Auditing - Basics

BY:

CA KAMAL GARG

Auditing Classes for CA Final and CA PCC/ PE II

- **Faculty:** CA Kamal Garg
- **Places:**

1. Chennai: 09444048990;
2. Ernakulam (Kerala/ Cochin): 09447170048;
3. Bangalore: 09444162695

- **Visit us at:** www.sreeramcoachingpoint.com

Auditing - Definition

- Auditing is a *systematic* & *independent* examination of accounting and other underlying data and information to give an opinion in the audit report

- **How to Learn this Definition**

Auditing – Definition: **Just Remember - AUDITOR**

- Auditing is a ***systematic*** and ***independent*** examination of:

1. **A** – **A**ccounting & other
2. **U** – **U**nderlying
3. **D** – **D**ata and
4. **I** – **I**nformation
5. **T** – **T**o give an
6. **O** – **O**pinion in
7. **R** – the audit **R**eport

Audit Definition - Components

- ***Systematic:*** carry the audit as per laid procedures and guidelines;
- ***Independent:*** auditor should act unbiased;

Systematic

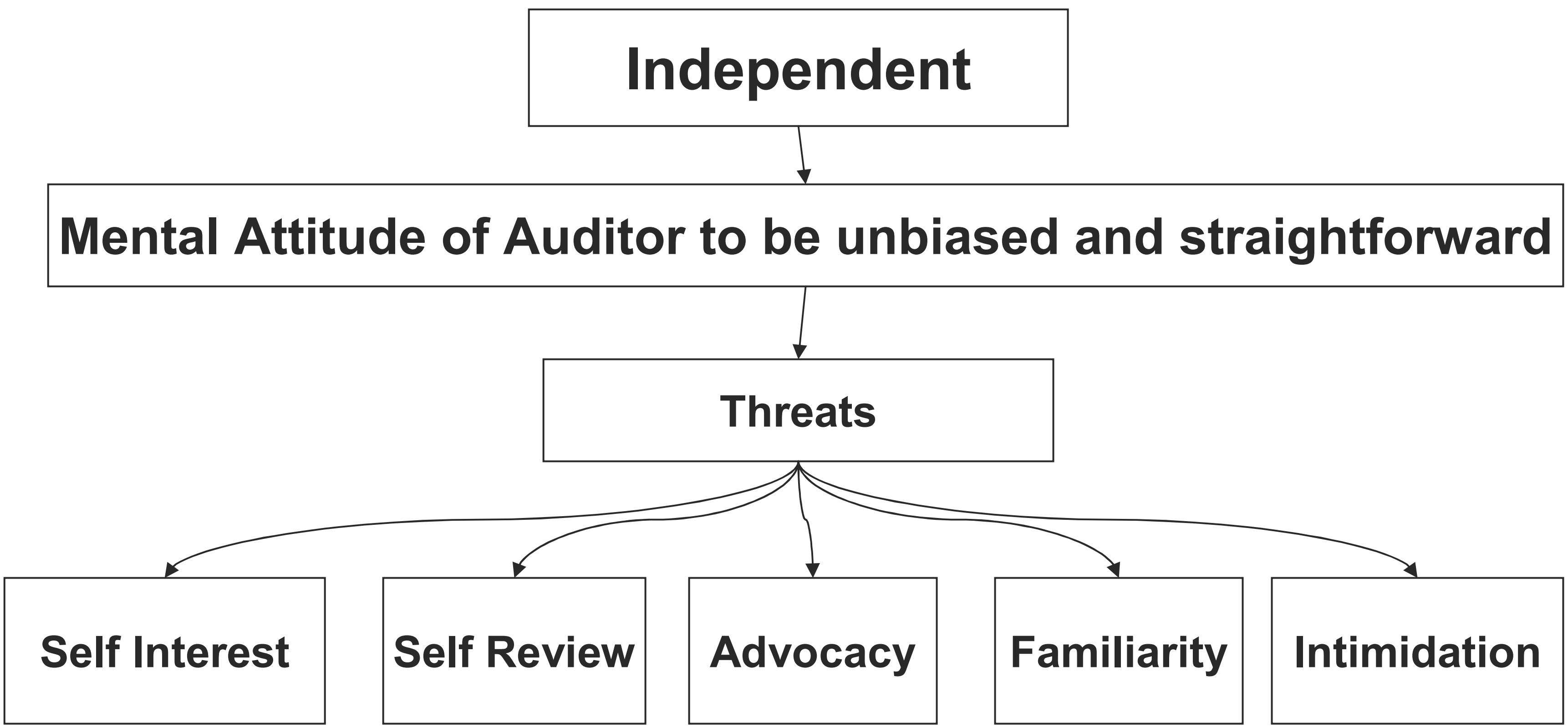
Systematic

Compliance with applicable Regulatory Requirements

Compliance with applicable Financial Reporting Framework

Proper Training and Auditing Framework (like AAS) helps in achieving this

Independent



Threats to Independence

1. **Self Interest** – Presence of financial interest (including too much dependence on audit fees);
2. **Advocacy** – Promoting client's objectives/ interests, e.g. dealing in shares of auditee company;
3. **Familiarity** – Relationship with clients (e.g. long association, accepting gifts, relative at senior post, etc.);
4. **Intimidation** – deterring auditors' activities (e.g. replacements)
5. **Self Review** – Combination of (2) to (4) if happened in past

