CHAPTER 4

AUDIT EVIDENCE

LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- Audit Evidence (SA 500)- Meaning, types, relevance and reliability, sufficiency and appropriateness and sources of audit evidence, audit procedures, nature and timing of audit procedures, Assertions, selecting items for testing, relying on the work of management expert and evaluation of audit evidence.
- Using the work of internal Auditors (SA 610)- Meaning, scope and objective, nature and extent of work of internal audit function, their activities, external auditor's responsibility for audit and objective having internal audit function, coordination between external auditor and internal auditor.
- Audit Sampling (SA 530)- Meaning of Sample, sampling unit, sampling process, approaches and methods of sampling.
- Audit Evidence- Specific Considerations for Selected Items (SA 501)- inventory, litigation and claims involving the entity, and segment information.
- External Confirmations (SA 505)- meaning, definition of external, positive and negative confirmations.
- Initial Audit Engagements-Opening Balances (SA 510) - meaning and objective, sufficient appropriate audit evidence, audit procedures, and reporting regarding opening balances.
- Related Parties (SA 550)- Definition, meaning and nature of related parties relationship and transactions.
- Analytical Procedures SA (520)- meaning, scope, nature, timing, purpose, objective and forming overall conclusion based on analytical procedures.
- Practicality of above concepts by studying through examples and case studies

CHAPTER OVERVIEW

Audit Evidence

- by using work of internal Auditors
- by audit sampling
- by specific considerations of selected items
- by external confirmations
- by checking opening balances
- by checking related parties transactions
- by analytical procedures

Audit Sampling (SA 530)

- Meaning of audit sampling
- Approaches to audit sampling
- Sample design, size and selection of items for testing
- Performing audit procedures
- Nature and cause of deviations and mis-statements
- Projecting mis-statements
- Evaluating results of audit sampling

Analytical Procedures

- Meaning
- Reliance on Analytical Procedures
- Purpose & Timing
- Investigatiing the results
- Substantive Analytical Procedures

"Audit evidence" is the very core on the basis of which conclusions are drawn and opinion is formed by an auditor. In fact, it is the foundation upon which edifice of auditing is built. On a Sunday evening, Sameer was interacting with one of his friends, Shekhar, who had joined articleship and was part of an engagement team conducting audit of a company engaged in manufacturing activities. He got to know that Shekhar was part of team attending physical count process of inventories of the company as at year end. Besides, he was also responsible for going through sales of the company, checking few sales invoices and tracing those entries in books.

After some days, both of them had a chance to meet again. Informal conversations between them drifted towards audit of that company. Sameer was visibly excited to know that his friend was helping seniors in designing and sending confirmation requests to the entities to whom this company had sold goods. "Such a process must be providing sufficient appropriate evidence for the purpose of audit"- He murmured in between.

He had an inkling that evidence should provide satisfaction to the auditor. What are the contours of it? Whether a piece of evidence coming from outside the company can only provide comfort to the auditor? What about company's internal documents and records? Aren't these also pieces of information which form part of audit evidence? His inquisitiveness was prompting him to know whether audit evidence has only to be in writing. Or can it take some other forms? Whether evidence in other forms can suffice for purpose of audit?

Besides, he was also trying to understand about nuances of inventory counting process which had cropped up in their previous discussion. Such procedures help auditor to obtain audit evidence. He precisely wanted to understand what such procedures are called as. Are there other procedures also?

He also recalled his earlier discussion where Shekhar had told him regarding his responsibility of checking "few sales invoices". How the team would have arrived at the decision to check those sample invoices? Are some methods or techniques involved in it? How does team ensure that items being selected for checking are truly representative? Recapitulating that choosing of inappropriate sampling methods can lead to increase in detection risk and consequent rise in audit risk, significance of selecting appropriate samples was not lost on him.

1. AUDIT EVIDENCE

1.1 Introduction

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgement.

In accordance with SA 500, the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to draw reasonable conclusions on which to base the auditor's opinion.

1.2 Meaning of Audit Evidence as per SA 500

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Audit evidence is Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based

It includes both information contained in the accounting records underlying the financial statements and other information

ILLUSTRATION 1

The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

SOLUTION

There exists a very important relationship between Audit Evidence and opinion of the Auditor. While conducting an audit of a company, the auditor obtains audit evidence and with the help of that audit evidence obtained, the auditor forms an audit opinion on the financial statements of that company.

Explaining this further, audit evidence includes:-

(1) Information contained in the accounting records

Accounting records include

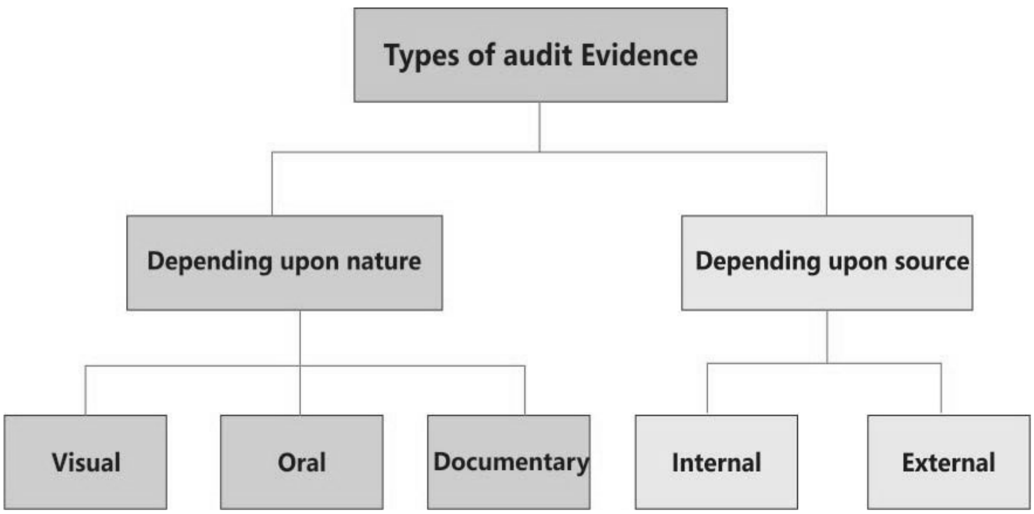
- the records of initial accounting entries and supporting records, such as cheques and records of electronic fund transfers;
- invoices;
- contracts;

- the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
- records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) **Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements** Other information which the auditor may use as audit evidence includes, for example

- minutes of the meetings,
- written confirmations from trade receivables and trade payables,
- manuals containing details of internal control etc.

1.3 Types of Audit Evidence



(a) Depending upon nature:

1. **Visual:** For example, observing physical verification of inventory conducted by the client's staff.
2. **Oral:** For example, discussion with the management and various officers of the client.

3. **Documentary:** For example, fixed deposit certificate, loan agreement, sales bill etc.

(b) Depending upon source:

1. **Internal Evidence:** Evidence which originates within the organisation being audited is internal evidence.

Example

Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

2. **External evidence:** The evidence that originates outside the client's organization is external evidence.

Example

Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff.

The external evidence is generally considered to be **more reliable as they come from third parties** who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence **e.g. an invoice of an associated concern,** he should exercise greater vigilance in that matter.

As an ordinary rule, the auditor should try to **match internal and external evidence as far as practicable.** Where external evidence is not readily available to match, the auditor should see as to what extent the various internal evidences corroborate one another.

ILLUSTRATION 2

An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more *appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted.*

Give your views as auditor of Genuine Limited.

SOLUTION

Audit evidence obtained externally is more appropriate from reliability point of view as compared to those which are obtained internally. The reason that audit evidence obtained externally is more appropriate from the point of view of reliability is that there is a very low risk that they can be altered or changed.

1.4 Relevance and Reliability of audit evidence

The auditor has to express opinion on the truth and fairness on the financial statements. He shall consider the relevance and reliability of the information to be used as audit evidence.

The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

1.4.1 Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Example

If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. **For example**, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, **for example**, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

1.4.2 Reliability

Information to be used as audit evidence should be reliable.

Reliability of information to be used as audit evidence, and therefore of **the audit evidence itself, is** influenced **by its source and its nature**, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

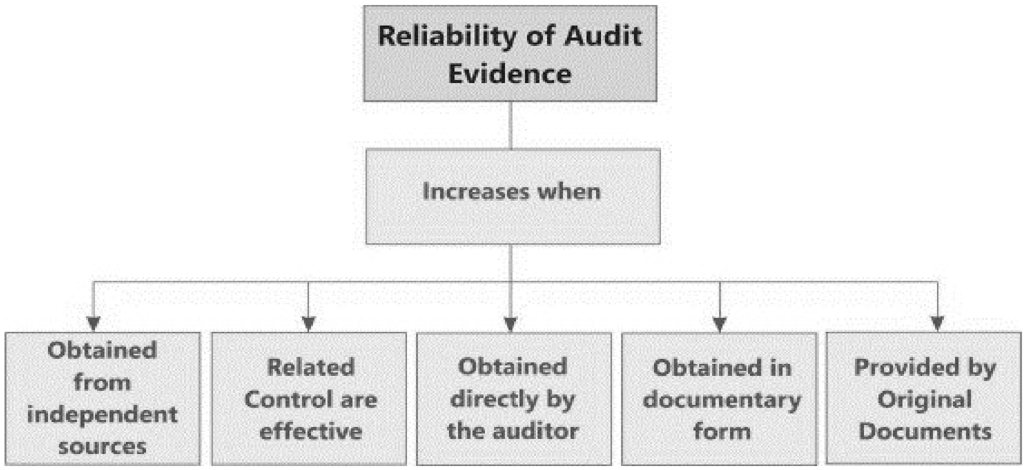
Therefore, **generalisations about the reliability** of various kinds of audit evidence **are subject to important exceptions**. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

For example,

information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity.

While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is **increased when it is obtained from independent sources outside the entity.**
- The reliability of audit evidence that is generated internally is **increased when the related controls,** including those over its preparation and maintenance, **imposed by the entity are effective**.
- Audit evidence obtained **directly by the auditor (for example, observation of the application of a control**) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in **documentary form,** whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence obtained as original documents is more reliable than audit evidence obtained as photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form because in these cases the reliability of which may depend on the controls over their preparation and maintenance.



