Diploma in Financial Management & Accountability

- A joint initiative of TISS & FMSF

Course Material

Audit

Paper - VII

Module - IV

Faculty: Mr. Suresh Kejriwal

UNIT- 4
PREPARATION FOR AN AUDIT

4.1. INTRODUCTION

For effective work one has to frame a proper scheme of work and determine the techniques that are needed for collection of purposeful evidence. The scheme of auditing process envisages the following:

a) Formulating audit programme on the basis of knowledge of client's business.

b) Determination of the extent of checking on the basis of compliance procedures.

c) Carrying out the steps in the procedure on the basis of programme and the extent of substantive checking that may be required.

d) Keeping a record of notes and inquiries and maintenance of working papers.

e) Formulation of opinion about financial statements and review with reference to accounting standards.

f) Issuance of the audit report.

4.2. AUDIT PROCESS

One must take care to ensure that nothing is missed in the process which needs to be followed to achieve the audit objective. The following audit process in that order may be taken as a specimen:

(a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.

(b) Examination and evaluation of the nature, extent and efficacy of the system of internal control. The nature, extent and timing of substantive procedures, would depend upon the extent of satisfaction an auditor obtains after evaluating the internal control system. The determination of extent of test checking would also depend upon the same.

(c) Ascertaining the arithmetical accuracy of the books of account by checking posting, casting, crass-casting, carry forwards, opening and closing balances, etc.

(d) Examining the documentary evidence (both internal and external) and the authority in support of the transaction, i.e., vouching :

(e) Checking the validity of transactions with reference to :

(i) provisions affecting the accounts and audit in any Act or Rules;

(ii) rules and regulations governing the constitution and management of the organisation i.e., the memorandum and articles of association in the case of a company, partnership deed in the case of a firm, trust deed in the case of a trust and bye-laws in the case of a co-operative society;

(iii) minute books for appropriate sanction of the transactions by competent authority;

(iv) other legal documents such as the prospectus, returns submitted to legal authorities, contracts and agreements, e.g., vendors' agreement, lease agreement, selling agency agreement, collaboration agreements, etc.; and

(v) well recognised accounting principles and practices e.g., distinction between capital and revenue, accrual system of accounting, valuation principles, etc.

(f) Ensuring that there is adequate disclosure of information and, in particular, the annual accounts are prepared in such a manner as to convey the real picture about the assets and liabilities and of the operating result (profit or loss) of the organisation. For this purpose, the auditor must conform the prescribed legal requirement, if any, as to the form of accounts and have due regard to the best current accounting practice, Reference to Schedule VI in case of companies and compliance with accounting standards will have to be seen.

(g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.

(h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.

(i) Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.

(j) Determination of the significant accounting ratio and subjecting the accounts to ratio analysis to locate the areas showing departure from the expected state of affairs.

4.3. AUDIT TECHNIQUES

For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques commonly adopted by the auditors are the following :

1. Posting checking
2. Casting checking
3. Physical examination and count
4. Confirmation
5. Inquiry
6. Year-end scrutiny

7. Re-computation
8. Tracing in subsequent period
9. Bank Reconciliation

The two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work;; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires and examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence. As per AAS-5 on Audit Evidence, basically audit procedures are broadly of two types viz. compliance procedures and tests of detail. Test of details are further comprised of substantive audit procedures and analytical review procedures. Vouching is a substantive audit procedure which involves audit techniques like casting, cross-casting, checking of posting, etc. On the other hand, verification of assets and liabilities is a substantive audit procedure which involves application of audit techniques like physical examination, confirmation from third parties, etc.

4.4. AUDIT PLANNING

As per Auditing & Assurance Standard 1, "Basic Principles Governing an Audit", Audit Planning is one of the basic principles. Accordingly, it states:

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

Objectives of Planning: Adequate audit planning helps to :

- Ensure that appropriate attention is devoted to important areas of the audit;
- Ensure that potential problems are promptly identified;
- Ensure that the work is completed expeditiously;
- Utilize the assistants properly; and
- Co-ordinate the work done by other auditors and experts.

