Statistical Sampling.

Each one of these methods is discussed below:

1. **Judgmental Sampling** - In this method, the sample size is determined on the basis of the personal experience and the knowledge of the auditor. It is one of the simple methods of sampling. It may be noted that this method, though simple in its applicability, is neither scientific nor objective. The risk of personal bias in selection of sample is always present. Thus, an element of subjectivity does prevail in this method.
2. **Statistical Sampling** - This method is more scientific in its approach than the method of judgmental sampling. It involves application of mathematical techniques like theory of probability, use of random number tables etc. But it may also be noted that the auditor need not require having an in depth understanding of the statistical techniques because published statistical tables are available which indicate the sample size based on predetermined criteria.

• The advantages of statistical techniques, properly applied, over judgement sampling are:

- (a) Conclusions about the total population can be stated with a know confidence and precision;
- (b) Sample size is objectively determined;
- (c) Time and money may be saved by limiting sample size to that required to achieve a given result.

For these reasons, whenever the size and homogeneity of the group to be checked permits, statistical sampling is generally to be preferred to judgement sampling. Statistical sampling is most likely to be successful when the following conditions are present:

- (a) A large population to be checked;
- (b) The population consists of similar items;
- (c) Items for checking easily selected and located;
- (d) The error rate is reasonable low (e.g. good system of internal control in force).

• Selection of the sample

Auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

While there are a number of selection methods, three methods commonly used are:

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1. Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.
 2. Interval sampling or Systematic selection, which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (e.g. every 20th voucher number) or on monetary totals (e.g. every 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.
 3. Haphazard selection, which may be an acceptable alternative to random selection, provided that 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, toward items which are easily located, as they may not be representative.
- **Stratified Sampling :** This method involves dividing the whole population into separate groups. These groups are called **strata**. The sample is taken from these strata. Each stratum is treated as if it was a separate population and the proportionate of items is selected from this stratum. This method is based on the logic that in case of highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each stratum. In a way, this method is an extension of random sampling. For example, debtors' balances may be divided into following strata:

Balances in excess of Rs.1,00,000;

Balances in the range of Rs. 75,000 - Rs. 1,00,000;

Balances in the range of Rs. 25,000 - Rs. 75,000; and

Balances below Rs. 25,000

- **Sampling risk**

While determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error.

Sampling Risk: Sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

A) Tests of Control:

1. Risk of Under Reliance: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.
2. Risk of Over Reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment

B) Substantive procedures:

1. Risk of Incorrect Rejection: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.
 2. Risk of Incorrect Acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially misstated, in fact it is materially misstated.
- The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial
 - Statements than either the risk of under reliance or the risk of incorrect rejection. Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

A) Tolerable Error:

- Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive

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procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

B) Expected Error:

- If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures.

Audit Risk

Ans: Audit risk is the risk of a material misstatement of a financial statement item that is or should be included in the audited financial statements of an entity. In theory, audit risk ranges anywhere from zero, where there is complete certainty of no material misstatement, to one, where there is complete certainty of a material misstatement. In practice, however, audit risk is always greater than zero.

1. **Audit risk** :- it is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Such misstatements can result from either fraud or error.
2. **Inherent risk** :- it is the susceptibility of a account balance or class of transaction to misstatements that could be material, either individually or when taken together with misstatements in other balance or classes, assuming that there were no internal controls.
3. **Control risk** :- it is the risk that misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when taken together with misstatements in other balances or classes, will not be prevented/detected/corrected on timely basis by the accounting and internal control systems.
4. **Detection risk** :- it is the risk that an auditor's substantive procedures (the procedures designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system) will not detect a misstatement that exists in account balance or class of transactions that could be material, either individually or when taken together with misstatements in other balances or classes.

Surprise Checks

Ans: It is well accepted that the audit constitutes a moral check on the employees of the client and thus have a deterrent effect. But at the same time, if the auditor or his staff visits at regular intervals, the client or his staff may get time to be well prepared in advance for the audit queries. This may impair the deterrent effect. Thus, there is a need of element of surprise.

- The Council of ICAI has made the following recommendations in this regard:
1. Surprise checks should be considered as a desirable part of each audit.
 2. The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:
 - ✓ Verification of cash and investments.
 - ✓ Test verification of stores and stocks and the records relating thereto.
 - ✓ Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.
 3. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.
 4. The results of the surprise checks should be communicated to the management if they reveal weakness in the internal control system or the existence of fraud or error.
 5. The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.
 6. The results of surprise checks should be included in the audit report if they are material and affect the true and fair view of the accounts on which the reporting is done.