1.5 Sufficient appropriate audit evidence

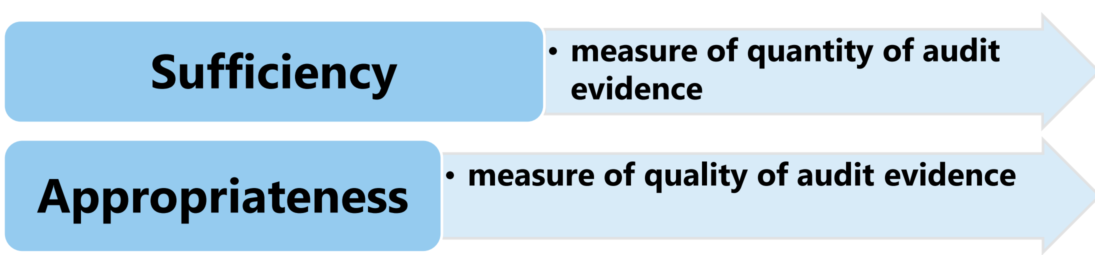
The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements.

1.5.1 Sufficiency and Appropriateness are interrelated.

The sufficiency and appropriateness of audit evidence are interrelated. **Sufficiency** is the measure of the **quantity of audit evidence.**

The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required)

Appropriateness is the measure of the **quality of audit evidence;** that is, **its relevance and its reliability** in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and nature, and is dependent on the individual circumstances under which it is obtained.



1.5.2 Obtaining Sufficient and appropriate Audit Evidence by the Auditor

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidence.

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit.

It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence.

Also, information that may be used as audit evidence may have been prepared using the work of a management's expert.

Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.

In addition, **in some cases the absence of information** (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, **also constitutes audit evidence.**

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. The auditor uses various audit procedures to obtain audit evidence such as inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry.

Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment.

SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

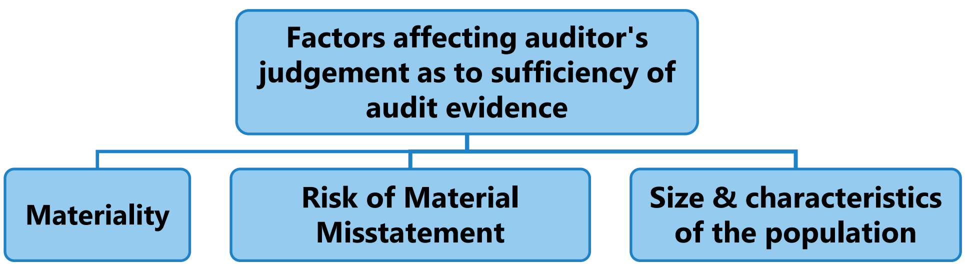
ILLUSTRATION 3

There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

SOLUTION

Sufficiency and Appropriateness of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

1.5.3 Further, auditor's judgement as to sufficiency may be affected by the factors such as:



(a) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(b) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

- Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
- Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(c) **Size & characteristics of a population:** It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

1.6 Source of audit evidence

Some audit evidence is obtained by performing audit procedures to test the accounting records.

Example

- ♦ through analysis and review,
- ♦ reperforming procedures followed in the financial reporting process,
- ♦ and reconciling related types and applications of the same information.

Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.

Example

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors.

1.7 Audit procedures for obtaining audit evidence

Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

- (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
- (ii) Substantive procedures, including tests of details and substantive analytical procedures.

1.7.1 Audit procedures to obtain audit evidence can include:

(i) Inspection

(ii) Observation

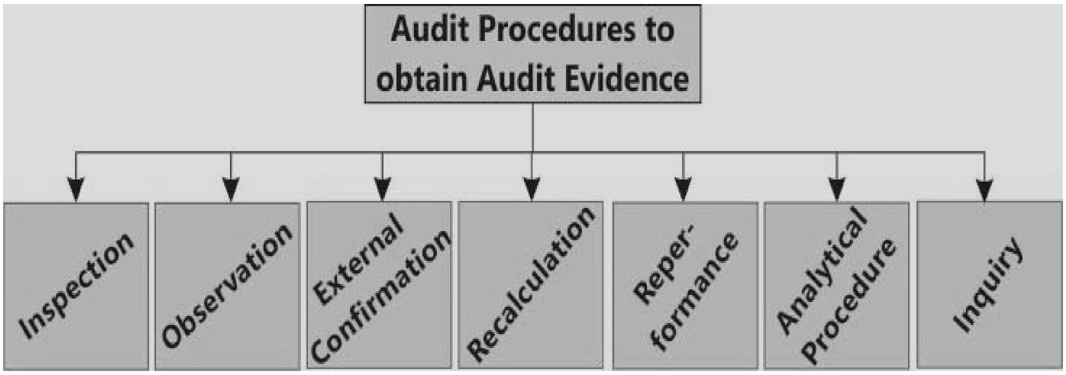
(iii) External Confirmation

(iv) Recalculation

(v) Reperformance

(vi) Analytical Procedures

(vii) Inquiry



(i) Inspection

Inspection involves **examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.** Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent **direct audit evidence of the existence of an asset, for example**, a document constituting **a financial instrument such as a stock or bond.** Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

ILLUSTRATION 4

While auditing the books of accounts of AB Limited for the financial year 2022-23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

SOLUTION

The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

(ii) Observation

Observation consists of looking at a process or procedure being performed by others.

For example,

the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) External Confirmation

An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.

Example

The auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

Example

The absence of a "side agreement" that may influence revenue recognition.

(iv) Recalculation

Recalculation consists of **checking the mathematical accuracy of documents or records.** Recalculation may be performed manually or electronically.

(v) Reperformance

Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Example

Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable.

(vi) Analytical Procedures

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass **the investigation of identified fluctuations and relationships** that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) Inquiry

Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.

Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, **for example**, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

1.7.2 The following points are also relevant in respect of audit procedures for auditor's consideration:

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor.

Audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.

1.7.3 Nature and Timing of the Audit Procedures

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.

For example,

source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time.

For example

if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

At this stage, it would be pertinent to discuss the concept of Risk assessment procedures and Further audit procedures:

1.7a Risk assessment procedures:

Risk assessment procedures refer to 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 fraud or error, at the financial statement and assertion levels.

Risk assessment procedures are the audit procedures performed to obtain an understanding of the entity and its environment to identify and assess the risks of material misstatement, at the financial statement and assertion levels.

1.7b Further Audit Procedures

Further Audit Procedures comprise of:

(i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

Further Audit Procedures comprise of:

(i) Tests of Controls; and

(ii) Substantive of procedures

1.7.b(i) Tests of controls

Test of controls may be defined as an audit procedure **designed to evaluate the operating effectiveness of controls** in preventing, or detecting and correcting, material misstatements at the assertion level.

Audit procedures designed → to evaluate the operating effectiveness of controls → in preventing or detecting and correcting material misstatement at the assertion level

1.7.b(ii) Substantive Procedures- Tests of details and Substantive analytical procedures

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

In other words, Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level.

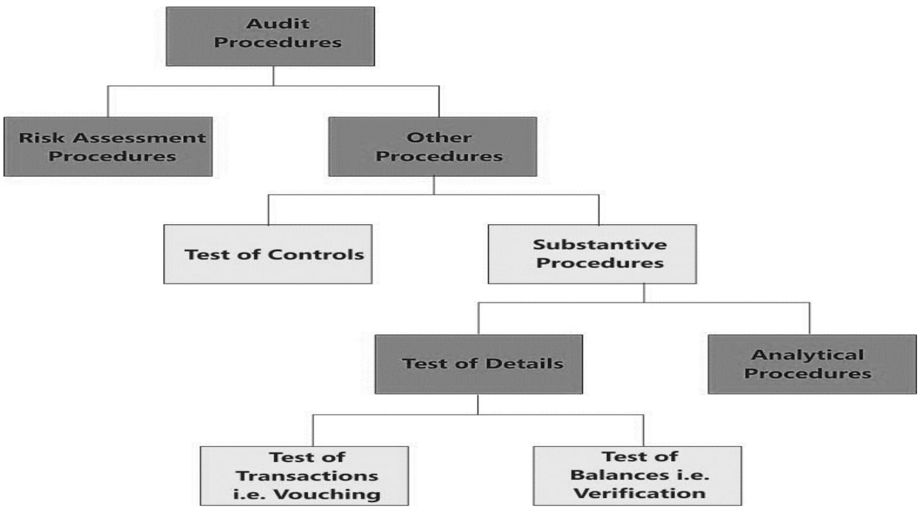
Audit procedures designed → to detect material misstatement → at the assertion level

Substantive procedures comprise:

(i) Tests of details (of classes of transactions, account balances, and disclosures), and

(ii) Substantive analytical procedures.

The following chart illustrates different audit procedures:



Test Your Understanding 1

On perusal of financial statements of a company, auditor of company finds that notes to accounts contain ageing of trade payables in accordance with requirements of Schedule III of the Companies Act, 2013. The accountant of the company is responsible for ensuring proper ageing of trade payables included in notes to accounts. The auditor wants to verify whether the ageing of trade payables made in financial statements is proper or not. Identify what he is trying to do.

Test Your Understanding 2

CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

Test Your Understanding 3

A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

1.8 Assertions

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Representations by management

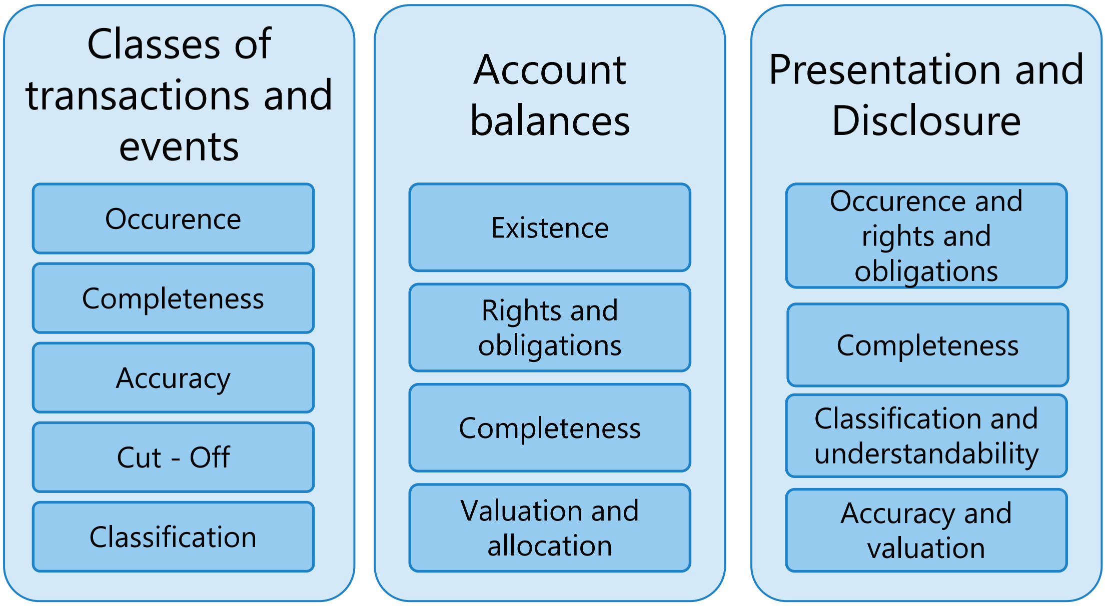
that are embodied in the financial statements

to consider different types of potential misstatements

1.8.1 Assertions contained in the Financial Statements.

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

2. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:



(a) **Assertions about classes of transactions and events for the period under audit:**

(i) **Occurrence** – transactions and events that have been recorded have occurred and pertain to the entity.

