3. PREPARATION FOR AN AUDIT

CONCEPT 1 - AGREEING THE TERMS OF ENGAGEMENT

Q.No.1. State the purpose of letter of engagement? (C) (PM)

1. **STATUTORY AUDIT:**
   - **a)** The legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies.
   - **b)** In these cases, the respective law governs the appointment of auditors and their duties.
2. **NON-STATUTORY AUDIT:**
   - **a)** In this case, it is a matter of contract.
   - **b)** The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms.
   - **c)** In such cases, there may be a misunderstanding about the exact scope of the work.
   - **d)** It is, therefore, of the greatest importance, both for the accountant and client, that each party should be clear about the nature of the engagement. It must be reduced in writing and should exactly specify the scope of the work so that the possibility of misunderstanding is reduced to a great extent.
   - **e)** The audit engagement letter is sent by the auditor to his client which documents, the objective and scope of the audit, the extent of his responsibilities to the client and the form of report.
   - **f)** SA 210 lays down the standards on agreeing the terms of the engagement with the client and the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

Q.No.2. "An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so." Discuss? (B) (PM, RTP M15, M17)

Before completing the audit engagement, if the auditor is requested to change the terms of engagement, then the auditor shall determine whether there is reasonable justification for doing so.

1. **REQUEST FOR CHANGE IN TERMS OF ENGAGEMENT:** A request from the client for the auditor to change the engagement may result from
   - **i)** Change in circumstances,
   - **ii)** Misunderstanding as to the nature of an audit or related service originally requested or
   - **iii)** Restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

   The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.
2. **ACCEPTANCE OF CHANGE IN TERMS OF ENGAGEMENT:**
   - **a)** If there is a reasonable justification, the auditor can accept to change the terms of engagement.
   - **b)** Further the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
   - **c)** In order to avoid confusion, the report would not include reference to the original engagement; or any procedures that may have been performed in the original engagement.

3. NON-ACCEPTANCE OF CHANGE IN TERMS OF ENGAGEMENT:

a) The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.

b) If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

i) Withdraw from the audit engagement where possible under applicable law or regulation; and

ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

SIMILAR QUESTION:

1. Mr. Intelligent, a Chartered Accountant, was engaged by XYZ Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors which was accepted by the Company. In the course of audit of the company, Mr. Intelligent was unable to obtain appropriate sufficient evidence regarding receivables. The client further requested for a change in the terms of engagement. (PM, RTP N15, N09 – 5M)

A. Refer above answer.

Q.No.3. "P" an auditor decides not to send a new audit engagement letter to G ltd every year. Whether he is right in his approach? State the circumstances where sending new engagement letter, would be appropriate. (A) (PM, N11 – 5M, N14 – 5M N15 – 5M)

1. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

2. The auditor may decide not to send a new audit engagement letter or other written agreement each period. **(N 17 – 2M)**

3. CIRCUMSTANCES WHEN IT IS APPROPRIATE TO SEND A NEW ENGAGEMENT LETTER FOR A RECURRING AUDIT:

a) Any indication that the entity misunderstands the objective and scope of the audit.

b) Any revised or special terms of the audit engagement.

c) A recent change of senior management.

d) A significant change in ownership.

e) A significant change in nature or size of the entity's business.

f) A change in legal or regulatory requirements.

g) A change in the financial reporting framework adopted in the preparation of the financial statements.

h) A change in other reporting requirements. For example, CARO, 2016.

SIMILAR QUESTIONS:

1. "It is not mandatory to send a new engagement letter in recurring audit, but sometimes it becomes mandatory to send new letter". Explain those situations where new engagement letter is to be sent. (PM, N11 – 5M)

A. Refer above answer.

2. Indicate the factors which make it appropriate for an auditor to send a new engagement letter for a recurring audit. (N14 – 5M)

A. Refer above answer.

CONCEPT 2 - OBTAINING AN UNDERSTANDING OF THE BUSINESS OF CLIENT

Q.No.4. In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315. (B) (PM)

1. The auditor needs to obtain knowledge of the client's business in order to understand the classes of transactions, account balances, and disclosures in the financial statements.

2. The auditor shall obtain an understanding of the following:

- **a)** Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
- **b)** The nature of the entity, including:
  - **i)** its operations;
  - **ii)** its ownership and governance structures;
  - **iii)** the types of investments that the entity is making and plans to make, and
  - **iv)** the way that the entity it is financed;
- **c)** The auditor shall evaluate
  - **i)** the entity's selection and application of accounting policies
  - **ii)** whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
  - **iii)** the reasons for changes in accounting policies.
- **d)** The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- **e)** The measurement and review of the entity's financial performance.

SIMILAR QUESTIONS:

1. State the matters to be considered for acquiring knowledge of the business of the client by the auditor.

A. Refer above answer.

2. Auditor is required to identify and assess the risk of material misstatement through understanding the entity and its environment. Explain the various matters of which auditor should obtain understanding? (RTP N17)

A. Refer above answer.

Q.No.5 Write a short note on: Sources of obtaining knowledge of Client's business. (C) (PM, N17 – 6M, M09 – 5M)

An Auditor Can Obtain This Information From:

- **a)** Clients annual report to shareholders;
- **b)** Minutes of shareholders/board of directors;
- **c)** Internal financial management reports of current & previous year;
- **d)** Previous year audit working papers
- **e)** Discussion with client
- **f)** Publications like trade journals, magazines, newspaper and
- **g)** Visit to client's premises.

SIMILAR QUESTIONS:

1. **Write a short note on: knowledge of Client's business. (PM, M 09 – 5M)**

A. Refer above answer.

CONCEPT 3 – AUDIT STRATEGY AND AUDIT PROGRAMME

Q.No.6 Discuss the factors the auditor will consider while establishing the overall strategy? (B) (M16 RTP)

1. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan
2. In establishing the overall audit strategy, the auditor shall;
   a) Identify the characteristics of the engagement that define its scope;
   b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
   c) Consider the factors that are significant in directing the engagement team's efforts;
   d) Consider the results of preliminary engagement activities.
   e) Ascertain the Nature, Timing and Extent of procedures.

