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SAMPLE CONTENT

SMART NOTES

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(SEM IV)

Auditing

SMART NOTES

AUDITING

S.Y.B.Com. Sem – IV

Mumbai University

(As per the revised syllabus: 2017-18)

Salient Features:

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Note:

1. There are only four modules as per the syllabus prescribed by the University. However, we have broken the 4th modules into two chapters for clear demarcation between the two topics
2. Any content given in boxes is only for your understanding and for better clarity. Students are not expected to write it in any exam.

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2	Test checking – advantages, disadvantages, precautions				
3	Routine checking – meaning and features (NOT IN SYLLABUS)				
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Note: R1, R2, R3, R4 refer to your 1st, 2nd, 3rd and 4th reading of the syllabus. You can mark it with a tick as you study.

CHAPTER 3- AUDIT TECHNIQUES AND INTERNAL AUDIT INTRODUCTION

Audit techniques means the methods used to obtain audit evidence. "SA-500 Audit Evidence" talks about the audit techniques used to obtain audit evidence.

Q.1. What is test checking? Give practical examples. What are the features of test checking? When can test check be used?

Ans: It may not be possible for the auditor may to check all the financial records of the auditee completely. He may select a few items and check them properly. If they are found correct, he may assume that all transactions of similar nature have been recorded properly. This partial checking of records by the auditor is called as test checking. From an examination of a representative sample, auditor can form an opinion about the entire class of transactions. Thus, test checking means examining less than 100% of the items in population. The selection of items is done through the process of $\boxed{\text{sampling.}}$

According to Prof. Meigs, "Test checking means to select and examine a representative sample from a large number of similar items".

Generally, when we say that "test check" was done, it means that sample transactions were selected and checked out of all the transactions by the auditor using his personal judgement. If the sample is selected by using statistical techniques, it is called a statistical sampling.

PRACTICAL EXAMPLES OF TEST CHECKING

i. Vouching expenses only for 3 months out of 12.
ii. Vouching expenses only above Rs. 5,000/-
iii. Scrutinizing accounts of only major debtors.

The following are the features of test check:
(Smart Code: FETUR)

1. FULL COVERAGE OVER A PERIOD OF TIME

Test checking is planned in such a way that the audit programmes for 3 to 5 years would cover all types of transactions.

Eg: If the expense vouching for the months of June, December, February have been done in the audit of F.Y. 2012-13, the auditor may take up expense vouching for the months of July, October and January in the audit of F.Y. 2013-14. In such a way, the vouching for all the months will be covered over the years.

2. EVERY MATERIAL ITEM IS CHECKED COMPLETELY

All the material items, non-recurring or unusual items are checked completely whereas the other items are test checked. Test checking is mainly applied to routine transactions.

Eg: A company "Vikrant steel and Pipes Pvt. Ltd." earns income by supplying steel and pipes to various building contractors on a regular basis. Suppose in a year it earns some income from supplying pipes to a building contractor in New York, USA, then the auditor will check all documents relating to these transaction since it is non-recurring or unusual in nature.

3. THEORY OF PROBABILITY

The sample under test check is selected with the probability that all other transactions would be similar to the sample. Therefore, on examining a sample, the auditor can make a judgement about the entire class of transactions.

4. USE OF JUDGEMENT

The auditor uses his judgement while deciding the extent of test checking. The auditor's judgement is based on his previous experiences.

Eg: An auditor may be of the view based on his experiences that a lot of bogus entries are passed in the month of March since it is the last month of the year. Therefore, he may vouch all the transactions of March in the audit every year and not use test check.

5. REQUIRES SURPRISE ELEMENT

Test checking involves an element of surprise. The selection of sample is done in a manner such that the client's employees are not able to predict the area that will be audited in a particular audit.