(ii) **Completeness** – all transactions and events that should have been recorded have been recorded.

(iii) **Accuracy** – amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) **Cut-off** – transactions and events have been recorded in the correct accounting period.

(v) **Classification** – transactions and events have been recorded in the proper accounts.

(b) **Assertions about account balances at the period end:**

(i) **Existence** – assets, liabilities, and equity interests exist.

(ii) **Rights and obligations** – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) **Completeness** – all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) **Valuation and allocation** – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) **Assertions about presentation and disclosure:**

(i) **Occurrence and rights and obligations** – disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) **Completeness** – all disclosures that should have been included in the financial statements have been included.

(iii) **Classification and understandability** – financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) **Accuracy and valuation** – financial and other information are disclosed fairly and at appropriate amounts.

3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered.

   For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

4. When making assertions about the financial statements of certain entities, especially, **for example**, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed.

Example

When we find in the balance sheet, an item under current assets reading as "cash in hand - ₹ 10,000" the obvious assertions that would strike the mind are the following:

(i) The firm concerned had ₹ 10,000 in hand in valid notes and coins on the balance sheet day;

(ii) That the cash was free and available for expenditure to the firm; and

(iii) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

Example

Particulars		₹
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,000	
Depreciation for the year	13,000	83,000
		1,17,000

The assertions are as follows:

(i) the firm owns the plant and machinery;

(ii) the historical cost of plant and machinery is ₹ 2 lacs;

(iii) the plant and machinery physically exists;

(iv) the asset is being utilised in the business of the company productively;

(v) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and

(vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements.

Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.

An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹ 4,00,000

The description does not give us a complete picture. We do not know:

(i) the name of the lender, if it is relevant;

(ii) the nature of security provided; and

(iii) the rate at which interest in payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position.

Negative assertions are also encountered in the financial statements and the same may be expressed or implied. **For example,**

if it is stated that there is no contingent liability it would be an expressed negative assertion;

On the other hand, if in the balance sheet there is no item as "building", it would be an **implied negative assertion** that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgements of these specific assertions he arrives at a judgement on the financial statements as a whole.

1.9 Audit Trail

An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction. Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.

It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.

Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem. Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can help entities in their regular system operations.

However, audit trails involve costs. The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails.

Systems which have a feature of audit trail inspires confidence in auditors. It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

1.10 Information to Be Used as Audit Evidence

1.10.1 When information to be used as audit evidence has been prepared using the work of a management's expert, the nature, timing and extent of audit procedures may be affected by such matters;

- The nature and complexity of the matter to which the management's expert relates.

- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

1.10.2 When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

(a) Obtaining audit evidence about the accuracy and completeness of the information; and

(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

1.11 Selecting Items for Testing to Obtain Audit Evidence

When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);

(b) Selecting specific items; and

(c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the auditors' judgement to obtain audit evidence.

1.11(a) Selecting All Items

The auditor may decide that it will be **most appropriate to examine the entire population of items** that make up a class of transactions or account balance (or a stratum within that population).

100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details.

100% examination may be appropriate when,

For example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

1.11(b) Selecting Specific Items

The auditor may decide to select specific items from a population.

In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested.

The judgmental selection of specific items is subject to non-sampling risk.

Specific items selected may include:

- **High value or key items.**

  The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.

For example

items that are suspicious, unusual, particularly risk-prone or that have a history of error.

- **All items over a certain amount.**

  The auditor may decide **to examine items whose recorded values exceed a certain amount** so as to verify a large proportion of the total amount of a class of transactions or account balance.

- **Items to obtain information.**

  The auditor may examine items to obtain information about matters **such as the nature of the entity or the nature of transactions.**

1.11(c) Audit Sampling

Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in subsequent paragraphs.

1.12 Inconsistency in or Doubts over Reliability of Audit Evidence

If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

For example

responses to inquiries of management, internal audit, and others are inconsistent.

SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.

Who is management's expert?

An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

1.13 Relying on the work of a management's expert

If the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements.

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes;

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

1.14 Evaluation of Audit Evidence

SA 500 "Audit Evidence" is applicable to all the audit evidence obtained during the course of the audit to enable the auditor to obtain **sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.**

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

The auditor has to conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment.

2. USING THE WORK OF INTERNAL AUDITORS (SA 610)

2.1 Definition of Internal Audit Function

Internal audit function refers to

A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

The objectives and scope of internal audit functions typically include **assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control** such as the following:

(1) Activities Relating to Governance

The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

(2) Activities Relating to Risk Management

- **The internal audit function may assist the entity by identifying and evaluating significant exposures to risk** and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures **to assist the entity in the detection of fraud.**

(3) Activities Relating to Internal Control

- **Evaluation of internal control**. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control.

For example

> the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

- **Examination of financial and operating information.** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- **Review of operating activities**. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
- **Review of compliance with laws and regulations**. The internal audit function may be assigned to review compliance with laws, regulations, and other external requirements, and with management policies and directives and other internal requirements.

2.2 Ways in which the external auditor may make use of the function for purposes of the audit.

While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

(i) to obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud.

(ii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.

(iii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (**referred to as "direct assistance"**).

2.3 Scope of SA 610

Standard on Auditing (SA) 610 deals with the external auditor's responsibilities if using the work of internal auditors. This includes

(a) using the work of the internal audit function in obtaining audit evidence and

(b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

Nothing in this SA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy.

2.4 External Auditor's Responsibility for the audit

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200. This SA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

2.5 Objectives of the external auditor, where the entity has an internal audit function

The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, **are**:

(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination:

(b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and

(c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

2.6 Evaluating the Internal Audit Function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

(A) The extent to which the internal audit function's organizational status and relevant policies and procedures support the **objectivity** of the internal auditors;

(B) The level of **competence** of the internal audit function; and

(C) Whether the internal audit function applies a **systematic and disciplined approach, including quality control**.

Objectivity and Competence

The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important **in determining**

whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

2.6A Objectivity and its evaluation

Objectivity refers to the **ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments**.

Factors that may affect the external auditor's evaluation in relation to Objectivity include the following:

1. Whether the organizational status of the internal audit function, including the function's authority and accountability, supports **the ability of the function to be free from bias, conflict of interest or undue influence of others** to override professional judgments.

   For example

   whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

2. Whether those charged with governance **oversee employment decisions** related to the internal audit function.

   For example

   determining the appropriate remuneration policy.

3. Whether there are **any constraints or restrictions** placed on the internal audit function **by management or those charged with governance, for example,** in communicating the internal audit function's findings to the external auditor.

4. Whether the internal audit function is **free of any conflicting responsibilities, for example,** having managerial or operational duties or responsibilities that are outside of the internal audit function.

2.6B Competence and its evaluation

Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.

Factors that may affect the external auditor's determination in relation to competence include the following:

1. Whether the internal audit function is **adequately and appropriately resourced** relative to the size of the entity and the nature of its operations.
2. Whether there are **established policies for hiring, training and assigning internal auditors to internal audit engagements.**
3. Whether the internal auditors have **adequate technical training and proficiency in auditing.**
4. Whether the internal auditors possess the required **knowledge relating to the entity's financial reporting and the applicable financial reporting framework.**

Objectivity and competence may be viewed as a continuum.

Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

2.6C Application of a Systematic and Disciplined Approach

The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

1. **The existence, adequacy and use of documented internal audit procedures or guidance covering** such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.

2. Whether the internal audit function has **appropriate quality control policies and procedures.**

2.7 Circumstances When Work of the Internal Audit Function Cannot Be Used

The external auditor shall not use the work of the internal audit function if the external auditor determines that:

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

2.8 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan.

In other words, once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

Examples of work of the internal audit function that can be used by the external auditor include the following:

1. Testing of the operating effectiveness of controls.
2. Substantive procedures involving limited judgment.
3. Observations of inventory counts.
4. Tracing transactions through the information system relevant to financial reporting.
5. Testing of compliance with regulatory requirements.

2.9 Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly

The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly if:

(a) The more judgment is involved in:

  (i) Planning and performing relevant audit procedures; and

  (ii) Evaluating the audit evidence gathered;

(b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;

(c) The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and

(d) The lower the level of competence of the internal audit function.

2.10 Using the Work of the Internal Audit Function

If the external auditor plans to use the work of the internal audit function, the external auditor shall

(A) discuss the planned use of its work with the function as a basis for coordinating their respective activities.

(B) read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

(C) perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit.

Discussion and Coordination with the Internal Audit Function

In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

1. The timing of such work.
2. The nature of the work performed.
3. The extent of audit coverage.
4. Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
5. Proposed methods of item selection and sample sizes.
6. Documentation of the work performed.
7. Review and reporting procedures.

Coordination between the external auditor and the internal audit function is effective when, for example;

1. Discussions take place at appropriate intervals throughout the period.
2. The external auditor informs the internal audit function of significant matters that may affect the function.
3. The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

2.11 Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

The external auditor **may be prohibited by law or regulation** from obtaining direct assistance from internal auditors.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

The external auditor shall not use an internal auditor to provide direct assistance if:

(a) There are significant threats to the objectivity of the internal auditor; or

(b) The internal auditor lacks sufficient competence to perform the proposed work.

The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

(a) Involve making significant judgments in the audit;

(b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;

(c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

2.12 Basics of Internal Financial Control and Reporting Requirements

You have already read about basics of Internal Financial Control and regulatory/reporting requirements in Chapter 3 in detail. Now, we shall understand distinction between Internal Financial Control and Internal Control over financial reporting.