SIMILAR QUESTIONS:

1. **"Auditor shall establish an overall strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan." Comment (M11 – 5M)**

A. Refer above answer.

Q.No.7. Write a short note on Audit Programme. (C) (PM, M16 RTP)

1. **MEANING:** An audit programme is a detailed plan of applying the audit procedure in the given circumstances for accomplishing the audit objectives.
2. **FRAMING OF AUDIT PROGRAMME:**
   a) It is framed keeping in view of the following:
      - The nature, size and composition of the business,
      - Dependability of the internal control and
      - The given scope of work.
   b) The following points should be included in framing an audit programme:
      i) Audit objective
      ii) Audit procedure to be applied
      iii) Extent of check
      iv) Timing of check
      v) Allocation of work amongst the team members
      vi) Special instructions based on past experience of the client.
3. It provides sufficient details to serve as a set of instructions to the audit team and also helps to control proper execution of work.
4. **Periodical Review:** There should be periodic review of the audit programme to assess, whether
   a) It continues to be adequate for obtaining evidence about the transactions or

b) It is required to be altered -

i) To include some additional works which were left out originally, but found relevant for the particular audit situation (or)

ii) To drop any original work framed earlier that was found to be unnecessary (or) irrelevant.

SIMILAR QUESTIONS:

1. "An audit programme is a detailed plan of applying the audit procedure in the given circumstance for accomplishing the audit objectives". Discuss (M16 RTP)

A. Refer above answer.

Q.No.8. What are the advantages of use of Audit programme? (A) (RTP M17, N13 – 5M, M16 – 5M)

A. ADVANTAGES / ROLE OF AUDIT PROGRAMME IN AUDIT PLAN AND PERFORMANCE: The audit programme is helpful both in planning and performance stages of audit, as stated below

1. The audit programme lists down areas of audit before commencement. So it contains entire perspective of audit
2. The audit timing is built therein; thereby it becomes a schedule of audit plan.
3. Selection of assistants for the jobs on the basis of capability becomes easier.
4. It provides clear set of instructions of the work to the assistants carrying out the audit.
5. Since the assistants sign the programme after completing their work, it holds their responsibility for the work performed.
6. The working papers of the audit staff can be reviewed in comparison with the audit programme for evaluating the performance of audit staff.
7. It also helps in preparing a diary of the performance and also base for billing the clients for the time and manpower involved in the audit.

B. OTHER ADVANTAGES:

1. It serves as a guide for audits to be carried out in the succeeding year.
2. A properly drawn up audit programme serves as evidence in the court of law to prove that the auditor has exercised reasonable skill and care when the auditor is charged with gross negligence.

SIMILAR QUESTIONS:

1. How does an audit programme help to plan and perform the audit? (M16 – 5M)

A. Refer point no. A in above for all these questions.

2. Explain the role of Audit Programme in Audit Plan and Performance?

A. Refer point no. A in above for all these questions.

3. Despite of several disadvantages, audit programme is required to start an audit. Discuss. (N13 – 5M)

A. Refer above answer.

Q.No.9. What are the disadvantages of the use of an Audit Programme? (B) (N15 RTP, M12 – 4M)

Some disadvantages are also there in the use of audit programme but most of them can be removed by taking some concrete steps. The disadvantages are:

1. The audit assistants may feel mechanical and may carry out their work without any understanding.
2. The programme may become rigid and inflexible with respect to the changes in business, such as changes in internal control at a certain area may require changes in audit programme from those originally drafted.
3. Inefficient assistants may escape from their responsibilities on the ground that no instruction is contained therein with respect to a certain matter.
4. A fully standardized audit programme may kill the initiative of efficient and enterprising assistants.

SIMILAR QUESTIONS:

1. **"All the disadvantages of audit program may be eliminated by imaginative supervision of the work carried on by the assistants." Explain stating the advantages and disadvantages of an audit program. (RTP M17)**

A. Refer 8th and 9th Questions.

Q.No.10. What are the precautions to be taken by the auditor to overcome the disadvantages of audit programme? (C) (FOR STUDENTS SELF STUDY)

The disadvantages of Audit programme may be eliminated by taking the following precautions:

1. The audit assistants should be consulted while preparing the audit programme.
2. The auditor should thoroughly review the internal control system of the client's & find out the areas of weaknesses and design his audit programme accordingly so that these areas may be covered thoroughly.
3. The audit programme should also be changed if the auditor finds that some new business or new systems has been adopted by his client.
4. The auditor should change the audit programme from time to time so that it does not become sterotyped.
5. There should be frequent audit assistants meetings so that all audit staff can exchange their experiences with others.

Q.No.11. Describe set of instructions which an auditor has to give to his client before starting the actual audit. (C) (PM, N14 RTP, N09 - 4M)

FOLLOWING INSTRUCTIONS ARE GIVEN BY THE AUDITOR TO THE CLIENT BEFORE THE START OF AUDIT:

a) The accounts should be totaled up and trial balance and final accounts to be kept ready.
b) Vouchers should be serially arranged.
c) Schedule of trade receivables and trade payables should be prepared.
d) Schedule of outstanding expenses, prepaid expenses and accrued income to be kept ready.
e) A list of bad and doubtful debts should be prepared.
f) Schedule of investments should be prepared.
g) Certified list of goods returned to be prepared.
h) Statement of permanent capital expenditure to be prepared.
i) Schedule of deferred revenue expenditures to be prepared.
j) Names and addresses of managers and other officers should be kept ready.

ALTERNATIVE ANSWER:

a) It is the responsibility of the management to prepare the financial statements, to select and consistently apply the appropriate accounting policies.

b) Management is responsible for the maintenance of adequate accounting records and internal controls for safeguarding assets of the company.

c) Unrestricted access to whatever records, documentation and other information required in connection with the audit.

d) Management's responsibility for making judgments of estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity.

e) Management's responsibility for preparation of the financial statements as a going concern.