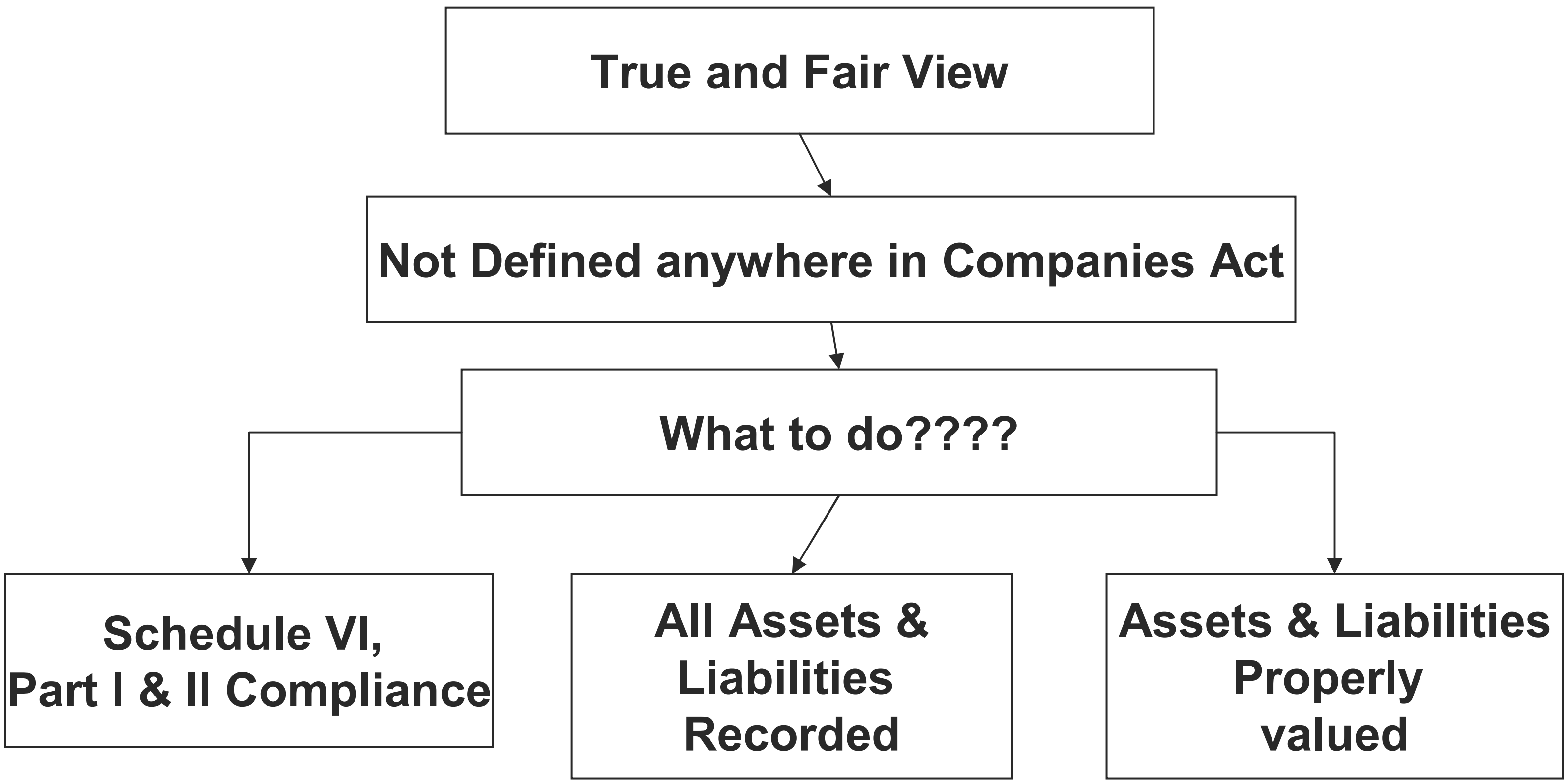
Safeguards to Independence

- Companies Act, 1956
- Code of Ethics
- C& AG safeguarded through C & AG Act

Audit Definition - Comprehensive

- Audit is a systematic and independent examination of **financial statements** to ensure that they reflect a **true and fair view**
- **Financial Statements** = Balance Sheet, Profit & Loss Account and Cash Flow Statement

True and Fair View



True and Fair View – Comprehensive Approach