Distinction between Internal Financial Control and Internal Control over financial reporting

The term Internal Financial Controls (IFC) refers to the policies and procedures put in place by companies for ensuring reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws and regulations, safeguarding of assets and prevention and detection of frauds.

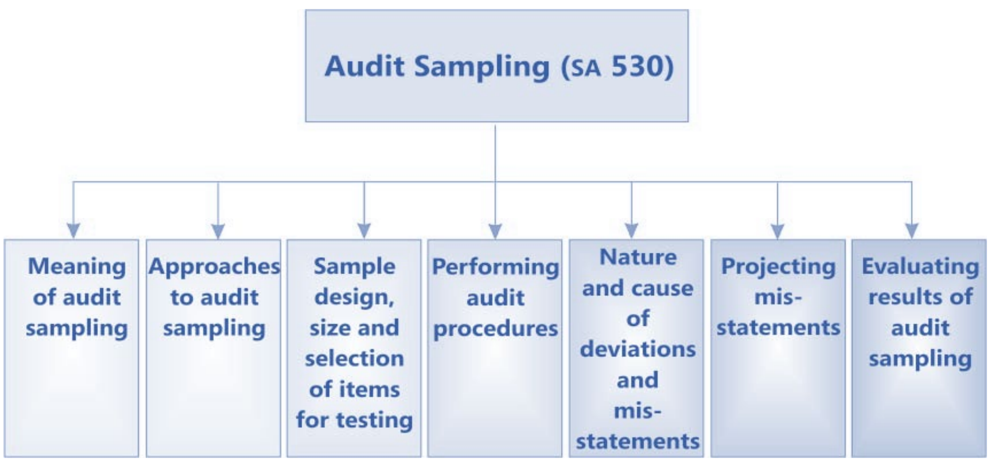
On the other hand, Internal controls over financial reporting is required where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, *such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.*

Therefore, "internal financial control" is a wider term where as "internal controls over financial reporting" is a narrower term restricted to entity's internal controls over financial reporting only.

3. AUDIT SAMPLING (SA 530)

3.1 Sampling: An Audit Procedure

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e the internal controls as designed by the management are for the very purpose of prevention, detection and correction of frauds and errors. Thus the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of **principles and controls** with a curtailment of non-consequential routine checking.



By routine checking we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

3.2 Meaning of Audit Sampling

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all sampling units (i.e all the items in the population) have a equal chance of selection. This is to ensure that the items selected represent the entire population which enables the auditor to draw conclusions and express his opinion based on a pre-determined objective.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Scope of SA 530

SA 530 becomes applicable when the auditor has decided to use audit sampling in performing audit procedures. This standard deals with the **auditor's use of -**

- Statistical and
- Non-statistical sampling

when designing and selecting the-

(i) audit sample,

(ii) performing tests of controls and tests of details, and

(iii) evaluating the results from the sample.

SA 500 "Audit Evidence", deals with the auditor's responsibility to design and perform audit procedures to *obtain sufficient appropriate* audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

SA 500 lays down the means available to the auditor for selecting the items for testing. One of those is audit sampling. Hence SA 530 complements SA 500.

3.3 Population

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

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.

3.3.1 Characteristics of Population

1. Appropriateness: The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. Appropriate means population from which the samples are drawn shall be ***relevant*** for the specific objective under audit. This is because when the samples are drawn, the audit procedures are applied on the sample and the conclusions are projected on the population.

It is important for the auditor to ensure that the population is appropriate to the objective of the audit procedure, which will include consideration of the direction of testing.

Example

If the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

2. **Completeness:** The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions about whether a control activity is operated effectively during the financial reporting period, the population needs to include all relevant items i.e all the activities that form part of that relevant internal control, throughout the entire period. If population is complete in all respects, the conclusions drawn on the population will be considered to be reasonable.

3. **Reliable:** When performing the audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate. Auditor should obtain evidence about the reliability of population. If population is not reliable with respect to accuracy and source, the sample drawn will definitely not be relevant for the specific audit objective.

3.4 Sampling Unit

The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. It is a selection from the population that is used as an extrapolation of the population. Audit procedures are applied on these units and the conclusions drawn from them are projected on the population.

In simple words, conclusions drawn on the sample becomes the conclusion of the population from where it is drawn.

Example: If the auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The auditor defines the sampling unit in order to obtain an ***efficient and effective*** sample to achieve the particular audit objectives. The conclusion on the population is based on the audit procedures applied on the sampling unit.

Sample must be representative

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

SAMPLING PROCESS is performed on

- **Tests of controls** to identify deviations from expected internal controls
- **Tests of details** to identify misstatements of account balances and class of transactions

3.5 Approaches to Sampling (Types of Sampling)

Approaches to Sampling

- Statistical Sampling
- Non-Statistical Sampling

Audit sampling enables the auditor to obtain and evaluate audit evidence about **some characteristic of the items selected** in order to form or assist in forming a conclusion about the population, from which the sample is drawn. Audit sampling can be applied using either

A) **non-statistical** or

B) **statistical** sampling approaches.

Statistical sampling is an approach to sampling that has the random selection of the sample units; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Sample is chosen by applying certain mathematical and statistical methods. A sampling approach that does not have the above features s considered as **non-statistical sampling**.

1. An approach to sampling that has the random selections of the sample items	2. The use of probability theory to evaluate sample results, and	3. The use of probability theory including measurement of sampling risk characteristics

Characteristics of Statistical sampling approach

3.5A Statistical Sampling-More Scientific

1. Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of ***mathematical laws of probability*** in determining the appropriate sample size in varying circumstances.

2. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

3. There Is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased and the samples selected are not prejudged.

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

3.5B Non-Statistical Sampling

Under this approach, the sample size and its composition are determined on the basis of the ***personal experience and knowledge*** of the auditor.

This approach has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. **For example**, March, June and September may be selected in year one and different months would be selected in the next year, On basis of value of items, top 10 highest value. Etc.

An attempt would be made to avoid establishing a pattern of selection year after year, i.e the way of selecting samples, to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined. Also, because year end transaction are prone to high risk of misappropriation.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated.

The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

This method is simple to operate but sometimes the sample may not be a true representative of the total population because of personal bias and no scientific method of selection.

3.6 Sampling Vs Traditional method of Auditing

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. Sampling is used as a part of Tests of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for tests of details (i.e checking of transactions and balances)

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

Example

Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice – if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgement. However, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

(i) Size of the organisation under audit.

(ii) State of the internal control.

(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

(v) Degree of the desired confidence.

3.7 Appropriateness of Sampling Approaches

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective.

The advantages of statistical sampling may be summarized as follows -

(1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(2) The sample selection is more objective and thereby more defensible.

(3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

(4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

(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 mistakes are not as large.

(6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Sometimes the audit staff has no knowledge about sampling technique used, in such circumstances using statistical sampling becomes complex and inappropriate.

3.8 Sampling Process

SAMPLE DESIGN
↓
SAMPLE SIZE
↓
SAMPLE SELECTION
↓
AUDIT PROCEDURES
↓
NATURE AND CAUSE OF DEVIATION AND
↓
PROJECTING
↓
EVALUATING RESULTS OF AUDIT

3.9 Sample Design, Size and Selection of Items for Testing

When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. Sample selected must be representative of the population.

3.9.1 Sample Design

When designing an audit sample,

i) the auditor's consideration includes the ***specific purpose*** to be achieved and the ***combination of audit procedures*** that is likely to best achieve that purpose.

ii) Consideration of the ***nature of the audit evidence*** sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

iii) In fulfilling the requirement of **SA 500 "Audit Evidence**", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements.

Example

In a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a wrong posting between customer accounts does not affect the total accounts receivable balance.

Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

Example

If the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls.

Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

3.9.1A Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing *tests of details*, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the *allowance for doubtful accounts* in the valuation of accounts receivable, balances may be stratified by age.

Stratification: Dividing a population into discrete sub population which have identifying characteristics is called as Stratification. Each Sub population is called as Stratum and units under those sub population are referred to as Strata.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

The results of samples from the units drawn under each sub population are projected to that respective stratum. In order to draw an opinion on the overall population, the auditor needs to combine the results of all the stratum to check for possible deviation or risk of material misstatement.

Projected misstatements of each stratum will be combined together to consider the possible effect of misstatement in the account balances and class of transactions.

Example

20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

Value-Weighted Selection: When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.

One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

In value weighted selection, the sample size, its selection and evaluation will result in a conclusion in monetary amounts.

3.9.2 Sample Size

The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

The level of sampling risk that the auditor is willing to accept affects the sample size required.

The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. There are various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non- statistical approach is chosen.

3.9.2A Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

(i) When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. ***Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls*** (and therefore, the sample size is increased). Thus, sample size will increase.

(ii) If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be. Tolerable error is the maximum error in the population that auditor is ready to accept in a given sample size. Smaller the tolerable error, larger will be the sample size.

(iii) When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as ***higher the expected rate of deviation, larger the sample size*** needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures.

High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

(iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will ***increase the sample size***. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

(v) In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be ***negligible effect*** on sample size due to increase in the number of sampling units in the population.

3.9.2B Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

(i) ***The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be***. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be. Thus we can say that there will be an increase in sample size in case of an increase in the auditor's assessment of the risk of material misstatement.

(ii) ***The more the auditor is relying on other substantive procedures*** (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, ***the smaller the sample size can be***. Hence, if there is an increase in the use of other substantive procedures directed at the same assertion, the size of sample will decrease.

(iii) An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will ***increase the sample size***. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

(iv) ***An increase in tolerable misstatement will decrease the sample size*** as lower the tolerable misstatement, the larger the sample size needs to be.

(v) ***The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size*** needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent, to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures. So, sample size will increase in case of an increase in the amount of misstatement the auditor expects to find in the population.

(vi) ***When stratification of the population is appropriate then sample size will decrease*** as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

(vii) There will be ***negligible effect*** on sample size due to number of sampling units in the population. For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures.)

3.9.3 Selection of Items for Testing

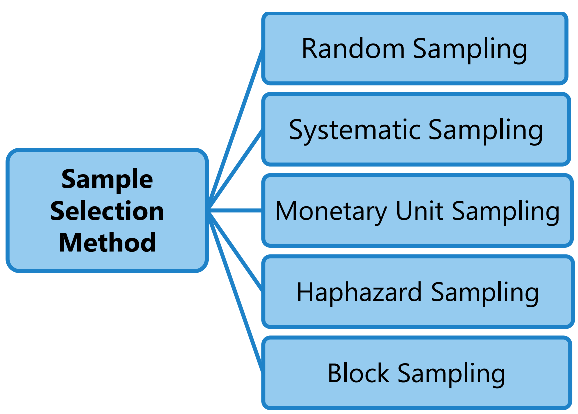
The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection.