4.5. DEVELOPMENT OF OVERLAL AUDIT PROGRAMME

The auditor should prepare a written audit programme setting forth the procedure required to implement the Audit Plan. The programme may also contain the audit objectives for each area and should have sufficient detail to solve, as a guideline to the assistants.

While preparing audit programme of an NGO, the Auditor has to be very careful of the accounting process and internal controls in place and accordingly he has to estimate the quantum of reliance, which he may have on the internal control systems and also the adequacy of the accounting processes in terms of AS-1. The Auditor should also map the financial systems and accordingly distribute the available time frame and the co-ordination of his own assistants, clients, personnel and involvement of other Auditors or experts.

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures. Further, the chapter on Audit Checklist may be referred.

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- The terms of his engagement and any statutory responsibilities.

- The nature and timing of reports or other communications.

- The applicable legal or statutory requirements.

- The accounting policies adopted by the client and changes in those policies.

- The effect of new accounting or auditing pronouncements on the audit.

- The identification of significant audit areas.

- The setting of materiality levels for audit purpose.

- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial members of the entity are interested and with whom transactions are likely.

- The degree of reliance he is able to place on accounting system and internal control.

- Possible rotation of emphasis on specific audit areas.

- The nature and extent of audit evidence to be obtained.

- The work of internal auditors and the extent of their involvement, if any, in the audit.

- The involvement of other auditors in the audit of subsidiaries or branches of the client.

- The involvement of experts.

- The allocation of work to be undertaken between joint Auditors and the procedures for its control and review.

- Establishing and coordinating staffing requirements.

The auditor should document his overall plan. The form and extent of the documentation will vary depending on the size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be an effective planning tool.

4.6. AUDIT WORKING PAPERS

The audit working paper constitutes the link between the auditor's report and the client's records. AAS- 3 on "Documentation" refers to working papers prepared or obtained by the auditor and retained by him in connection with the performance of his audit. The object of working papers is to record and demonstrate the audit work from one year to another. Working papers should record audit plans. The nature, timing and extent of auditing procedures performed and the conclusions drawn from the evidence obtained. The working papers should provide for

- Means of controlling current audit work
- Supervision and review of the audit work
- Evidence of audit work performed to support the auditor's opinion

Working papers would also provide the evidence of work performed in case of charge of negligence brought against the auditors.

4.6.1. Importance of working papers: The audit working papers are of vital importance whether the audit is statutory or private, internal or the management audit. Audit working papers records evidence gathered by the auditor which will help him in arriving at his conclusions. Working papers are tool for accomplishing the purpose of audit. Also, they act as a support for work accomplished. The importance of working papers is as follows:

- The auditor can find out how and to what extent his assistants have followed his instructions
- The audit working papers help the auditors in finalizing their report.
- They can be useful when there is change in audit staff. The new member of staff can go through them and pick up the thread left by his predecessor.
- It reveals how the work was performed by the audit staff.
- They help in evaluating internal control and accounting system of the client.
- They help in preparing audit plan for the next year.

- Queries in respect of earlier years can be given proper attention in future.
- They aid in first organizing the audit and then co-ordinating the same.
- They help the auditors to fix responsibility on the staff member who signs each schedule checked by them. They act as an evidence in court of law when a charge of negligence is brought against the auditor.

4.6.2. Form & Content of working papers: The form and content of audit working paper may vary from one audit to other. The form and content of working papers are affected by matters like:

- Nature of engagement
- Form of auditor's report
- Nature and complexity of client's business
- Nature and conditions of client's records
- Degree of reliance on internal controls
- Need in particular circumstances for direction, supervision and review of work performed by assistant.

4.6.3. Classification of Audit Working papers

Permanent Audit Files – They are updated with information regarding legal and organizational structure of the entity.

Current Audit Files – They contain information relating primarily to the audit of a single period, e.g. correspondence relating to acceptance of annual reappointment, analysis of transactions and balances etc.