- **True & Fair View:**

1. Implies that there should be **no Material Misstatement**;
2. **Materiality:** Professional Judgement/ AS 1/ Schedule VI/ Other Laws (i.e. if other laws are violated);
3. **Misstatement:** See other presentations

Accounting vs. Auditing

- ***Auditing begins where accounting ends***

1. Meaning;
2. Frequency;
3. Qualifications;
4. Legal Requirements

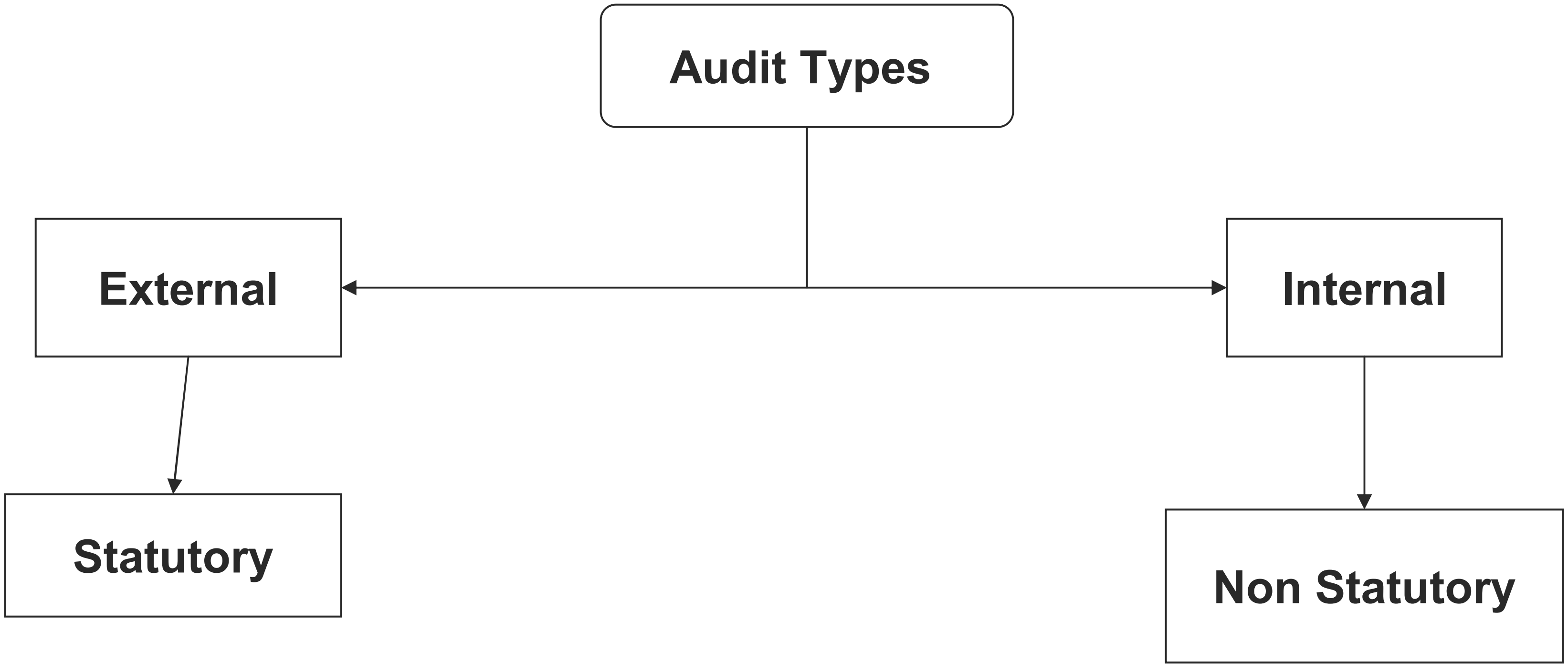
Audit Definition & Basic Principles (AAS 1)