3.9.3A Sample Selection Methods

Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.



Some of the important methods of selecting the sample are discussed below -

(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–

(i) Simple Random Sampling*:** Under this method each unit of the whole population *e.g.* purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. ***Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cellphones like the random number generator.

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range.

Example

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 55,000 to ₹ 2,25,000 and not in the range between ₹ 525 to ₹ 10,50,000.

***(ii) Stratified Sampling*:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

Example

1. In the above case, trade receivables balances may be divided into four groups as follows:-

(a) balances in excess of ₹ 10,00,000;

(b) balances in the range of ₹ 7,75,001 to ₹ 10,00,000;

(c) balances in the range of ₹ 5,50,001 to ₹ 7,75,000;

(d) balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and

(e) balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group *i.e.* balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected. Random sample is chosen from each stratum using random number tables.

The reasoning behind the stratified sampling is that for a ***highly diversified population***, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Stratification means dividing heterogeneous (Diversified) population into Homogeneous (having similar characteristics) sub population, where samples are drawn from each sub population.

Therefore, we can say that random selection method is applied through random number generators, for example, random number tables.

(2) Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Example

If in a population of branch sales, particular branch sales occur only as every 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch.

If Accountant A is responsible to record all transaction in a particular month and Accountant B for next month; if this structure is same throughout the year, and the auditor determines as his sample to check every transaction of alternate months, then only one accountant's work is checked by the auditor i.e either Accountant A or B depending upon which month the checking started from. The work of other is overlooked and there could be a possibility of material misstatement in the transactions recorded by him.

Therefore, systematic sampling when chosen as a method should be carefully applied to bring together every type of transaction within its purview. More than one starting point can be considered to minimize such risk.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(3) Monetary Unit Sampling: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability **(for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page)** and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard sampling has no structured approach, does not involve judgement and does not even use the random number tables.

(5) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. 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. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample. Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once. Further, if the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily overlooked by management's practice of recording them.

Example

Take the first 200 sales invoices from the sales day book in the month of September, alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

There is a close similarity between this method and non-statistical sampling. Consequently, it has similar characteristics, namely, simplicity and economy. On the other hand, there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

3.10 Performing Audit Procedures

(i) The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

(ii) If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a **replacement item**.

(iii) 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 from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.

(iv) An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined. A replacement would then mean a proper and valid cheque through which payment has been made.

(v) An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost. If the documentation of a sales is lost, like the sales order record, sales invoice, document for dispatch etc., then confirmation can be sought from the debtor as per SA 505. If it is a cash sale, the cash book can be cross verified for the existence of such transactions.

(vi) An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

(vii) Another example for replacement of a sample could be, if all transactions of computerized sales are being checked, for example sales recorded through a bar code scanner, and incidentally a sample of manual billing gets selected, then such item can be replaced after adequately checking the correctness of the manual bill with the supporting documents available. If replacement is not possible or reasonable, alternative audit procedure can be applied.

3.11 Nature and Cause of Deviations and Misstatements

(i) In analyzing the deviations and misstatements identified, the auditor may observe that many have a **common feature**, for example, type of transaction, location, product line or period of time.

(ii) In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

(iii) Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

(iv) 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.

(v) The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Anomaly may be defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

3.12 Projecting Misstatements

(i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

(ii) When a misstatement has been established as **an anomaly**, it may **be excluded** when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

(iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, **no explicit projection of deviations** is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

3.13 Evaluating Results of Audit Sampling

The auditor shall evaluate-

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Few Important terms to make the understanding better

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).

Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Test Your Understanding 4

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

Test Your Understanding 5

CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.

Test Your Understanding 6

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

4. AUDIT EVIDENCE-SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (SA 501)

4.1 Meaning of Audit Evidence- Specific Considerations for Selected Items

The auditor has to express his opinion on financial statements of an entity. For this, he has to examine the books of accounts. He needs evidence in support of transactions recorded in books of accounts. There are some transactions for which he needs specific considerations. For example, inventory

SA **501- "Audit Evidence- Specific Considerations for Selected Items"** deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of **inventory, litigation and claims involving the entity, and segment information** in an audit of financial statements.

4.2 Objective of the Auditor in respect of Specific Considerations for Selected Items

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

(A) Existence and condition of inventory;

(B) Completeness of litigation and claims involving the entity; and

(C) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

4.3 Inventory

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) **Attendance at physical inventory counting,** unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts.

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

4.4 Attendance at Physical Inventory Counting

Attendance at Physical Inventory Counting Involves:

(a) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;

(b) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and

(c) Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

4.5 Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include, **for example:**

(a) Nature of inventory.

(b) Stages of completion of work in progress.

(c) The risks of material misstatement related to inventory.

(d) The nature of the internal control related to inventory.

(e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(f) The timing of physical inventory counting.

(g) Whether the entity maintains a perpetual inventory system.

(h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate

(i) Whether the assistance of an auditor's expert is needed to obtain sufficient appropriate audit evidence.

4.6 Physical Inventory Counting Conducted other than at the Date of the Financial Statements

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

4.7 If the auditor unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

4.8 Attendance at Physical Inventory Counting becomes impractical

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory.

For example

where inventory is held in a location that may pose threats to the safety of the auditor.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

In some cases where attendance is impracticable, alternative audit procedures, for **example** inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

4.9 When inventory under the custody and control of a third party- What will the auditor do?

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

Other audit procedure may include -

For Example

- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.

ILLUSTRATION 5

JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

Required

Suggest the audit procedures in the given case.

SOLUTION

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

4.10 Litigation and Claims

The auditor shall design and perform **audit procedures** in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

In addition to the procedures identified above **other relevant procedures include,**

For example

using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540 establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

4.11 If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity's External Legal Counsel

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct **communication with the entity's external legal counsel.**

The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(a) A list of litigation and claims;

(b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, **for example**, where:

i) The auditor determines that the matter is a significant risk.

ii) The matter is complex.

iii) There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

Further if:

(a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and

(b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,

the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

ILLUSTRATION 6

Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

Required

Suggest the auditor with reference to SAs.

SOLUTION

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

Test Your Understanding 7

The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?

4.12 Segment Information

> Definition of segment information
>
> Segment Information refers to information about different types of products and services of an enterprise and its operations in different geographical areas.

4.13 Obtaining sufficient appropriate audit evidence regarding the presentation and disclosure of segment information

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

(a) Obtaining an understanding of the methods used by management in determining segment information, and:

  (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and

  (ii) Where appropriate, testing the application of such methods; and

(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

4.14 Auditor's responsibility regarding the presentation and disclosure of segment information

The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

4.15 Understanding of the Methods Used by Management

Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

1. Sales, transfers and charges between segments, and elimination of intersegment amounts.
2. Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
3. The allocation of assets and costs among segments.
4. Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

5. EXTERNAL CONFIRMATIONS (SA 505);

5.1 Introduction

SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

It also includes the following generalisations applicable to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

5.2 Scope of this SA

The Standard on Auditing (SA) 505 "**External Confirmations"** deals with the auditor's use of external confirmation procedures **to obtain audit evidence** in accordance with the requirements of SA 500.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity.

SA505 is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

Thus, **the objective of the auditor**, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

5.3 Definition of External Confirmation:

External **confirmation** may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

5.4 Definitions of other terms:

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The exception needs to be assessed to the entire population after analyzing the reason for difference.

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees.

Non-response – A failure of the confirming party to respond to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

ILLUSTRATION 7

During the financial year 2022-23, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was ₹ 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of ₹ 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

SOLUTION

The above-mentioned situation is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

5.5 External Confirmation Procedures adopted by the Auditor to Obtain Audit Evidence

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

(a) Determining the Information to be Confirmed or Requested

External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

(b) Selecting the Appropriate Confirming Party

Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed.

For example

a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

(c) Designing Confirmation Requests

1. Design of a confirmation request

The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

2. Factors to be considered by auditor when designing confirmation requests

Factors to consider when designing confirmation requests include:

(i) The assertions being addressed.

(ii) Specific identified risks of material misstatement, including fraud risks.

(iii) The layout and presentation of the confirmation request.

(iv) Prior experience on the audit or similar engagements.

(v) The method of communication (for example, in paper form, or by electronic or other medium)

(vi) Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.

(vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

3. Positive confirmation request

A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. **A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence**. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

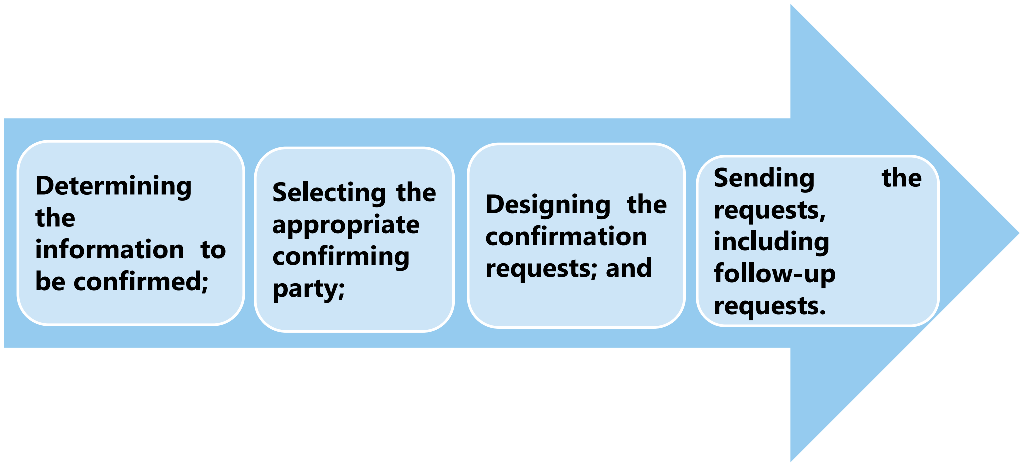
4. Determination of properly addressed requests

Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

(d) Follow-Up on Confirmation Requests

The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time.

For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.



