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AUDITING TECHNIQUES AND INTERNAL AUDIT INTRODUCTION I

STRUCTURE

4.0 OBJECTIVES

- Know the meaning of Test Checking
- Understand the features of Test Checking
- Know the advantages and disadvantages of Test Checking
- Distinguish between test checking and routing checking
- Understand the meaning of Audit sample

4.1 TEST CHECKING MEANING

4.1.1 Meaning: Examination in Depth means examination of a few selected transactions from the-beginning lo. the end through the entire flow of the transaction. It involves studying the recording of transactions the
various stages through which they have passed **2. Aspects of Verification**

(a) At each stage, relevant records and authorities are examined; it is also judged whether the person who has | exercised the authority in relation to the transactions is fit to do so in terms of-the prescribed procedure.

(b) While auditing in depth, the Auditor reviews all the accounting and operational aspects of the| transaction from the origin to the end. This enables him to have an overall view and evaluate the procedures through selected transactions.

3. A Representative Sample must be open and each item selected must be traced meticulously. :

4. A smaller number of transactions are checked at each successive stage with a in-depth test, on statistical grounds (based on probability theory) that the optimum sample size decreases as the Auditor's "level oft confidence" concerning the functioning of the

system increases.

5. **Examination in depth** reconstructs the audit trail and reveals more about the functioning (or malfunctioning) of the client's system in practice than the haphazard and mechanical approach to testing

6. **Example:** Audit in depth of transactions relating to purchase of goods involves verification of the following

(a) Purchase Requisition - pie-printed, pre-numbered and authorised;

(b) Invitation of quotations and analysis of the same;

(c) Official Purchase Order, sequentially pre-numbered, authorised and placed with approved suppliers only;

(d) Receipt of goods, together with Delivery Challan / Advice Note;

(e) Admission of goods to stores after verification of quality, quantity etc.;

(f) Entry in Stores Records;

(g) Receipt of Supplier's Invoice and Statement;

(h) Approval of Purchase Invoice regarding compliance for specification, quantity and quality;

(i) Entries in Purchases day book;

(j) Postings to Purchase Ledger and Purchase Ledger Control Account;

(k) Payment of Cheque in settlement of invoice after availing discounts; if any;

(1) Entry for payment in Cash / Bank Book;

(m) Posting from Cash Book to Ledger and Control Accounts.

1. Test Checking means to select and examine a representative sample from a large number of similar items.

2. Test Checking is an accepted auditing procedure wherein instead of checking all transactions, only a part of it is checked in detail to form an opinion on the whole

4.2 FEATURES OF TEST CHECKING

Test checking consists of selecting and checking a proportion of transactions selected by the Auditor. The salient features of Test Checking are -

1. Scientific: It is a mathematical truth that a scientifically selected sample would reveal the features and characteristics of the population. The statistical theory of sampling is based on a scientific law. Hence, it

can be relied upon to a greater extent than any arbitrary technique which lacks basis and acceptability.

2. Estimation Process: Test Checking and Sampling can never .bring complete reliability; it cannot give accurate results. It is a process of estimation. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular

3. Coverage of material items: Entries involving large amounts or relating to material accounts are ..seen exhaustively and other entries are picked up for verification from the remainder according to a certain plan. Sometimes entries are checked for a few specified months exhaustively and the rest go unchecked.

4. Full Coverage over a time period: Test Check is normally planned in such a way that the audit programmes for 3 to 5 years cover all types of transactions in case of a medium or large sized Company. Thus, if in one year the months of January, June and December are checked; April, July and September may be checked in the second year and so on.

5. Surprise Element: The staff and management of the Auditee Company should not be able to anticipate the pattern of test checking, otherwise they will predict the areas and periods to be covered in any one year and will be careful regarding the same.

6. Flexibility: If test checking becomes routine, predictable and mechanical, it loses its value. Hence, the Auditor should keep changing the methods of test checking at reasonably frequent intervals.

7. Judgment Based: The extent of test checking would primarily depend on the Auditor's judgment of a particular situation. This judgement in turn depends on tne previous experience of the Auditor, current developments and the efficacy of Internal Control System.

4.3 FACTORS TO BE CONSIDERED

The factors to be considered for deciding upon the extent of checking on a sampling plan are -

1. Size of the organization under audit.
2. State and efficacy of the internal control.
3. Adequacy and reliability of books and records.
4. Tolerable error range.
5. Degree of the desired confidence.

WHEN TEST CHECK CAN BE USED?

Test checks can be adopted in the following cases -

1. Volume of Transactions: In case of big concerns where number of transactions is quite large.

2. Time factor: Where the Auditor has very little time at his disposal to check all the transactions of a medium or large sized concern.

Identical Transactions: When there are a number of transactions of identical and homogeneous nature. **Internal Control:** When there exists a satisfactory internal control system, manual and / or computerized.

4.4 ADVANTAGES AND DISADVANTAGES OF TEST CHECKING

4.4.1 ADVANTAGES OF TEST CHECKING

The advantages of Test Checking include -

Audit Objective: The Auditor is required to form an opinion on the Financial Statements. Even after 100% checking, he may not derive absolute satisfaction. Hence, proper and careful test checking serves the audit objective in obtaining reasonable audit assurance.

Expertise: Application of test check principles involves the application of mind and intelligent judgment. It enables the Auditor to use his expertise effectively.

Exception Principle: Test Checking adopts the principle of exception in control. If certain aspects of internal control do not create suspicion, there is no need to verify all those transactions exhaustively.