1. Audit is a **systematic and independent** examination of **financial statements** prepared as per the **applicable regulatory requirements** and **financial reporting framework**,
2. To ensure that they (i.e. the financial statements) reflect **a true and fair view** (i.e. they are **not materially misstated**)

Special Points

1. Financial Statements are the responsibility of management **(AAS – 2)**;
2. Therefore, Auditors adopt **Professional Skepticism** approach;
3. Where the auditor **delegates work** to his assistants/ articles/ other CA, he is not absolved of his responsibilities **(AAS 1);**
4. **Audit Plan** should be made and reviewed **(AAS 1 and AAS 8);**
5. **Knowledge of Business (AAS 20)**

Classification or Types of Audit



Internal Auditor vs. External Auditor

- Appointment;
- Scope of work;
- Objective;
- Reported Authority;
- Degree of Independence;

Relationship between Internal and External Auditor (AAS 10)

- Principal Auditor and Other Auditor;
- Component(s) of Enterprise;
- Proper coordination;

- **Principal Auditor should consider:**

1. Professional competence of other;
2. Advising what/ how would be the use of other's work;
3. Areas of special considerations;
4. Time table for completing work;
5. Other's limitation on scope;
6. Other's significant findings;
7. Conducting supplementary tests by other, if required; and
8. Proper documentation by both

Objectives of Audit

1. **Primary Objective:** Expression of Opinion (i.e. whether T & F view is there);

2. **Secondary Objective:** Prevention & Detection of Errors & Frauds

3. ***Objectives may differ from one audit to other (e.g. internal audits)***

Audit Evidence (AAS 5)

- **Facts & reasons** needed to give audit opinion;
- Also one of the basic principle of audit (AAS 1);
- Evidence to be **sufficient** and **appropriate**;
- Sufficiency = Quantum;
- Appropriate = Relevance & Reliability;
- Evidence may be External or Internal, Written or Oral

Audit Evidence (AAS 5)….contd.

- **Factors affecting audit evidence collection:**

1. Nature of item;
2. Internal controls;
3. Nature & size of business;
4. Materiality;
5. Type of information available;
6. Previous audits' experience

- **Methods to Obtain Audit Evidence:**

1. Inspection – examination of records etc.;
2. Observation – witnessing a process;
3. Inquiry & confirmation – seeking app. Info;
4. Computation – checking arithmetical accuracy;
5. Analytical review – ratio analysis etc. (materiality test)

External Confirmations (AAS 30)

- Expounds the concept from AAS 5;
- Process of obtaining & evaluating audit evidence obtained from III party (e.g. Banks, Debtors, Creditors, etc.);
- Confirmation requests are send and responses are received;
- Confirmation Request = Positive form of request and Negative form of request;
- Positive Form = Reply from III party needed in all cases;
- Negative Form = Reply needed only in the event of disagreement;

External Confirmations (AAS 30)…..contd.

- If no response is received, **apply more extensive substantive procedures**;
- **Positive form used (more reliable)** where:

1. Audit risk/ Account Balances are high;
2. Internal controls are weak;
3. Material accounts are irregular or inaccurate

- **Negative Form (less reliable)** used where:

1. Audit risk is low;
2. Small balances involved;
3. Have no reason to believe that III party would not respond (i.e. auditor believes no material misstatement will result)

External Confirmations (AAS 30)…..contd.

- **Other Points:**

1. Preferably confirmation should be sought by auditors;
2. If confirmations received are of no much help then undertake additional audit procedures;
3. **Management may request not to seek confirmation??**

YES

- Examine the nature of evidence available to support the management's request;
- Take request in written form;
- Document reasons of agreeing with management;
- Apply alternative procedures
- **ELSE Limitation on Scope**

Professional Skepticism

- Professional skepticism in auditing implies **an attitude** that includes a questioning mind and a critical assessment of audit evidence **without being obsessively suspicious** or skeptical.
- Auditors **adopt an attitude** of professional skepticism when they evaluate *audit evidence*.
- When the auditor adopts such an attitude, the auditor does **not accept evidence gathered at its face value;**
- Rather, the auditor evaluates the evidence bearing in mind the possibility that, for example:

1. the evidence **may** be **misleading**,
2. the evidence **may** be **incomplete**, or
3. the person providing the evidence **may** be either incompetent or motivated to provide evidence that is misleading or incomplete.