CONCEPT 4 – AUDIT WORKING PAPERS (OR) AUDIT DOCUMENTATION

Q.No.12 Write a short note on: Audit working papers. (A) (PM)

1. MEANING: As per SA 230 "Audit Documentation", Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

2. PURPOSES OF AUDIT DOCUMENTATION: **(PM, RTP N14, M11 – 5M, M15 - 6M)**

   a) Assisting the engagement team to plan and perform the audit.

   b) It provides guidance to the audit staff with regard to the manner of checking the schedules

   c) To fix responsibility on the staff member who signs each schedule checked by him.

   d) Assisting members of the engagement team for properly directing and supervising and reviewing in accordance with SA 220.

   e) Retaining a record of significant matters to future audits.

   f) Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

   g) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

   h) Acting as an evidence that

      i) The audit was properly planned and performed in accordance with SAs and applicable legal and regulatory requirements and

      ii) The conclusions reached are appropriate on the basis of results of audit procedures performed.

   The auditor should

   - Adopt reasonable procedures for custody and confidentiality of his working papers and
   - Retain them for a period of time sufficient to meet the needs of his practice and any legal or professional requirements.

3. OWNERSHIP:

   a) Unless otherwise specified by law or regulation, audit documentation is the property of the auditor.

   b) He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine

      i) The validity of the work performed, or,

      ii) The independence of the auditor or of his personnel in the case of assurance engagements.

4. **RETENTION PERIOD:** The retention period for audit engagements ordinarily is minimum seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.
5. **CUSTODY:** The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and

SIMILAR QUESTIONS:

1. **Explain advantages of "Audit working papers". (PM, RTP N17,RTP N14)**

A. Refer point no. 2 in above answer.

2. **Explain in briefly the utility of Working Papers to an auditor.**

A. Refer point no. 2 in above answer.

3. **Importance of Audit working papers. (M15 – 4M, N11 – 4M, N13 – 4M)**

A. Refer point no. 2 in above answer.

4. **Discuss clearly the objectives of audit working papers?**

A. Refer point no. 2 in above answer.

5. **"Audit documentation serves a number of additional purposes." Explain with reference to SA-230. (M11 – 5M, M15 – 6M)**

A. Refer point no. 2 in above answer.

6. **What does SA 230 says about utility, ownership, custody and retention of working papers? (PM)**

A: Refer point no. 2 (first two points), C, D and E in above answer.

7. **What are audit working papers and why should they be carefully preserved by the Auditor? (PM, N14 RTP)(N17 – 5M)**

A. Refer above answer.

8. **The audit working papers constitute the link between the auditor's report and the client's records. Discuss stating clearly the objectives of audit working papers. (N16, M15 RTP)**

A. Refer above answer.

(REFER PRACTICAL QUESTIONS – 1, 2, 3)

Q.No.13 Discuss the principles which govern the form and content of working papers? (A) (PM, M13 – 5M, N15 – 4M)

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

SIMILAR QUESTIONS:

1. **The form, contents and extent of audit documents depend on certain factors. Explain with reference to SA 230. (N15 – 4M)**

A. Refer above answer.

2. **Factors effecting the form, contents and extent of audit documentation. (PM, M13 – 5M)**

A. **Refer** above answer.

Q.No.14. Discuss various contents of Permanent Audit File and Current File. (A)(PM, N12 – 8M)

MEANING: As per SA 230 "Audit Documentation", Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

In case of recurring audits, auditors generally prepare two types of audit files.

1. **PERMANENT AUDIT FILE:** It includes –
   - **a)** Information regarding the legal and 9rganizational structure of the entity. For example MOA & AOA.
   - **b)** Copies of important legal documents, agreements and minutes relevant to the audit.
   - **c)** A record of the study and evaluation of the internal controls.
   - **d)** Copies of audited financial statements for previous years.
   - **e)** Analysis of significant ratios and trends.
   - **f)** Record of communication with the retiring auditor.
   - **g)** Notes regarding significant accounting policies.
   - **h)** Significant audit observations of earlier years.
   - **i)** List of officers, their financial powers and authorities.
   - **j)** List of offices, factories, godowns, depots etc.,
2. **CURRENT AUDIT FILE:** It includes
   - **a)** Correspondence relating to acceptance of annual reappointment.
   - **b)** Annual letter of engagement and letter of weakness, if any sent by the auditor to the management.
   - **c)** Evidence of the planning process of the audit and audit programme.
   - **d)** Analysis of transactions and balances.
   - **e)** A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.
   - **f)** Copies of communications with other auditors, experts and other third parties.
   - **g)** Written representations or confirmation received from the client.
   - **h)** Conclusions reached by the auditor concerning significant aspects of the audit.
   - **i)** Copies of current year financial statements and related information and the related audit reports.
   - **j)** Extracts of matters in the minutes of Board Meetings (BM) and General Meetings(GM), as are relevant to the audit.

SIMILAR QUESTIONS:

1. **What are the Audit Working Papers? Discuss various contents of current file?**

A. Refer meaning and point no. 2 in above answer. **(N12 – 8M)**

2. **What are the Audit Working Papers? Discuss various contents of permanent file and current audit file? (PM)**

B. Refer above answer.

Q.No.15. Write short notes on Audit Note-book and what are the contents of Audit Note Book. (A) (PM, M 16 – 6M)

1. **MEANING:**
   - An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded.

- It forms part of audit working papers and for each year a fresh audit note book is maintained.

2. CLASSIFICATION:

   a) If an auditor classifies his working papers into permanent and current then audit note book shall form part of current file.

   b) In any case, it is a part of permanent record of the auditor which is available for future reference, if required.

3. ADVANTAGES:

   a) It helps in picking up the links of work when the concerned assistant is away or the work is stopped temporarily.

   b) It is also used for recording various queries raised in the course of the work and their state of disposal.

      i) In respect of disposed queries, explanation obtained and evidence seen would be recorded in the said book,

      ii) While queries remaining undisposed of, would be noted for follow up.