5.6 Management's refusal to allow the auditor to send a confirmation request-steps taken by the Auditor

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

(a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and **reasonableness;**

(b) Evaluate the implications of management's refusal on the auditor's assessment of the **relevant risks of material misstatement,** including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(c) **Perform alternative audit procedures** designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is **unreasonable,** or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

Inquire as to management's reasons for the refusal;

Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement; and

Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

5.6(a) Reasonableness of Management's Refusal

A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request.

The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

5.6(b) Implications for the Assessment of Risks of Material Misstatement

The auditor may conclude that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures.

For example

if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240.

5.6(c) Alternative Audit Procedures

Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

ILLUSTRATION 8

While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request.

Required

How would the auditor proceed?

SOLUTION

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

(a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

5.7 Negative Confirmations

Negative confirmations provide less persuasive audit evidence than positive confirmations.

Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

(a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;

(b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;

(c) A very low exception rate is expected; and

(d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

For example

Holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

5.8 Evaluating the Evidence Obtained

The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary.

When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

(a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;

(b) A response deemed unreliable;

(c) A non-response; or

(d) A response indicating an exception.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330.

Test Your Understanding 8

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well -functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

Test Your Understanding 9

On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?

6. INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES (SA 510)

6.1 Scope of this SA

The Standard on Auditing (SA) 510 "Initial Audit Engagements-Opening Balances" deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in SA 710 also apply.

6.2 Definitions

1. **Initial audit engagement refers** to an engagement in which either:

   (i) The financial statements for the prior period were not audited; or

   (ii) The financial statements for the prior period were audited by a predecessor auditor.

2. **Opening balances means** those account balances that exist at the beginning of the period.

   Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period.

   Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

3. **Predecessor auditor** – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

6.3 Objective of Auditor with respect to Opening Balances– in conducting an Initial Audit Engagement

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

6.4 Obtaining sufficient appropriate Audit evidence about opening balances by the Auditor

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

  (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

  (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

  (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.

If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

6.5 Procedures adopted by the Auditor to Obtain Audit Evidence regarding opening balances:

6.5.1 Nature and extent of Audit Procedures

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances **depend on such matters as**:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

6.5.2 If the prior period's financial statements were audited by a predecessor auditor

If the prior period's **financial statements were audited by a predecessor auditor**, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by **perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements.**

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

6.5.3 For current assets and liabilities

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.

For example

> The collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

6.5.4 For non- current assets and liabilities

For non-current assets and liabilities,

(i) such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by **examining the accounting records and other information** underlying the opening balances.

(ii) In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances **through confirmation with third parties.**

For example

> for long-term debt and investments audit evidence may be obtained through confirmation with third parties. In other cases, the auditor may need to carry out additional audit procedures.

6.6 Consistency of Accounting Policies relating to opening balances

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

If the auditor concludes that:

(a) the current period's accounting **policies are not consistently applied i**n relation to opening balances in accordance with the applicable financial reporting framework; or

(b) **a change in accounting policies** is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.

6.7 Reporting by the auditor with regard to opening balances

1. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances,

   the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

2. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

7. RELATED PARTIES (SA 550)

7.1 Scope of this SA

The Standard on Auditing (SA)550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.

7.2 Definition of Related Party

A party that is either

(i) A related party as defined in the applicable financial reporting framework; or

(ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:

    a. A person or other entity that has **control or significant influence**, directly or indirectly through one or more intermediaries, over the reporting entity;

    b. Another entity over which the reporting entity has **control or significant influence,** directly or indirectly through one or more intermediaries; or

    c. Another entity that is under common control with the reporting entity through having:

        i. Common controlling ownership;

        ii. Owners who are close family members; or

        iii. Common key management.

    However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

7.3 Meaning of control and significant influence in reference to related party

Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:

(a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and

(b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

The existence of the following relationships may indicate the presence of control or significant influence:

(i) Direct or indirect equity holdings or other financial interests in the entity.

(ii) The entity's holdings of direct or indirect equity or other financial interests in other entities.

(iii) Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).

(iv) Being a close family member of any person referred to in subparagraph (iii).

(v) Having a significant business relationship with any person referred to in subparagraph (iii).

7.4 Meaning of Related Parties with Dominant Influence

Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud.

7.5 Meaning of Special-Purpose Entities as Related Parties

In some circumstances, a special-purpose entity may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special- purpose entity's equity.

7.6 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.

However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

For example

(A) Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.

(B) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.

(C) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

7.7 Understanding the Entity's Related Party Relationships & Transactions

The auditor shall inquire of management regarding:

(a) The identity of the entity's related parties, including changes from the prior period;

(b) The nature of the relationships between the entity and these related parties; and

(c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, **to obtain an understanding of the controls,** if any, that management has established to -

(a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

(b) Authorise and approve significant transactions and arrangements with related parties; and

(c) Authorise and approve significant transactions and arrangements outside the normal course of business.

7.8 Considerations specific to smaller entities by the auditor

Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists.

Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions.

An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions.

For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, **through inquiry of management combined with other procedures, such as observation**

of management's oversight and review activities, and inspection of available relevant documentation.

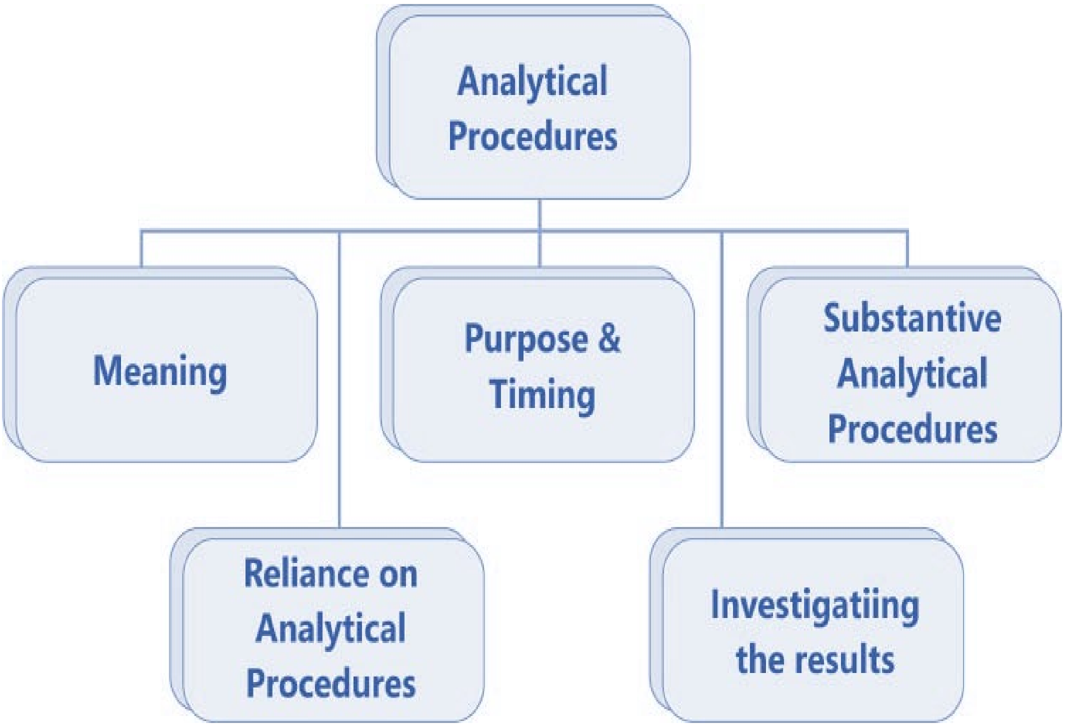
Question

How can an auditor verify the existence of related party relationships and transactions?

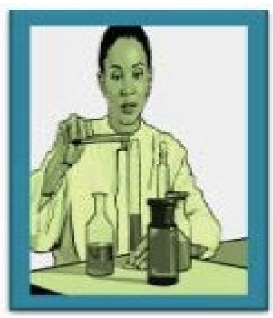
During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, **for example**:

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. Documents associated with the entity's filings with a securities regulator e.g, prospectuses)

8. ANALYTICAL PROCEDURES (SA 520)



8.1 Meaning of Analytical Procedures



Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like comparisons, trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA 520 on Analytical Procedures discusses the application of analytical procedures during an audit. Let us try to understand the concept discussed above with the help of the following illustration:

ILLUSTRATION 9

CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to ₹50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of ₹ 10,000/- per month for a *similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?*

SOLUTION

If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid ₹ 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

Meaning of Analytical Procedures. As per the Standard on Auditing **(SA) 520 "Analytical Procedures"**, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

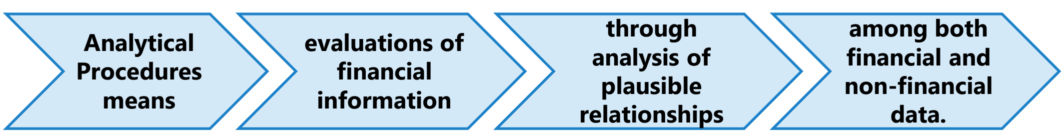


ILLUSTRATION 10

Analytical procedure involves analysis of relationship among financial and non-financial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2022-23.

SOLUTION

As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.

The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.

i.e. Total wages = Wages per worker x Total number of workers.

Here wages per worker is financial data i.e. in ₹ and total number of workers is a number which is a non financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in ₹) by analyzing the relationship between wages per worker (in ₹) which is financial data and number of workers which is a non financial data.

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

Comparisons of the entity's financial information with + **Consideration of relationships** + **Various other procedures** = **Analytical procedures**

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information are:

- Comparable information for prior periods.

Example:

CA Brijesh, while verifying the travelling expenses of PRT Ltd., may compare the travelling expenses of current year amounting to ₹ 2.50 lakhs with previous year travelling expense of PRT Ltd. amounting to ₹ 2 lakhs and infer that there has been an increase of 25% in the travelling expense incurred by the company. CA Brijesh may compare such percentage increase with the trend of the earlier several years.

Thus, CA Brijesh, can use comparable information for prior periods of PRT Ltd. while applying analytical procedure with respect to the expenses incurred by the company.

- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Examples of Analytical Procedures having consideration of relationships are:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

ILLUSTRATION 11

Particulars	Client		Industry	
Year	2021-22	2022-23	2021-22	2022-23
Inventory Turnover	2.8	2.9	3.1	2.8
Gross Margin	22.5%	22.7%	23.6%	22.2%

- Various methods may be used to perform analytical procedures.
- These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques.
- Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Thus, we can say that Analytical Procedures may be segregated into the following major types:

- as comparison of client and industry data,
- comparison of client data with similar prior period data,
- comparison of client data with client-determined expected results,

- comparison of client data with auditor-determined expected results and
- comparison of client data with expected results, using non financial data.