Test checking can be adopted /used under the following circumstances or the following factors are to be considered while adopting test checking:

i) STRONG INTERNAL CONTROL

When the organization has a strong internal control system (Eg: an internal audit department), then the auditor can adopt test check.

ii) LARGE VOLUME OF TRANSACTIONS

When there are a huge number of transactions then it is not practically possible to scrutinize every transaction and the auditor will have to adopt test check.

iii) LIMITED TIME

Many a times, there are fixed time lines within which the audit has to be completed and finalized. At such time, test check is the only way to adhere to timelines.

Q.2. What are the advantages and disadvantages of test checking? What are the precautions to be taken while test checking?

Ans: According to Prof. Meigs, "Test checking means to select and examine a representative sample from a large number of similar items".

The following are the advantages of test checking:
(smart code: MATTERS)

i) MORAL CHECK

Test checking creates a moral check on the employees of the client since they are unaware as to which transaction will be checked by the auditor. Therefore, they have to be alert all the time.

ii) AUDIT OBJECTIVE

The objective of audit is to form an opinion about the financial statements of the company. Test checking, when undertaken carefully and properly can fulfill the objective of auditing.

iii) TIME SAVING

Test checking enables the auditor to save a lot of time since each and every transaction is not checked. The time saved can be utilized to verify material and important transactions in depth.

iv) TIMELY COMPLETION OF AUDIT

Test checking facilitates timely completion of the audit work. The audit staff does not spend time on audit of routine items and rather works towards finalizing the accounts and closing the audit.

v) EXPERTISE

While test checking, the auditor uses his professional judgement in selecting a sample. Thus, it enables the auditor to use his expertise effectively.

vi) REDUCTION IN WORK LOAD

The auditor would be under tremendous work pressure if all the transaction during the year had to be checked As the auditor does not check each and every transaction the work of the auditor is reduced considerably.

vii) SPEEDY DECLARATION OF RESULTS

Since the audit work is completed in time the results can be declared faster which in-turn facilitates quick declaration of financial results and dividend for the year.

The following are the disadvantages of test checking:
(Smart code : DISADN)

i) DETAIL CHECKING IS NOT DONE

All the transactions are not covered in test checking hence it is not an auditing in full. Only a few areas may be checked in the audit.

ii) IT IS UNAUTHENTIC

Test checking involves checking a representative sample on the basis of which the auditor has to form an opinion about the entire class of transactions. Therefore, the auditor is not completely sure of the authenticity of all the transactions

iii) SELECTION OF SAMPLE IS ARBITRARY

The transactions to be checked and the extent of checking are selected on an arbitrary (i.e random) basis. The selection depends upon the personal judgement of the auditor.

iv) AUDIT ASSISTANTS MAY TAKE SMALLER SAMPLE

To reduce the work, the audit assistants may take smaller samples due to which a lot of transactions may remain unchecked.

Eg: While vouching expenses, the audit assistants may select two months in which transactions are very less.

v) DETECTION OF ERRORS AND FRAUDS MAY BE DIFFICULT

It is possible that some important areas may go unaudited and errors may not be detected as all the transactions are not covered in test checking. Therefore, there is a certain risk involved in test checking.

vi) NO ELEMENT OF SURPRISE

If there is no element of surprise in test checking then the client may be able to predict the pattern of checking. The client's employees will prepare themselves accordingly

The basic precaution in test checking is the proper selection of the representative sample. The selected sample should be similar to all transactions of that class. Further precautions to be taken are as follows:

(Smart Code: CAUTION)

i) CLASSIFY TRANSACTIONS

The transactions should be classified properly under suitable heads. Then sample should be selected from each head to cover all areas of the audit.