4. CONTENTS OF AUDIT NOTE – BOOK: It contains significant matters observed during the course of audit, a record of which should be kept in audit note book, normally include the following:

   i) Audit queries that are not cleared immediately.

   ii) Mistakes and Irregularities observed during the course of audit.

   iii) Unsatisfactory book-keeping arrangements, costing method.

   iv) Important information about the company which is not apparent from the accounts.

   v) Special points requiring consideration at the time of verification of annual accounts.

   vi) Important matters for future reference.

SIMILAR QUESTIONS:

1. **Write short on contents of Audit note book? (PM, M08 – 5M)**

A. Refer point no. 4 in above answer.

2. **What are the significant matters observed during the course of audit, a record of which should be kept in audit note book? (M 16 – 6M)**

A. Refer point no. 4 in above for answer.

3. **Write short on Audit Note Book? (PM)**

A. Refer 1, 2, 3 points in above answer.

CONCEPT 5 – TEST CHECKING/ SAMPLING

Q.No.16. Define the term Test Checking and state the circumstances under which it can be applied and cannot be applied. (C)

A. TEST CHECK: The term "test check" stands for Examination of a few selected transactions instead of a complete examination of all the transactions.

B. DETERMINATION OF EXTENT OF TEST CHECK: The extent of test checking is determined on the basis of examination of Internal Control system.

   1. If the system is found good, the detailed checking is curtailed and

2. if the system is weak, more detailed checking would be undertaken.

However, checking cannot be completely eliminated, it can only be scaled down or up.

C. CIRCUMSTANCES UNDER WHICH TEST CHECKS CAN BE ADOPTED:

1. In case of big concerns where number of transactions is quite large.
2. When the Auditor has very little time left for audit.
3. Number of transactions are quite repetitive or homogeneous in nature.
4. Existence of satisfactory internal control system.

D. CIRCUMSTANCES UNDER WHICH TEST CHECKS CANNOT BE ADOPTED:

1. Opening and closing balances.
2. Matters involving estimation and computation. Example, depreciation, taxation etc.
3. Presentation and disclosure of information in the financial statements.
4. Items which are material.
5. Transactions which the auditor is expected to check as required by law, e.g., transactions as referred to in Sec.143 (1) and Sec.143 (3) or computation of managerial remuneration.
6. Transactions of non-recurring nature (like export sales) or exceptional transactions.
7. When the internal control system is weak.

SIMILAR QUESTIONS:

1. **Name some transactions not suitable for test checking? (PM)**

A. Refer point no. D above in the above answer.

Q.No.17. What precautions should be taken by an auditor while applying test check techniques? (A) (PM, M15 RTP, M16 RTP, M14 - 8M, M 16 – 4M)

WHILE ADOPTING TEST CHECK TECHNIQUE, AN AUDITOR SHOULD TAKE FOLLOWING PRECAUTIONS:

1. Identification of the areas where test check may not be done.
2. The transactions of the concern should be classified under appropriate heads and may be stratified in case of wide variations between the transactions of the same kind.
3. Authorizations, documentations, recording of the transactions should be studied right from the beginning to end.
4. Examination of Internal control system to determine its strengths and weaknesses.
5. Preparation of test check plan with clear audit objective.
6. Based on examination of internal control system, the number of transactions to be selected for each test plan should be pre-determined.
7. Un-biased selection of the transactions with reference to the random number tables or other statistical methods.
8. Setting up criteria to judge what constitute material or immaterial errors.
9. Conducting of test checking according to the test check plan.
10. Further investigation of only material errors be carried out and all immaterial errors may be avoided.

SIMILAR QUESTIONS:

1. **You are the auditor of the company. What precautions you will suggest in adopting test checking technique for audit work? (M14 – 8M)**

A. Refer above answer

Q.No.18. What is meant by audit sampling? And what are the requirements relating to Sample Design, Sample Size and Sample Selection of items for testing as per SA 530? (A) (M16 – 5M, N13 – 5M, M16 RTP, PM)

AUDIT SAMPLING: The application of audit procedures to less than 100% of items within a population such that all sampling units have a chance of selection in order to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

1. **Sample Design**: When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.
2. **Sample Size:** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
3. **Sample Selection:** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

SIMILAR QUESTIONS:

1. **As per SA 530, discuss the meaning of audit sampling, sample design, sample size and selection of items for testing. (N13 – 5M, M16 RTP)**

A. Refer above answer.

Q.No.19. While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind? (C) (PM, N10 – 8M)

1. **MEANING:** The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.
2. **SAMPLING RISK CAN LEAD TO TWO TYPES OF ERRONEOUS CONCLUSIONS:**

   i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does.

   - It affects audit effectiveness and is more likely to lead to an inappropriate opinion.

   ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not.

   - It affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

SIMILAR QUESTIONS:

1. **"The auditor is faced with sampling risk in both the tests of control and substantive procedures". Comment on the statement with reference to SA 530. (PM, RTP N17)**

A. Refer above answer.

2. **Write a short note on: Sampling risk as per SA 530.**

A. Refer above answer.

Q.No.20. What is the meaning of sampling? Also discuss the methods of sampling. Explain in light of SA 530 " Audit Sampling"? (A) (PM, M15 RTP)

AUDIT SAMPLING: The application of audit procedures to less than 100% of items within a population such that all sampling units have a chance of selection in order to draw conclusions about the entire population.