Mis-statements

The misstatement can take place either:

- In a financial statement item; or
- In underlying account balance; or
- With class of transaction

of an entity.

Auditing vs. Investigation

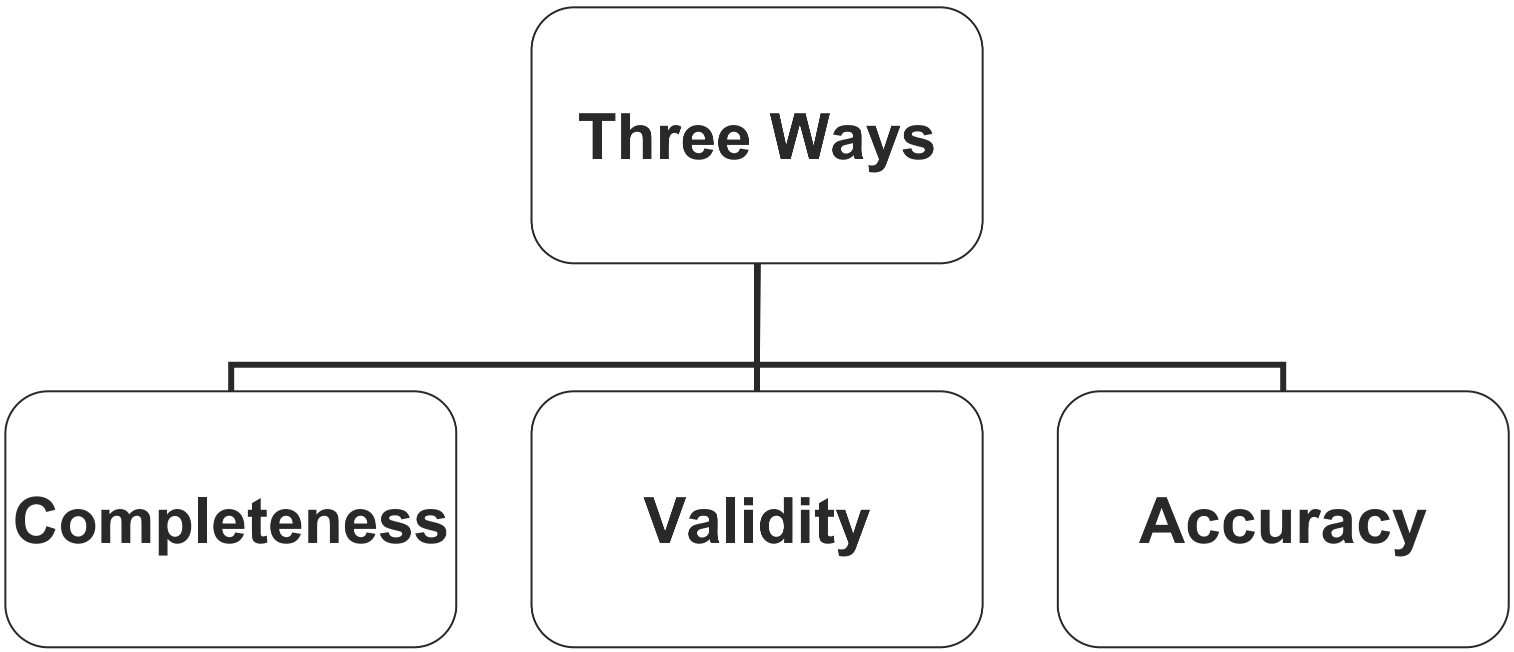
Mis-statements……contd.

Three ways of Mis-statements:

- ***not including*** in a financial statement item (or underlying account balance or class of transaction) ***an item that should be included***;
- ***including*** in a financial statement item (or underlying account balance or class of transaction) ***an item that should not be included;***
- ***including*** in a financial statement item (or underlying account balance or class of transaction) ***an item that should be included, but not including it accurately.***

Mis-statements……contd.

Categorising Mis-statements:



Mis-statements……contd.

Examples of Mis-statements *(category wise):*

- ***Misstatement Of Completeness:*** the omission of a valid liability;
- ***Misstatement Of Validity:*** the inclusion of a fictitious asset;
- ***Misstatement Of Accuracy:*** the inclusion of a valid asset, but at an incorrect value or with an incorrect description

Note: Auditors classify misstatements as *fraud* (intentional), other illegal acts such as non compliance with laws and regulations (either intentional or unintentional) and *errors* (unintentional).