8.2 Scope of SA 520

SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Objectives

The objectives of the auditor are:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

8.3 Purpose and timing of Analytical Procedures

8.3A Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year, reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

Example

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

On verifying the balances of **sundry account receivables** by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.

Also whether in the case of **account payable,** the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

In case of **inventories of raw materials and stores** at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

By reconciling the **amounts of interest and dividends** collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making **inter-firm and intra-firm comparison** of trading results.

Example

If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

- Similarly, it would also be possible **to compare the balances** on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
- If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the **administrative cost,** apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

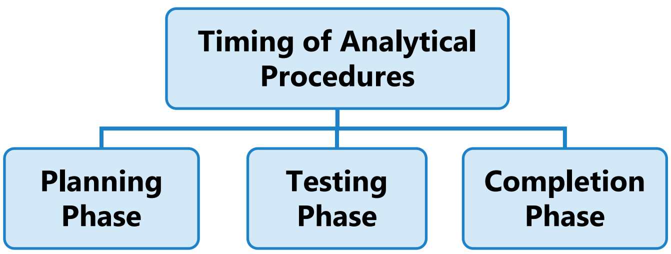
For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of GST paid.

Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, *e.g.,* commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

8.3B Timing of Analytical Procedures

Experienced auditors use analytical procedures in all stages of the audit. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.



8.3C Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example: Analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

8.4 Substantive Analytical Procedures

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

8.5 Factors to be considered for Substantive Audit Procedures

- **Availability of Data**
- **Disaggregation**
- **Account type**
- **Source**
- **Predictability**
- **Nature of Assertion**
- **Inherent Risk or "What can go Wrong"**

The auditor should consider the following factors for Substantive Audit Procedures:

i) **Availability of Data** – The availability of reliable and relevant data will facilitate effective analytical procedures.

ii) **Disaggregation** – The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.

iii) **Account Type** – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

Example

We can analyze data to understand the relationship to another account and through this, disaggregate the transactions flowing to and from the balance sheet account (e.g., sales and cash receipts flowing through trade receivables), or to compare ratios over time as this enhances our ability to obtain audit evidence for balance sheet accounts.

iv) **Source** – Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict.

Example

Transactions of routine nature like transactions related to sales and purchases are predictable and repetitive in nature. Therefore, on such data analytical procedures can be efficiently applied.

However, Significant Classes Transactions are those classes of transactions in a company's operations that are key to the financial statements and are not frequent in nature. Example: Expenditure on Research & Advertisement is not of routine nature and are subject to management judgement and therefore more difficult to predict.

v) **Predictability** – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

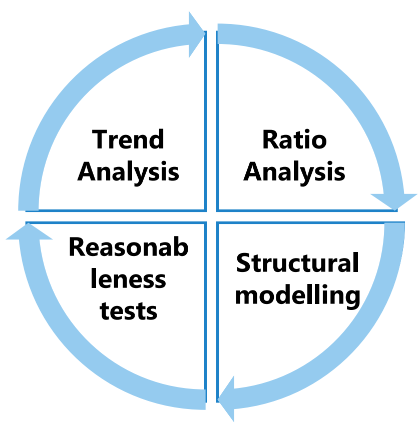
vi) **Nature of Assertion** – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.

vii) **Inherent Risk or "What Can Go Wrong"** – When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Example

When side agreements with respect to revenue recognition have been identified as a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

8.6 Techniques available as Substantive Analytical Procedures



The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. **Substantive analytical procedures generally take one of the following forms:**

i) **Trend analysis** – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

In other words, trend analysis implies analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

Example

The auditor may compare the salary paid by the company during the year under audit with the salary paid by the company for several earlier years. There may be some percentage increase in the salary expense over the years. However, an unusual increase in such expense amount may indicate that fraudulent payments are being made to fake employees.

ii) **Ratio analysis** – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Example

Financial ratios may include:

- Trade receivables or inventory turnover
- Freight expense as a percentage of sales revenue

Example

The statutory auditor can review the Gross profit ratio of the company for the year under audit. The auditor can further compare such GP ratio with the GP ratio of the company in the earlier years or the GP ratio of the other companies in the same industry for the year under audit.

iii) **Reasonableness tests** – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Example

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

iv) **Structural modelling** – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

8.7 Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

Determine suitability of analytical procedure

Evaluate reliability of data

Develop an expectation

Determine acceptable difference

(i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

8.8 Suitability of particular analytical procedures for given assertions

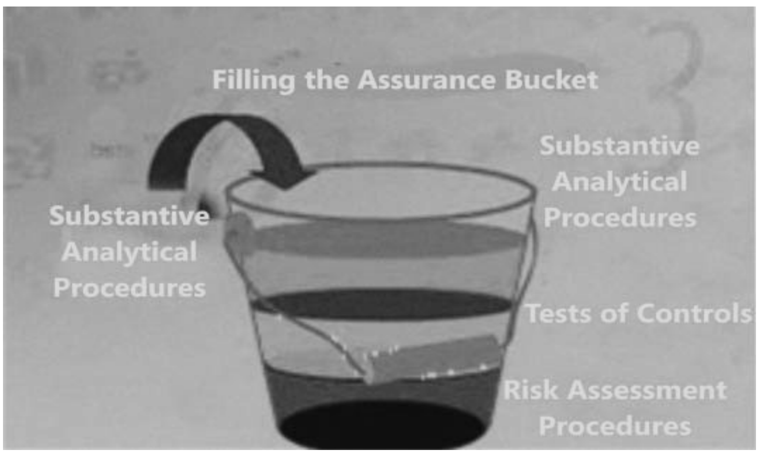
1. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
2. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.
3. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
4. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Example

If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, **for example,** the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. **For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.**



Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. **For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.**

8.9 The reliability of DATA

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) • **Source of Information**

(ii) • **Comparability of the information**

(iii) • **Nature & Relevance of Information**

(iv) • **Controls over the preparation of the information**

(i) Source of the information available. **For example**, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. **For example**, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. **For example**, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. **For example**, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

8.10 Evaluation of whether the expectation is sufficiently precise

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial.

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

8.11 Amount of difference of recorded amounts from expected values that is acceptable

The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

8.12 Investigating results of Analytical Procedures

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

8.13 Analytical procedures that assist when forming an overall conclusion

The conclusions drawn from the results of analytical procedures designed and performed in accordance with, are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

Test Your Understanding 10

An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues.

CASE STUDY 1

CA Drishti Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties. The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

In particular, she is attending physical inventory count process of the company at year end in accordance with requirements of SA 501.The inventory of the company includes raw materials consisting mainly of natural and dyed yarns, work in process in different stages of manufacturing and finished stocks of towels and bedspreads.

She is also planning sending confirmations to parties to whom the company has sold goods. On reviewing trade receivables list, she finds that the list also contains large number of parties having small balances. She further finds that these receivables have arisen due to sale of bedspreads to small time retailers and possibility of difference in balances as per company's records and as per records of these small-time retailers is low. Risk of misstatements in relation to trade receivables has been assessed as low. Besides, there is nothing to suggest that small-time retailers would disregard such requests.

While conducting audit, she is testing controls operating in the company. She is also conducting tests of various items of income and expenditure as well as balances appearing in balance sheet. She intends to rely upon sampling extensively.

Based on above description, answer the following questions:

1. *Which of the following statements is most appropriate regarding inventory count by auditor in accordance with SA 501?*

   (a) *She should inspect the inventory to ascertain its existence and condition at all locations, observe how company personnel are carrying out count procedures and perform test counting.*

   (b) *She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.*

   (c) *She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.*

   (d) *She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.*

2. *As regards inventories lying with third parties, which of following statements meets requirements of SA 501?*

   (a) *She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.*

   (b) *She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.*

   (c) *There is no obligation cast upon an auditor in respect of inventories lying with third parties.*

   (d) *She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.*

3. *Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?*

   (a) *She should not plan and design confirmation requests for large number of parties having small balances.*

   (b) *She should plan and design positive confirmation requests for large number of parties having small balances.*

   (c) *She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate*

   (d) *She should plan and design negative confirmation requests for large number of parties having small balances.*

4. *As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?*

   (a) *Sampling is used in tests of transactions as well as tests of controls.*

   (b) *Sampling is used in tests of balances as well as tests of controls.*

   (c) *Sampling is used in tests of details.*

   (d) *Sampling is used in tests of details as well as tests of controls.*

5. *Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?*

   (a) *Sampling risk can be eliminated.*

   (b) *Increase in sampling risk would lead to decrease in detection risk.*

   (c) *Decrease in sampling risk would lead to increase in detection risk.*

   (d) *Sampling risk will always be in existence.*

Answers to questions involving Case Study 1

1. **a** 2. **b** 3. **d** 4. **d** 5. **d**

CASE STUDY 2

Financial statements of a firm have been put up for audit before CA Manushi. On going through financial statements, she wants to verify assertions contained in financial statements and has planned certain procedures for carrying out detailed checking.

(A) She plans to verify some major bills debited in "Machinery repair" account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.

(B) She plans to verify that all balances appearing under trade payables are genuine and not fake.

(C) She plans to compare amount of wages paid in current year and last year. It is also planned to verify relationship between the number of employees and wages paid in both years.

(D) She is of the view that it is necessary to examine title deeds of "land" appearing in financial statements of the firm.

(E) The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms.

Based on above description, answer the following questions:

1. *As regards description given regarding verification of bills debited in "Machinery repair" account, identify what she intends to perform?*

   (a) *Tests of Controls*

   (b) *Tests of transactions*

   (c) *Tests of balances*

   (d) *Risk assessment procedures*

2. *Identify which type of assertion she intends to focus when she wants to ensure genuineness of trade payables.*

   (a) *Occurrence*

   (b) *Cut-off*

   (c) *Existence*

   (d) *Accuracy*

3. *As regards comparison of wages of current year and last year and comparison of relationship between the number of employees and wages paid in both years, identify what she is trying to do?*

   (a) She is intending to perform tests of details.

   (b) She is intending to perform tests of transactions.

   (c) She is intending to perform tests of balances.

   (d) She is intending to perform substantive analytical procedures.