Scientific Assessment of Risk: The Auditor assesses the risk of material misstatements in the Financial Statements in a scientific manner by drawing suitable samples and studying the same in detail.

Saving in time: As fewer transactions are verified, time is saved to a great extent. This, in turn, enables completion of all the audits / verification procedures in time.

Reduction in Work: Volume of work is reduced by test checking methods. Audit processes are not carried out mechanically on ail transactions.

4..4.2 DISADVANTAGES PRECAUTIONS

The disadvantages of Test Checking are –

Naive and Biased: The extent to which test checking can be resorted to is a matter of Auditor's personal assessment. It does not ensure selection of representative samples of adequate size and offers opportunities for bias to enter into selection process.

Unauthentic : Test Checking lacks authenticity, precision and an acceptable basis. It does not give the Auditor an idea about the degree of reliability that can be placed on the findings for application to the whole set of entries.

Higher Risk: runs the risk that some of the material error may not be discovered and some of the important areas may go unaudited. Sometimes, it may increase the level of inherent Audit Risk.

Unscientific: It involves lot of arbitrariness on the part of the Auditor in determining and selecting the number of transactions. Therefore, the approach cannot be considered as a scientific one.

Difference in activity levels: Where activity levels vary in a year, e.g. a few months of peak production and sales seasons, the Auditor cannot draw reasonable conclusions about the transactions of the whole year merely by checking transactions of a few specified months.

Lack of Surprise Element: If the surprise element is absent, the client may predict the pattern of checking.

4.5 TEST CHECKING VS ROUTING CHECKING

Particulars	Test checking	Routine checking
Meaning	Test checking is an accepted auditing procedure wherein only a part of its transactions is checked to form an opinion instead of checking the transactions.	Routine checking is the detailed checking of all transactional aspects such as casts, sub – casts, carry-forwards, extensions and calculations etc. in subsidiary books, checking of posting into the ledgers, casting of ledger accounts and extraction of their balances etc.
Objectives	To obtain a reasonable level of satisfaction about all transactions but verifying a few representative transactions called “sample”.	(a) to verify the arithmetical accuracy of the entries, (b) to verify the accuracy of posting to ledgers. © to check that the ledger accounts have been correctly balanced, and (d) to ensure that no figures are altered after checking.
Advantages	(a) Saving in time. (b) Proper and careful test checking is helpful & serves the audit objective. © Volume of work is reduced. (d) Time available for other audits.	(a) Checking of posting and ledgers. (b) Arithmetical accuracy can be checked. © Trial balance tallying is facilitated. (d) Easy detection of errors and frauds. (e) Delegation of audit work to junior staff.
Disadvantages	(a) Client staff may become careless. (b) Some errors and frauds may go undetected. © All items and transactions are not checked. (d) An elements of doubt and risk is present in the Auditor’s opinion.	(a) Is a highly mechanical process. (b) Monotonous activity may lead to boredom. © Major items of frauds and high level intricacies and complexities may not be revealed. (d) Compensating Errors and Errors of Principle will not come to light.

4.6 AUDIT SAMPLING

4.6.1 MEANING:

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the design and selection of an audit sample and the evaluation of the sample results. This AAS applies equally to both statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence

2. **When using either statistical or non-statistical sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.**

3. "Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

4. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount)does not qualify as audit sampling with respect to the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

4.6.2 FACTORS IN DETERMINING SAMPLE SIZE- SAMPLING RISK

(1)When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2.

SAMPLING RISK

(2) Sampling risk20 arises from the possibility that the auditor conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

(3) The auditor is faced with sampling risk in both tests of control and substantive procedure as follow:

(a) Tests of control:

(I) Risk of under reliance: The risk that, although the sample result dose not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(II) Risk of over reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such as an assessment.

(b) Substantive procedures:

(I) Risk of incorrect rejection: The risk that, although the sample results the supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.

(II) Risk of incorrect acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.

(4) The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

(5) Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Tolerable Error

1. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

16. In tests of control, the tolerable error is the maximum rate of

deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

2. If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures

4.6.3 SELECTION OF THE SAMPLE

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

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

Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.

Systematic selection, which involves selecting items using *a* constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.

* *Haphazard selection,* which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily

located, as they may not be representative.

4.6.4 EVALUATION OF SAMPLE RESULTS

20. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:

(a) analyse any errors detected in the sample;

(b) project the errors found in the sample to the population; and

(c) Reassess the sampling risk.

Analysis of Errors in the Sample

21. In analyzing the errors detected in the sample, the auditor will first need to determine that an item in question is in fact an error. In designing the sample, the auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be appropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

12. When the expected audit evidence regarding a specific sample item cannot be obtained, he auditor may be able to obtain sufficient appropriate audit evidence through performing Alternative procedures. For example, if a positive account receivable confirmation has been equated and no reply was received, the auditor may be able to obtain sufficient appropriate suit evidence that the receivable is valid by reviewing subsequent payments from the ;customer. If the auditor does not, or is unable to, perform satisfactory alternative procedures,)r if the procedures performed do not enable the auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

>3. The auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

24. In analysing the errors discovered, the auditor may observe that many have a common eature, for example, type of transaction, location, product line, or period of time. In such circumstances, the auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The auditor would then perform a separate analysis based on the items examined for 3ach

sub-population.

Projection of Errors

25. The auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method jsed to select the sampling unit. When projecting error results, the auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

Reassessing Sampling Risk

26. The auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative audit procedures.