A misstatement may be *material or immaterial*. Where the auditor believes that the financial statements contain a material misstatement, the auditor issues a qualified *audit opinion*

Management's Assertions (AAS – 11)

There are **two categories of assertions** by management that are of particular concern to auditors:

- Internal control assertions, and
- Financial statement assertions

Internal Control Assertions

- **Management is primarily responsible** for the *internal control procedures* it establishes.
- There is an **implied assertion** by the management that such internal control procedures are **effective as to both their design and operation.**
- The **auditor advises** management of **deficiencies** in significant internal control procedures of which he becomes aware.

Financial Statements Assertions

- **Auditors are not responsible for the preparation of the financial statements** of an entity. This is the responsibility of management.

- The financial statements prepared by management for audit are a collection of **assertions as to both the state of affairs of the entity at balance date and the results of its operations** for the period ended on that date.

Financial Statements Assertions……contd.

- <u>**Implied Assertion by Management:**</u> In broad terms, **management is asserting to the auditor** that the **financial statements,** and by implication the financial statement items and underlying account balances and classes of transaction, are **free of (material) misstatement.**

- **Auditor's Role:** That is, that the financial statement items, and underlying account balances and classes of transactions are, in all *material* respects, ***complete*****,** ***valid*** **and** ***accurate*** . One of the principal objectives of the auditor is to **add credibility to these assertions.**

Financial Statements Assertions and Level of Aggregation

- **Levels Of Aggregation?:** In an accounting information system it refers to the various levels at which accounting related data and information is recorded and summarized.

- Each and every information is summarised in **Financial Statements;**
- Each financial statement item is comprised of one or more **Account Balances**;
- Each account balance is comprised of transactions of **Various Classes**;

Levels of Aggregation

LEVEL I:
Financial Statements

↕

LEVEL II:
Account Balances

↕

LEVEL III:
Class of Transactions

Financial Statements Assertions and Level of Aggregation

- **Level I – Financial Statement Level:**
- Each item in the financial statements is **an aggregation of a number of account balances.** For example, the financial statement item "Inventory" is an aggregation of a number of different inventory-related account balances.
- When management prepares the financial statements, it asserts that the financial statement items are complete, valid and accurate.
- Auditors, in forming their opinion on the financial statements, test these assertions by gathering and evaluating *audit evidence* that relate to each of these financial statement level assertions.

Financial Statements Assertions and Level of Aggregation

- **Level II – Account Balance Level**
- **It is the level at which the aggregated transaction data contained in the various journals (e.g. cash receipts, sales and general journals) is recorded in, or 'posted to', the account balances in the general ledger to which the transactions relate.**
- **When management assert that the financial statements are complete, valid and accurate, it impliedly asserts that the underlying account balances are also complete, valid and accurate. For example, the assertion that "Inventory" in the financial statements is complete, valid and accurate, implies that underlying account balances such as "raw materials", "goods in transit", "finished goods", are also complete, valid and accurate.**
- **Auditors consider each account balance assertion individually.**

Financial Statements Assertions and Level of Aggregation

- **Level III – Class of Transaction**
- **It is the level at which the source documents (e.g. cash receipt advices, delivery advices, journal vouchers) are processed as transactions.**
- **An implied assertion that an account balance is complete, valid and accurate is also an implied assertion that classes of transaction underlying the account balance are also complete, valid and accurate.**
- **For example, the assertion that "raw materials" account balance is complete, valid and accurate also implies that underlying classes of transactions (e.g. purchases and sales transactions) are also complete, valid and accurate.**

Financial Statements Assertion *vis-à-vis* Level of Aggregation

LEVEL OF AGGREGATION	ASSERTIONS		
	Completeness	**Validity**	**Accuracy**
Financial statement item level	All valid account balances are included in the financial statement item.	All account balances included in the financial statement item (i) do exist and (ii) do pertain to the entity as at balance date.	All valid account balances included in the financial statement item are accurate as to (i) valuation and (ii) presentation and disclosure.

Financial Statements Assertion *vis-à-vis* Level of Aggregation

Account balance level	**All valid assets, liabilities, equities, revenues and expenses are included in the account balance.**	**<u>Balance sheet account balances:</u> All assets, liabilities and equities included in the account balance (i) do exist and (ii) are owned (controlled) by, or owed by, the entity as at balance date. <u>Income statement account balances:</u> All income and expenses included in the account balance (i) do pertain to the entity and (ii) have occurred during the relevant period.**	**All valid assets, liabilities, equities, revenues and expenses included in the account balance are accurate as to (i) valuation and (ii) classification.**

Financial Statements Assertion *vis-à-vis* Level of Aggregation

Class of transaction level	All valid economic events are included in the class of transaction.	All economic events included in the class (i) do pertain to the entity and (ii) have occurred during the relevant period.	All valid economic events included in the class are accurate as to (i) value and (ii) description.