Permanent Audit File

This file contains all the papers and document's which have a long – term use. They can be referred to on a repetitive engagement from year to year.

4.6.4. Contents of permanent Audit file

i) History/background of the NGO.

ii) Form & date of Registration and primary objectives.

iii) A copy of the registration certificate and the memorandum and articles of association.

iv) A copy of the registration certificate under section 12AA, 80G, 35AC of the Income Tax Act.

v) A copy of Income Tax Permanent Account Number, Tax Deduction Account Number and Income Tax Jurisdiction.

vi) A copy of FCRA registration certificate and designated bankers name, account number and addresses.

vii) A copy of Foreign Contribution Return sent to the Home Ministry.

viii) A copy of Income Tax Return submitted to Income Tax department.

ix) Returns and statements submitted to Registrar of Societies/Charity Commissioner.

x) An organization Chart.

xi) Details of work area, branches, downstream NGOs.

xii) Detail of major donors and important projects.

xiii) List of Trustees, Board Members along with their background and addresses.

xiv) List of books of account, supporting statements, documents, financial reports along with the chart of accounts should be kept.

4.6.5. Current Audit File

All the papers which pertain to the year under audit are filed in the current file.

- **Contents of current Audit file**

The current file normally contains all the papers that pertain to the year under audit. They include the following:

- The audit programme for the year.
- The internal control questionnaire issued to the client and replies against each item or question.
- Important adjustments or journal entries having a bearing on the final accounts.
- The working trial balance.
- Bank reconciliation statements, all schedules, confirmation letters and replies.
- Audit Notes.
- The record of work done.
- Schedule of depreciation, computation of tax liability, computation of dividend and such other relevant statements.
- Manuscript copies of current year's Final accounts together with all annexures, schedules, groupings and details.
- The manuscript working copy of the auditor's report.

4.7. TEST CHECKS

The term "test checks" stands for the method of auditing where instead of a complete examination of all the transactions recorded in the books of account only some of the transactions are selected and verified. The underlying idea is to test some of the transactions to form an opinion for the whole. According to Prof. Meig, "Test checking means to select and examine a representative sample from a large number of similar items."

The justification for test check lies on theory of probability which states, in effect, that a sample selected from a series of items will tend to show the same characteristics present in the full series of items, which is commonly referred to as the “Population” or “Universe”.

It is a common knowledge that the volume of transactions of a business is enormous nowadays and within the time and cost constraints, in which auditing is done, it is physical impossibility to check each and every transaction of a business (save only small business). Checking of each and every transaction which is mostly repetitive in nature is also not required provided the internal control system is satisfactory. However, to make the audit meaningful, the selection of transactions for checking should be on a basis that produces a representative sample, also neither too big nor too small. Whatever time is available with the auditor, the same should be allotted on a rational basis to the various audit processes and should not be exhausted only on routine checking.

4.8. SURPRISE CHECK

Surprise checks are important as a part of normal audit procedure. An element of surprise improves the effectiveness of the audit considerably. It is therefore, advisable to introduce surprise checks in the audit programme itself.

Surprise elements can be both with regard to

a) The selection of time for audit, and
b) The selection of the items for audit.

Surprise checks may be with respect to the verification of cash investments in securities etc. and tallying them with the appropriate books of account. The scope of surprise checks may be extended to the verification and examination of other items also. But a surprise must remain a surprise. There should not be any hint given to the staff of the client.

The frequency of surprise checks should be as per the necessity of each case. There cannot be any hard and fast rule for this. But where the management is far away from the works, it is advisable to carry out surprise checks at the works at unusual or unexpected intervals. In such cases, in particular, surprise checks should be considered as a necessary item of audit. But the results of the surprise checks must be communicated to the client or the top management immediately for taking corrective measures. The auditor also should see to it that adequate measures are taken by the management on his report.

SELF ASSESSMENT QUESTIONS

i) What is the importance of planning of audit?

ii) Why audit programs are necessary and how it is prepared?

iii) What are the audit techniques?

iv) What are the working papers and what are the different types of working file?

v) What is the difference between Surprise check and Test check?