METHODS OF SAMPLING:

1. **RANDOM SAMPLING:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below– **(RTP N17, M15 – 4M)**

   a) **Simple random sampling: (M12 – 4M)**

      i) Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected.

      ii) The selection of items is based on random number tables.

      iii) It is considered that random number tables are simple and easy to use and also provide assurance without any bias.

      iv) This method is suitable for homogenous populations without any wide variations.

   b) **Stratified Sampling: (M11 – 4M)**

      i) This is suitable in case of heterogeneous populations where there are wide variations within the population.

      ii) So it involves dividing the whole population into few separate groups called strata and taking a sample from each of them.

      iii) This process of dividing the population into groups is known as "**Stratification**".

      iv) Each stratum is treated as if it was a separate population and proportionate of items are selected from each of these stratum.

      v) The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

      vi) It can be seen that the stratified sampling is simply an extension of simple random sampling.

      vii) **For example,** while verifying the debtors balances the following strata may be formed: 0 to 25,000, 25,000 to 75,000, 75,000 to 1,00,000 & Over 1,00,000. In the above auditor may select all the items over 1,00,000 and reduce his % of checking gradually for other areas.

2. **SYSTEMATIC SELECTION:**

   a) **Block Selection:**

      i) This method involves selection of a block(s) of consecutive items from the population.

      ii) Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.

      E.g. first 200 invoices from the sales day book of September or any 4 blocks of 50 sales invoices. Similarly, all items in an alphabetical or numerical sequence may be selected e.g. all debtors with their names beginning with letter 'C'.

   b) **Cluster sample:**

      i) This method involves dividing the population into groups of items known as clusters.

      ii) A number of clusters are randomly selected from all the clusters rather than individual items of the population.

iii) The items of selected cluster can either be checked completely or a randomly selected proportion of them can be examined.

iv) As per SA 530, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

3. MONETARY UNIT SAMPLING: This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

4. HAPHAZARD SELECTION: **(N17 – 4M)**

a) In this method, the auditor selects the sample without following a structured technique.

b) Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability and thus attempt to ensure that all items in the population have a chance of selection.

c) Haphazard selection is not appropriate when using statistical sampling.

SIMILAR QUESTIONS:

1. Discuss the methods of Sampling in the light of SA 530 "Audit Sampling".

A. Refer above answer. **(N16 RTP)**

2. Write a short note on Stratified sampling. (PM, M11 – 4M)

A. Refer point no. 1 (b) in above answer.

3. Write a short note on Simple random sampling. (M12 – 4M)

A. Refer point no. 1 (a) in above answer.

4. Write a short note on Random sampling. (PM, M15 – 4M)

A. Refer point no. 1 in above Standard.

Q.No.21. Write short notes on Advantages of Statistical sampling in Auditing. (A)
(MTP N17, M14 – 4M, N11 – 4M, M08 – 5M)

1. Sample size does not increase in proportion to the increase in the size of population.
2. Sample selection is more objective and based on law of probability.
3. This provides the minimum sample size associated with a specified risk and precision level.
4. It also provides a means for deriving a calculated risk and corresponding precision.
5. It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistake are not large.

CONCEPT 6 – AUDIT RISK AND MATERIALITY

Q.No.22. Write a short note on Audit risk and Inter-relationship of its components.
(B) (N14 – 6M)

A. AUDIT RISK: Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated.

B. COMPONENTS OF AUDIT RISK: Audit risk is a function of the risks of material misstatement and detection risk.

1. Risk Of Material Misstatement:

The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows.

a) **Inherent risk:** It is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. **Eg.** Accounting estimates.

b) **Control Risk:** It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

2. **Detection Risk:** It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

C. **INTER-RELATIONSHIP OF COMPONENTS OF AUDIT RISK:**

1. The auditor cannot control the risk of material misstatement but he can only assess such risk and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.
2. 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.
3. For example, if the risks of material misstatement is high, then the auditor will perform more audit procedures there by the the detection risk is automatically reduced and vice versa.

Q.No.23. Explain the concept of materiality. (C) (PM, RTP M16)

1. **MEANING:** Misstatements are considered to be material if they, individually or in the aggregate, could influence the economic decisions of users taken on the basis of the financial statements.
2. **DETERMINATION OF MATERIALITY:**

a) If applicable financial reporting framework provides any reference to the auditor in determining materiality for the audit, then he shall consider such reference accordingly.

b) If there is no such reference, determination of materiality is a matter of professional judgment of auditor. In such case, Judgments as to what constitutes material is made according to the circumstances of each case by considering the following factors:

- Size of misstatement or
- Nature of misstatement
- Common financial information needs of users of the financial statements,

c) The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. **APPLICATION OF MATERIALITY:** The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Q.No.24. Explain concept of materiality and explain the factors which act as guiding factors to this concept. (B) (PM, N 09 – 6M, RTP N14)

CONCEPT OF MATERIALITY: Misstatements are considered to be material if they, individually or in the aggregate, could influence the economic decisions of users taken on the basis of the financial statements.

The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements. The concept of materiality is fundamental to the process of accounting.

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

FACTORS OR GUIDELINES FOR JUDGING MATERIALITY:

1. Materiality is a relative term. For example, Rs.1,000 may be a material amount for a small concern, but this may not be material for a large company.
2. Materiality is not only considered with respect to quantitative details but it also has qualitative dimensions.
3. Item of materiality may be determined individually or in aggregate. Several individual immaterial / unimportant items together may become a material amount in total.
4. Even a small amount may become material if its disclosure is essential statutorily. For example, a payment of Rs.100 to Directors as remuneration in excess of statutory limit will be material.
5. Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule III requires disclosure of items of expenditures which are in excess of one percent of the revenue from operations or Rs.1,00,000, whichever is higher.
6. No two material items should be set off against each other. For example, the surplus arising from a change in the accounting policy may not be set off against a non-recurring loss.
7. An item may not be important in current year but it was important when compared with previous year then that item would become material / important this year also.
8. A small mistake / fraud may be considered material if it converts a small profit into loss or vice-versa.

SIMILAR QUESTIONS:

1. **"SA 320 "Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items". Explain.**

A. Refer above answer. **(RTP N16)**

Q.No.25. Explain the relationship between Materiality and Audit risk. (A) (PM, N14 – 4M)

1. The auditor should consider materiality and its relationship with audit risk when conducting an audit.
2. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement. The audit should be planned so that audit risk is kept at an acceptably low level.
3. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality levels, the lower the audit risk and vice-versa.
   a) After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures.
   b) If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.
4. The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

CONCEPT 7 – FINAL AUDIT AND CONTINUOUS AUDIT

Q.NO.26. what is meant by final audit? What are its advantages and disadvantages? (B)

MEANING: A final or completed audit is commonly understood to be an audit which begins after the books have closed at the end of the accounting period and thereafter is carried on continuously until completed.
It is also called Annual or completed audit or periodical audit.