Management Representation (MR) (AAS 11)

- Obtain an acknowledgement from Management as to its responsibility for preparing & presenting Financial Information;
- The auditor should:

1. Seek corroborative audit evidence from sources within & outside the entity;
2. Evaluate the reasonableness & consistency of MR

- MR cannot be a substitute for other audit evidence.

Management Representation (MR) (AAS 11)…..contd.

- **Basic elements of MR:**

1. Written;
2. Addressed to auditor;
3. Dated & signed;
4. Date to be related to ***pre or at*** the date of audit report

- If **Management refuses**, it's a limitation on scope and extend audit procedures;
- If **Management unwilling**, consider self MR preparation and get it signed by Management

Audit Procedures

- **Compliance Procedures:**
- Soundness of Internal Control System (i.e. **Existence, Effectiveness & Continuity**)
- **Substantive Procedures:**
- If internal control system not sound, apply substantive procedures viz. **Test of Details of Transactions** **(e.g. audit in depth)** and **Analytical Procedures** **(e.g. ratio analysis)**

Internal Control System (ICS)

- A mechanism to **ensure the compliance** with **organisation policies and procedures**;
- In **particular ensure** that:

1. Assets are safeguarded;
2. Frauds and errors are prevented & detected;
3. Recording all transactions in books of account

- **Control Environment:** overall attitude, actions & awareness of BOD towards ICS;
- **Control Procedures:** designed to achieve desired ICS objectives

Internal Control System….contd.

- **Inherent Limitations:**

1. Management position to override controls;
2. Human error;
3. Circumvention through collusion;
4. Unusual transactions;
5. Nature of MIS (cost, skill etc.)

Letter of Weakness

Internal Check – a part of ICS

- A concept related to Organisational Independence;
- Employees perspective
- **Essentials of Good Internal Check System:**

1. Define authorities/ duties & responsibilities;
2. Division of responsibilities as per abilities;
3. Single work amongst different employees;
4. Regular job rotation;
5. Instruction manuals;
6. More usage of electronic system;
7. Various correspondence under proper authority;
8. Daily cash receipts for daily bank deposit

- **Very Important Point** = Everything under **Authorisation(s)**

Nature, Timing & Extent of Audit Procedures

- The nature timing and extent of planned audit procedures is a way of describing the contents of the audit program for an audit engagement.
- ***Nature:*** The nature of a planned audit procedure refers to both the **type of procedure** and **method used** to gather the evidence.
- The greater the *risk of material misstatement [RMM]* the more reliable & planned method used in substantive testing. In this regard, tests of detail are considered to gather more reliable evidence than analytical procedures;

Audit stage	Type of procedure	Manual methods of gathering evidence include:
Substantive testing	Test of detail	Physical examination, recalculation, confirmation, vouching, cut-off test, inquiry.
	Analytical procedure	Reasonableness test, ratio analysis, roll-forward procedure.

Nature, Timing & Extent of Audit Procedures……..contd.

- ***Timing:*** The timing of a planned audit procedure refers to **when the audit procedure is to be performed.**
- Audit procedures may be performed prior to balance date (e.g. during interim visits), on balance date or after balance date (e.g. during final visit).
- The greater the RMM relating to a particular account balance assertion, the more critical is the timing of the substantive testing procedure.
- For example, if the RMM relating to the validity of inventory is high, the auditor will plan substantive procedures relating to the validity [existence] of the account balance (for example, inventory counts) to be performed on balance date, but not before or after balance date. If this risk is not high, then the timing of these procedures is not as critical.

Nature, Timing & Extent of Audit Procedures……..contd.

- ***Extent:*** The extent of planned audit procedures simply refers to the **extent of the nature of the procedures.**
- For example,
- How many purchases invoices require vouching?
- How many computations (e.g. quantity on hand x unit cost) should be checked?
- The greater the RMM the more extensive the planned evidence gathered.