4. *In case of examination of title deeds of "land", which of the following fits into most appropriate description of such an audit procedure?*

   (a) Observation

   (b) Inspection

   (c) External confirmation

   (d) Enquiry

5. *She wants to verify whether conversion of foreign currency into Indian rupees is proper or not. Identify what she is trying to do?*

   (a) Reperformance

   (b) Recalculation

   (c) Observation

   (d) Inspection

Answers to questions involving Case Study 2

1.	**b**	2.	**c**	3.	**d**	4.	**b**	5.	**b**

SUMMARY

- Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.
- The quality of audit evidence is affected by the relevance and reliability of the information upon which it is based.

- The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements.
- Sufficiency is the measure of the quantity of audit evidence. Appropriateness is measure of quality of audit evidence.
- Audit procedures to obtain audit evidence can include inspection, observation, external confirmation, recalculation, reperformance, analytical procedures and inquiry.
- Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.
- Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
- Substantive procedures may be defined as audit procedures designed to detect material misstatements at the assertion level. These comprise of tests of details and substantive analytical procedures. Test of details comprise of tests of transactions and tests of balances.
- Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
- Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security.
- The auditor may rely on the works of experts employed by management, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements.
- Internal audit function refers to function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

- Audit sampling refers to the application of audit procedures to less than 100% of items within a population of audit relevance, such that all sampling units (i.e all the items in the population) have an equal chance of selection in accordance with SA 530. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.
- SA 501- "Audit Evidence- Specific Considerations for Selected Items" deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.
- SA 505 "External Confirmations" deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500.
- Standard on Auditing (SA) 510 "Initial Audit Engagements-Opening Balances" deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement.
- Standard on Auditing (SA)550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.
- "Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
- SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

TEST YOUR KNOWLEDGE

MCQs based Questions

(1) Which of the following is not one of functions of internal auditor of an organization?

(a) Performing assurance activities

(b) Performing consulting activities to improve governance of organization

(c) Performing risk management activities

(d) Expressing independent opinion on financial statements of organization

(2) An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?

(a) The risk that management may override controls in respect of related party transactions is lower.

(b) The risk that management may override controls in respect of related party transactions is higher.

(c) There is no effect on the risk that management may override controls in respect of related party transactions.

(d) Risk of overriding of controls by management has no relationship at all with related party transactions.

(3) Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?

(a) Efficient conduct of business

(b) Safeguarding of assets

(c) Prevention and detection of frauds and errors

(d) Assessing audit risk

(4) Which of the following is not an advantage of statistical sampling?

(a) Sample size does not increase in proportion to size of area tested.

(b) Sample selection is more objective.

(c) *It provides a means of deriving a calculated risk and corresponding precision.*

(d) *In case of verifying compliance with specific legal requirements, it is suitable.*

(5) *A company auditor receives external confirmation from an entity to whom company has sold goods. The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?*

(a) *It shows that said trade receivable exists.*

(b) *It shows that said trade receivable is properly valued.*

(c) *It shows that company has a right to said trade receivable.*

(d) *It shows that amount of said trade receivable has been recorded in proper account.*

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. *Purchase invoice is an example of internal evidence.*
2. *Sufficiency is the measure of the quality of audit evidence.*
3. *Inquiry alone is sufficient to test the operating effectiveness of controls.*
4. *When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries.*
5. *Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.*
6. *The method which involves dividing the population into groups of items is knows as block sampling.*
7. *Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.*
8. *Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.*

9. *Sample need not be representative.*

10. *The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.*

11. *When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.*

12. *Stratified Sampling is used for homogeneous population.*

13. *Non statistical sampling is considered to be more scientific than the statistical sampling.*

14. *In case of Statistical sampling, auditor's bias in choosing sample is involved.*

15. *In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population.*

16. *Low acceptable sampling risk requires larger sample size.*

17. *As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only.*

18. *Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.*

19. *Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.*

20. *Analytical Procedures are required in the planning phase only.*

21. *Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.*

22. *Ratio analysis is useful in analyzing revenue and expense account only.*

23. *Reasonableness test rely only on the events of the prior period like other analytical procedures.*

24. *The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.*

Theoretical Questions

1. *Many related party transactions are in the normal course of business. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Give few examples of such areas.*

2. *An auditor is appointed for the first time for audit of accounts of an entity. The accounts of previous year were unaudited. He is unable to obtain sufficient appropriate audit evidence regarding the opening balances. What is his responsibility in this regard?*

3. *Discuss some of circumstances when work of the internal auditor cannot be used by external auditor.*

4. *Discuss what is understood by "appropriateness" of audit evidence.*

5. *Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors.*

6. *Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.*

7. *Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.*

8. *M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach?*

9. *While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?*

10. *The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.*

11. *When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.*

12. *Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.*

13. *The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on "Analytical Procedures"?*

14. *Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain*

15. *What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA 520 on "Analytical procedures".*

16. *Define Analytical Procedures.*

17. *M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2022-23-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?*

18. *What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.*

19. *What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".*

20. *With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.*

21. *While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?*

22. *Write short notes on the following:*

    (a) Advantages of Statistical sampling in Auditing.

    (b) Stratified sampling

23. *What precautions should be taken by the auditor while applying test check techniques?*

24. *Explain the factors to be considered while determining the extent of checking on a sampling plan.*

ANSWERS/SOLUTIONS

Answers to the MCQs based Questions

1.	**d**	2.	**b**	3.	**d**	4.	**d**	5.	**b**

Answers to Correct/Incorrect

1. **Incorrect:** Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

2. **Incorrect:** Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

3. **Incorrect:** Inquiry along with other audit procedures (for example observation, inspection, external confirmation etc.) would only enable the auditor to test the operating effectiveness of controls. Inquiry alone is not sufficient to test the operating effectiveness of controls.

4. **Incorrect:** When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.

5. **Incorrect:** Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

6. **Incorrect:** The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

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

8. **Incorrect:** Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

9. **Incorrect:** Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

10. **Incorrect**: The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

11. **Incorrect:** Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

12. **Incorrect:** Stratified sampling is used when the population is diversified i.e heterogeneous. The population is divided into sub population having similar characteristics. Sample are then chosen from these sub populations which are called as Stratum. Therefore, stratified sampling is not useful in case of homogeneous population.

13. **Incorrect**: Statistical sampling uses scientific method of choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

14. **Incorrect:** Statistical sampling uses scientific method choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditor's judgment and past experience is used to choose samples without and scientific method. Hence, personal bias is involved in Non statistical sampling and not Statistical.

15. Incorrect: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population**.**

16. Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

17. Incorrect. As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

18. Incorrect. Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

19. Incorrect. Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

(i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

20. Incorrect. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

21. Incorrect. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

22. Incorrect: Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts

23. Incorrect: Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

24. Incorrect: Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Answers to the Theoretical Questions

1. Refer to heading " Nature of related party relationships and transactions"

2. Refer to heading "Reporting by the auditor with regard to opening balances"

3. Refer to heading "Circumstances when work of the internal audit function cannot be used"

4. Refer to heading "Sufficient appropriate audit evidence".

5. Refer to heading "Audit trail".

6. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

   ### Analytical Procedures in Planning the Audit

   In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

   For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

7. Refer to heading "Objective of Auditor with respect to Opening Balances – in conducting an Initial Audit Engagement'

8. Initial audit engagement is an engagement in which either:

   (i) The financial statements for the prior period were not audited; or

   (ii) The financial statements for the prior period were audited by a predecessor auditor.

   From the above, it is quite clear that CA Pankaj is not correct *in* his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

   Audit Procedures regarding Opening Balances; The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

   The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

   (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

   (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

   (c) Performing one or more of the following:

      (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

      (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

      (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

9. While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

Trend analysis – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Structural modelling – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

10. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

11. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

    (a) Determining the information to be confirmed or requested;

    (b) Selecting the appropriate confirming party;

    (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

    (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

12. Matters relevant in planning attendance at physical inventory counting include, for example:

    (a) Nature of inventory.

    (b) Stages of completion of work in progress.

    (c) The risks of material misstatement related to inventory.

    (d) The nature of the internal control related to inventory.

    (e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

    (f) The timing of physical inventory counting.

    (g) Whether the entity maintains a perpetual inventory system.

(h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate

(i) Whether the assistance of an auditor's expert is needed.

13. **As per SA 520 "Analytical Procedures"** If while applying analytical procedures in accordance with SA 520, the statutory auditor identifies fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. and obtain sufficient and appropriate audit evidence relevant to management response. Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

14. **Audit evidence is necessary to support the auditor's opinion and report**. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's

expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

15. Refer to heading '**The reliability of data (SA 520)'**

16. **Meaning of Analytical Procedures:** As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

    Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

17. As per SA 510, **"Initial Engagement- Opening balances"** the objective of the auditor with respect to the opening balances is to obtain sufficient and appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

18. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:

(a) Materiality: It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(b) Risk of material misstatement: It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

- Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
- Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(c) **Size of a population:** It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

19. **Meaning of Audit Sampling:** "Audit Sampling" means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Refer to heading "Samples Selection methods".

20. **Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

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

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.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

21. **Risk Factors while applying Sampling Techniques:** As per SA 530 "Audit Sampling", sampling risk is 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. 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 tests of details, that a material misstatement does not exists when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

22. **(a) Advantages of Statistical Sampling in Auditing:** Refer to heading " Appropriateness of Sampling Approaches".

(b) Stratified Sampling: Refer to heading "Samples Selection methods"..

23. Precautions to be taken while applying test check techniques are

- Thorough study of accounting system should be done before adopting sampling.
- Proper study of internal control systems.
- Areas which are not suitable for sampling should be carefully considered. Eg: compliance with statutory provisions, transactions of unusual nature etc.
- Proper planning for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly classified (stratified)
- Sample size should be appropriately determined.
- Sample should be chosen in unbiased way,
- Errors located in the sample should be analysed properly.

24. The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

    (i) Size of the organisation under audit.

    (ii) State of the internal control.

    (iii) Adequacy and reliability of books and records.

    (iv) Tolerable error range.

    (v) Degree of the desired confidence.

Answers to Questions involving Test Your Understanding

1. The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

2. Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.

3. The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

4. One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

5. In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons

of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

6. In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

7. As per requirements of SA-501, If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

8. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

   (a) Determining the information to be confirmed or requested;

   (b) Selecting the appropriate confirming party;

   (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

   (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

   In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

9. In terms of requirements of SA 505, if management refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to

management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.

10. Analytical procedures in relation to revenue can include:-

    (i) Comparing revenue of current year with previous year and investigating significant fluctuations

    (ii) Comparing revenue of current year with budgeted targets and investigating significant fluctuations.