ADVANTAGES:

1. It is most economical in terms of time and cost.
2. It is suitable for small businesses.
3. Such audit does not disturb the work of the client's staff, since the books of accounts are already prepared and handed over to the auditor for audit.
4. Since it is done at one time, the auditor will not lose the continuity of his work and also there is no need of having to return on separate occasions to complete the work.
5. The possibility of figures being altered after work has been done is also avoided since the audit is carried at a time.

DISADVANTAGES:

1. Not suitable for large organizations.
2. Complete checking is not possible since the time available for audit is less.
3. Since the auditor goes for test checking, the chances of non detection of frauds and errors is high.
4. It is not much effective in improving the moral check over the client's staff.
5. Frauds and errors are detected at the year end.
6. Accounting periods of several clients may end on the same date, and thus difficulties may be experienced in allocating audit staff.
7. Client's staff may not maintain books of account up-to-date since the audit is commenced after the end of the financial year.

Q.No.27. What is meant by Continuous Audit? What are its advantages and disadvantages? (A) (PM)

MEANING: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round at quite frequent intervals say weekly, monthly, quarterly etc.
It is also known as detailed audit.

ADVANTAGES / CONTINOUS AUDIT IS PREFERRED FOR THE FOLLOWING REASONS:

1. It is suitable for large organizations.
2. Detailed examination is possible since audit is conducted in a phased manner.
3. Since the auditor goes for detailed checking, the chances of non detection of frauds and errors is less.
4. The frequent attendance by the audit staff acts as moral check on the employees of the client from committing a fraud.
5. Early detection of frauds and errors even before closure of financial year.
6. Optimum utilization of audit resources such as efficient allocation of audit assistants is possible.

7. The accounting staff of the client is motivated to keep the books of account up-to date.
8. The constant association of the auditor with the accounts and the affairs of the client provide him with an opportunity to obtain a more detailed knowledge of the client's affairs, thereby he can discharge his duties more efficiently.

DISADVANTAGES / DRAWBACKS:

1. It is time consuming and very expensive. Hence not economical for small organizations.
2. It causes more inconvenience to the client staff since auditor frequently visits their office.
3. Due to the audit being carried out in several installments, the audit staff may fail to keep track of things which they had not checked on their last or an earlier visit as a result the auditor is likely to lose the continuity of work.
4. There is a possibility of alteration of audited figures by the client's staff, after completion of audit.

Q.No.28. What is continuous audit and what are the precautions that should be taken to avoid the disadvantages of continuous audit? (A) (PM, M13 - 8M, N15 – 4M)

MEANING: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round at quite frequent intervals say weekly, monthly, quarterly etc.

PRECAUTIONS TO OVERCOME THE DISADVANTAGES OF CONTINUOUS AUDIT:

1. During the course of each visit, work should be completed up to a definite stage so as to avoid loose ends.
2. At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.
3. The visits should be at irregular intervals of time so that the client's staff
   - May not in advance know the exact date when the audit would be resumed and
   - Thus may not be able to prepare themselves in advance for the same.
4. The nominal accounts should be checked only at the time of final closing.
5. The client's staff should be instructed not to alter or correct audited figures. The auditor should also place a special form of ticks against figures altered and neither its purpose nor significance should be disclosed to the client's staff.

QUESTIONS FOR ACADEMIC INTEREST – FOR STUDENT SELF STUDY

Q.No.29. Write a short note on 'Matters that the auditor may consider when obtaining an understanding of the nature of the entity'. (C) (PM)

Following are some of the examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity-

1. **Business operations** – such as:

   Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.

   i) Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).

   ii) Alliances, joint ventures, and outsourcing activities.

   iii) Geographic dispersion and industry segmentation.

iv) Location of production facilities, warehouses, and offices, and location and quantities of inventories.

v) Key customers and important suppliers of goods and services, employment arrangements.

vi) Research and development activities and expenditures.

vii) Transactions with related parties.

2. **Investments and investment activities – such as:**

i) Planned or recently executed acquisitions or divestitures.

ii) Investments and dispositions of securities and loans.

iii) Capital investment activities.

iv) Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

3. **Financing and financing activities – such as:**

i) Major subsidiaries and associated entities, including consolidated and non consolidated structures.

ii) Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.

iii) Beneficial owners (local, foreign, business reputation and experience) and related parties.

iv) Use of derivative financial instruments.

4. **Financial reporting – such as:**

i) Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).

ii) Revenue recognition practices.

iii) Accounting for fair values.

iv) Foreign currency assets, liabilities and transactions.

v) Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

Q.No.30. "In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed". Comment. (C) (PM)

1. **Selection of Audit Sample:** Audit Sampling 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 characteristics of the items selected in order to form or assist in forming a conclusion concerning the population.
2. The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.
3. Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.
4. In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.
5. Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

Q.No.31. Explain the Inherent Risk with reference to the relevant Standards on Auditing? (C) (PM)

Inherent Risk: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
As per **SA 330 "The Auditor's Responses to Assessed Risks"** , while designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account
balance, or disclosure (i.e., the inherent risk) and obtain more persuasive audit evidence the higher the auditor's assessment of risk.

As per **SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment"**, for this purpose, the auditor shall:

1. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
2. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
3. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
4. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

PRACTICAL QUESTIONS

Q.No.1. Should branch auditor of a company comply with the request of the principal auditor of the company to give photocopy of the working papers pertaining to the branch audit? Explain. (PM)

<u>OWNERSHIP OF WORKING PAPERS</u>: As per SA 230 "Audit Documentation", working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is not required to provide the clients or other auditors' access to his working papers.

Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

Q.No.2. M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year. (PM)

<u>OWNERSHIP OF WORKING PAPERS:</u> As per SA 230 on "Audit Documentations" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor's exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can't insist upon the auditor to handover the working papers of the previous year.

Q.No.3. R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director? (N10 – 4M)

OWNERSHIP OF WORKING PAPERS: As per SA 230 on "Audit Documentations" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement. Working papers are the important records of the auditor. They serve as evidence of the auditor's exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Therefore, the managing directors of the company cannot demand copies of working papers from the auditor.

SA 210 (REVISED) AGREEING THE TERMS OF AUDIT ENGAGEMENTS (ON OR AFTER APRIL 1, 2010)

1. ***Scope of this SA:*** *This Standard on Auditing (SA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance.*
2. ***Effective Date:*** *This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.*

A. OBJECTIVE OF AUDITOR:

The objective of the auditor is to accept or continue an audit engagement only after satisfying the following two requirements:

a) Establishing whether the preconditions for an audit are present and

b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

3. PRECONDTIONS FOR AN AUDIT:

1. **Financial reporting framework:** Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and
2. **Management responsibility:** Obtain an agreement from the management that they are accepting their responsibility for the following activities:

a) Preparation of the financial statements in accordance with the applicable financial reporting framework.

b) Designing and implementing necessary internal control to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

c) To provide the auditor with:

- Access to all information such as records, documentation and other matters;

- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

4. PURPOSE OF LETTER OF ENGAGEMENT: Refer Q.no.1 in above.
5. CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT: Refer Q.no.2 in above.
6. RECURRING AUDITS: Refer Q.no.3 in above.

EXAMINATION QUESTIONS:

1. **Write short on Pre conditions for an audit?**

A: Refer point no. B in above Standard.

SA 230 (Revised) AUDIT DOCUMENTATION (w.e.f. 1st April' 2009)

1. ***Scope of this SA:*** *This Standard on Auditing (SA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.*
2. ***Effective Date:*** *This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.*

A. DEFINITIONS:

1. **Audit documentation:**
   - **i)** It refers to a record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. It is commonly known as "working papers" or "Work papers".
   - **ii)** **Examples:** Audit program, audit plan, audit note book etc.
   - **iii)** Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit.
   - **iv)** The auditor may include abstracts or copies of entity's records as a part of audit documentation. But audit documentation, however, is not a substitute for entity's accounting records.
2. **Audit file:** One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
3. **Experienced auditor:**
   - **a)** An individual, who has practical audit experience, and a reasonable understanding of the following:
     - **i)** Audit processes.
     - **ii)** SA's and applicable legal and regulatory requirements.
     - **iii)** The business environment in which the entity operates and
     - **iv)** Auditing and financial reporting issues relevant to the entity's industry.
   - **b)** He may be internal or external to the firm appointed as auditor.

B. PURPOSE OF AUDIT DOCUMENTATION: Refer Q.no.12 (B) in above.

(PM, RTP N14, M11 – 5M, M15 - 6M)

C. FORM, CONTENT AND EXTENT OF AUDIT DOCUMENTATION:

1. **Manner of preparing the audit documentation as a whole:** The auditor shall prepare audit documentation in such a way that it will enable an experienced auditor, having no previous connection with the audit, to understand:

a) The nature, timing, and extent of the audit procedures performed.

b) The results of the audit procedures performed, and the audit evidence obtained; and

c) The conclusions reached thereon, and significant matters raised and significant professional judgments made in reaching those conclusions.

2. **Manner of documenting the Audit procedures:** In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

a) The characteristics of the specific items or matters tested;

b) Persons who performed the audit work and the date on which such work was completed

c) Persons who reviewed the audit work performed and the date and extent of such review.

3. **Factors effecting the Form, content and extent of Audit documentation:**

Refer Q.no.13 in above. **(PM, M13 – 5M) (N15 – 4M)**

D. **MATTERS ARISING AFTER THE DATE OF THE AUDITOR'S REPORT:**

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

a) The circumstances encountered;

b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

c) When and by whom the resulting changes to audit documentation were made and reviewed.

E. **ASSEMBLY OF FINAL AUDIT FILE:**

1. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. (within 60 days as per SQC 1)

2. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

F. **RETENTION PERIOD:** Refer Q.no.12 (D) in above.

G. **OWNERSHIP:** Refer Q.no.12(C) in above. **(N10 – 4M)**

SA 300 (Revised) PLANNING AN AUDIT OF FINANCIAL STATEMENTS (on or after 1st April 2008)

1. ***Scope of this SA:*** *It deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified.*

A. **PRELIMINARY ENGAGEMENT ACTIVITIES:**

The auditor shall undertake the following activities at the beginning of the current audit engagement

1. Performing procedures required by SA 220 regarding the continuance of the client relationship;

2. Evaluating compliance with ethical requirements, including independence, as required by SA 220; and

3. Establishing an understanding of the terms of the engagement, as required by SA 210.

B. **ESTABLISHING AN OVERALL AUDIT STRATEGY:** **(M11 – 5M)**

C. **DOCUMENTATION:**

The auditor shall document:

a) The overall audit strategy;

b) The audit plan; and

c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

D. ADDITIONAL CONSIDERATIONS IN INITIAL AUDIT ENGAGEMENT:

The auditor shall undertake the following activities prior to starting an initial audit:

1. Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement; and

2. Communicating with the predecessor auditor where there has been a change of auditors, in compliance with relevant ethical requirements.

EXAMINATION QUESTIONS:

1. Write a short note on: Preliminary Activities as per SA 300? (M17 RTP)

A. Refer point no. A and D in above Standard.

SA 315 IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT (w.e.f. April 1, 2008)

A. RISK ASSESSMENT PROCEDURES:

The audit procedures performed

- to obtain an understanding of the entity and its environment, including the entity's internal control,
- to identify and assess the risks of material misstatement, whether due to frauds or errors, at the financial statement and assertion levels.

B. UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT:

1. Required understanding: Refer Q.no.4 in above.

2. Sources of obtaining such understanding: Refer Q.no.5 in above.

C. UNDERSTANDING OF INTERNAL CONTROLS:

a) The auditor shall obtain an understanding of internal control relevant to the audit.

b) Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.

c) He shall evaluate the design of controls and determine whether they have been implemented.

D. IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT:

1. *The auditor shall identify and assess the risks of material misstatement at:*

a) *The financial statement level; and*

b) *The assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.*

2. *For this purpose, the auditor shall:*

a) *Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls.*

b) *Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;*

c) *Relate the identified risks to what can go wrong at the assertion level.*

d) *Consider the likelihood of misstatement, and whether the potential misstatement is of a magnitude that could result in a material misstatement.*

E. **IDENTIFICATION OF SIGNIFICANT RISKS:**

1. **Significant risk:** It refers to an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.
2. As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.
3. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following-
   i) Whether the risk is a risk of fraud;
   ii) Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention;
   iii) The complexity of transactions;
   iv) Whether the risk involves significant transactions with related parties;
   v) The degree of subjectivity in the measurement of financial information related to the risk,
   vi) Whether the risk involves unusual transactions that are outside the normal course of business for the entity.

F. **ASSERTIONS USED BY THE AUDITOR TO CONSIDER THE DIFFERENT TYPES OF POTENTIAL MISSTATEMENTS:**

Refer Q.No.6 in "Chapter no. 2. Basic concepts in Auditing".

EXAMINATION QUESTIONS:

1. **The auditor may exercise his judgement to identify which risks are significant risks. Explain the above in context of SA-315. (PM, MTP N17)**

A: Refer point no. E in above Standard.

SA 320 (Revised) MATERIALITY IN PLANNING AND PERFORMING AN AUDIT (On or after April 1, 2010).

A. **CONCEPT OF MATERIALITY:** Refer Q.no.23 in above.

B. **FACTORS/CRITERIA TO BE CONSIDERED FOR DETERMINING OR JUDGING MATERIALITY:** Refer Q.no.24 in above. **(N15 – 4M)**

C. **RELATIONSHIP BETWEEN MATERIALITY AND AUDIT RISK:** Refer Q.no.25 in above.

D. **FACTORS THAT MAY AFFECT THE IDENTIFICATION OF AN APPROPRIATE BENCHMARK IN DETERMINING MATERIALITY:**

1. As per SA 320 "Materiality in Planning and Performing an Audit", determining materiality involves the exercise of professional judgment.
2. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.
3. Factors that may affect the identification of an appropriate benchmark include the following-
   i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses;
   ii) Items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

iii) The nature of the entity and the industry and economic environment in which the entity operates;

iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

v) The relative volatility of the benchmark.

E. AUDIT PLANNING AND MATERIALITY:

i) Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not. SA 320 on "materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit.

ii) When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor's preliminary assessment if materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures.

iii) This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk.

iv) It may be noted that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures.

F. PERFORMANCE OF MATERIALITY:

1. Performance materiality means the amount or amounts set by the auditor at, less than materiality for the financial statements as a whole, to reduce to an appropriately low level, the probability that the aggregate of uncorrected and deducted misstatements, exceeds materiality for the financial statements as a whole.

2. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

EXAMINATION QUESTIONS:

1. **Write a short note on: Factors affecting the identification of an appropriate bench mark in determination of materiality.**

A. Refer point no. D in above standard.

2. **With reference to SA 320, indicate the factors which may affect the identification of an appropriate bench mark in determining materiality for the financial statement as a whole.**

A. Refer point no. D in above standard. **(PM, M17 MTP)**

3. **Write a short note on: Audit planning and Materiality. (M13 – 4M)**

A. Refer point no. E in above Standard.

SA 530 (Revised) AUDIT SAMPLING (w.e.f. 1st April, 2009)

A. DEFINITIONS:

1. **Population:** The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

2. **Sampling unit:** The individual items constituting a population.

3. **Statistical sampling:** An approach to sampling that has the following characteristics:

i) Random selection of the sample items; and

ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

4. **Non-statistical sampling:** A sampling approach that does not have the following characteristics:
   - **i)** Random selection of the sample items; and
   - **ii)** The use of probability theory to evaluate sample results, including measurement of sampling risk.
5. **Stratification:** The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
6. **Anomaly**: A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
7. **Tolerable misstatement:** Acceptable monetary amount of misstatements, in the population, set by the auditor.
8. **Tolerable rate of deviation:** Acceptable rate of deviation, from prescribed internal control procedures, set by the auditor.
9. **Non-sampling risk:** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

B. SAMPLING RISK: Refer Q.no.19 in above. **(PM, N10 – 8M)**

C. SAMPLE DESIGN, SIZE AND SELECTION OF ITEMS FOR TESTING:

Refer Q.no.18 in above.

D. SAMPLE SELECTION METHODS: Refer Q.no.20 in above. **(PM, N16 RTP)**

E. PERFORMING AUDIT PROCEDURES:

1. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
2. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation or a misstatement.

F. NATURE AND CAUSE OF DEVIATIONS AND MISSTATEMENTS:

- **a)** The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluates their possible effect.
- **b)** In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.

G. EVALUATION OF SAMPLE RESULTS:

- **a) Analysis of error in sample:**
  - **i)** The auditor should analyze cause of the error and its impact on the other phases of audit.
  - **ii)** If he finds a common trend in error, he may carry out extended audit procedures in those areas.
- **b) Projection of errors:** After establishing an error, the auditor should project the possibility of error to the entire population by a suitable method. When projecting errors, the auditor should also consider the qualitative aspects of error found.
- **c) Reassessing sampling Risk:** The auditor needs to consider whether errors in population exceed the tolerable error. In case it does, he has to revise the sampling risk, alternatively, he may have to extend his audit procedure or perform alternate audit procedures.

H. ADVANTAGES OF STATISTICAL SAMPLING: Refer Q.no.21 in above. **(M14 – 4M, N11- 4M)**

THE END