Audit – Whether related to Propriety of Business

- **Propriety????:**

1. It is Quality of being Appropriate
2. Section 227 (1A) & (4A) of the Companies Act, 1956;
3. CARO

- **Future Viability and Audit Opinion????**
- **Confidentiality (AAS 1)**

Prevention & Detection of Errors and Frauds (AAS 4)

- **Errors** – Unintentional;
- **Frauds** – Intentional
- Financial Statements responsibility of the management;
- **Material cases reported** to Management;
- Diligent Auditor not responsible for deep frauds committed by Management ***(Re Kingston Cotton Mills Case)***

Vouching & Verification

- Both are distinctive terms;
- Teeming & Lading fraud can be traced
- **Basic Elements of Vouching & Verification:**

1. ICS and Internal Checks;
2. Applicable regulatory requirements, if any;
3. Accounting Framework, if any;
4. Cut off Procedures;
5. VCREP;
6. Substantive Procedures

Whether MR Required??????

AAS 23 : Related Parties

- **Auditor and RP?????**
- RP?
- RPT?
- MR required?
- Process to identify RP/ RPT?

Audit Risk (AAS – 6)

- 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
- A financial statement item includes any related notes to the financial statements

Audit Risk…….contd.

- Audit risk ranges anywhere from zero (0.0), where there is complete certainty of no material misstatement, to one (1.0), where there is complete certainty of a material misstatement
- In practice, however, audit risk is always greater than zero, due to the limitations inherent in both accounting and auditing

Components of Audit Risk

- the risk of a material misstatement of a financial statement item in the unaudited financial statements [RMM] and
- the risk that the misstatement will not be detected by the auditor (equal to one minus the probability of detection by the auditor, (1 - Pr(Da))
- Thus, if there was a 50% risk of a material misstatement in a financial statement item in the unaudited financial statements and a probability of 80% that the misstatement would be detected by the auditor, audit risk, or the risk of a material misstatement in the audited financial statements would be equal to 10%. i.e.
- AR = RMM x (1 - Pr(Da)) = 0.5 x (1 - 0.8) = 0.10

Decomposing RMM in Unaudited Financial Statements

- the inherent risk of a material misstatement occurring (RMMi) and
- the risk that it will not be detected by the entity (equal to one minus the probability of the entity detecting the misstatement (1 - Pr(De)).
- Thus, substituting the two components of RMM, audit risk can be mathematically defined as follows:
- AR = RMMi x (1 - Pr(De)) x (1 - Pr(Da))
- Thus, if there was:
- an 80% inherent risk of a material misstatement in a financial statement item,
- a 30% probability of such a misstatement being detected by the entity, and
- a probability of 40% that, if not detected by the entity, the misstatement would be detected by the auditor,
- audit risk, or the risk of a material misstatement in the audited financial statements would be equal to 33.6%. i.e.
- AR = RMMi x (1 - Pr(De)) x (1 - Pr(Da))= 0.8 x (1 - 0.3) x (1 - 0.4) = 0.336

Decomposing RMM in Unaudited Financial Statements…….contd.

- The three components of audit risk (RMMi, 1 - Pr(De), and 1 - Pr(Da)), are referred to respectively as inherent risk [IR], control risk [CR] and detection risk [DR].
- This gives rise to the audit risk model of: AR = IR x CR x DR,
- IR, inherent risk, is the perceived level of risk that a material misstatement may occur in the client's unaudited financial statements, or underlying levels of aggregation, in the absence of internal control procedures. In the last example above, inherent risk was 80%.
- CR, control risk, is the perceived level of risk that a material misstatement in the client's unaudited financial statements, or underlying levels of aggregation, will not be detected and corrected by the management's internal control procedures. In the last example above, control risk was 70%.
- DR, detection risk, is the perceived level of risk that a material misstatement in the client's unaudited financial statements, or underlying levels of aggregation, will not be detected by the auditor. In the last example above, detection risk was 60%.

Evaluating Audit Risk

- In practice, however, auditors evaluate risk components using terms such as LOW, MODERATE or HIGH rather than using precise probabilities
- There are two distinct concepts of audit risk - the acceptable level of audit risk and the achievable level of audit risk.
- The acceptable level of audit risk [AR*] is the risk of a material financial statement misstatement that is acceptable to the auditor.
- The achievable level of audit risk [AR] is the risk the audited financial statements will contain a material misstatement.

Relationship between different components of Audit Risk

		Auditors' assessment of control risk		
		High	Medium	Low
Auditors' assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

Relationship between different components of Audit Risk……..contd.

- The shaded areas in this table relate to detection risk.
- The auditor should make a combined assessment of the inherent and control risks.
- This is because the management often reacts to inherent risk situations by designing suitable accounting and internal control system to prevent or detect and correct material misstatement.
- There is an inverse relationship between detection risks and the combined level of inherent and control risks.