Eg: The auditor may classify transactions as manufacturing expenses, indirect expenses, domestic sales, export sales, sundry debtors, sundry creditors, office expenses, factory expenses etc.

ii) AVOID UNSUITABLE AREAS

The auditor should identify the areas where test check is not suitable. For important transactions, it is better to check all of them. Also, there are certain areas where test check cannot be used like

- Bank Reconciliation
- Non-recurring items
- Opening tracing and closing tracing (i.e. checking whether the financial statements tally with the trial balance)
- Verification of fixed assets
- Transactions of high amounts
- Transactions with related parties
- Items where accounting standards require detailed checking

Also, test checking cannot be adopted on the areas where the internal controls are weak.

iii) UNDERSTAND SYSTEMS

The auditor should understand the system and procedures that are followed in the organization for recording a transaction. It includes understanding the organization's procedure followed right from recording, authorization, documentation and checking.

iv) THE NUMBER OF TRANSACTIONS TO BE PRE-DECIDED

The number of transactions to be selected for test check should be decided in advance while planning the audit. It should not be left at the option of the audit assistants.

v) INVESTIGATE SIGNIFICANT ERRORS

The auditor needs to set criteria to judge what is a material error and what is not a material error. If he finds material errors during test check, then he may investigate further and also increase the extent of test check.

vi) OBSERVE INTERNAL CONTROL SYSTEM

The auditor should study the whole internal control system to understand if the internal control system is existent, efficient and operational during the year. The extent of test checking shall depend on the outcome of the auditor's study of the internal control system.

vii) NO BIAS IN SAMPLE SELECTION

The samples should be selected on a random basis and there should not be any bias in their selection.

Q.3. What is routine checking & What are its features?
(NOT IN SYLLABUS)

Ans: Earlier, when accounting was not computerized, books of accounts were maintained in physical register. Entries used to be passed in a journal and then posted into separate ledger accounts. Therefore, there was a high chance of error and hence routine checking had to be done by the auditor where he used to check the totalling whether every entry has been posted in the correct ledger accounts, totalling of ledger, carry forward, brought forward etc. The auditor used to check all these things in the books of accounts and place a tick mark for every item/figure checked.

The main objects/advantages of routine checking are
i) To verify the correctness of the accounting entries
ii) To verify the arithmetical accuracy of the entries.
iii) To verify the accuracy of postings of ledgers
iv) To verify the balancing of ledger accounts, and
v) To ensure that no entries are altered after they have been audited.

However, now as the accounting has become computerized and accounting packages being available in the market, once a journal entry is passed, the posting is automatically done in the ledger accounts and there is no need to also check totaling.

The features, advantages and disadvantages of routine checking have been answered keeping in mind the earlier times when books were maintained physically.

i) DETAIL CHECKING
Routine checking involves detailed checking of each and every accounting stage viz. entries in the books of original entry, posting into ledgers and preparation of trial balance

ii) JUNIOR MEMBERS
This work is usually done by the junior members of the audit staff because it is mechanical and monotonous in nature

iii) DISTINCTIVE TICKS
Distinctive ticks are used in routine checking for different purposes like totals, posting, vouching, bank reconciliation etc

iv) ERRORS / FRAUDS

Routine checking helps to detect the clerical errors & frauds easily. It involves checking the recording of entire transaction right from journal to ledger to trial balance

Q.4. What is audit sampling? What is the purpose of sampling? What are the methods of selecting a sample?

Ans: As discussed, in 'Test Check', an auditor examines a representative sample from a large number of similar items. The selection of items is done through the process of 'audit sampling'. The selection of the audit sample is extremely crucial when the test check is adopted in the audit. On examination of the sample, the auditor is in a position to obtain audit evidence and form conclusions about that class of items.

The following are the purposes of sampling:

1. To enable the auditor to design and select an audit sample
2. To evaluate sample results
3. To obtain appropriate audit evidence

The following are the methods of selecting sample items:

i) RANDOM SELECTION

Under this method, all items in the population (Eg. all ledger accounts under the head 'Debtors') have an equal chance of selection. In other words, there is no specific system or limit for selection. Suppose, it is decided that 30 out of 100 ledger accounts under 'debtors' is the sample size, then all the 100 ledger accounts are open to selection as sample. Generally, a random number table is used to for selection of samples. Now, there are computer programs or computer aided auditing tools (CAAT) which help the auditor to generate random numbers and accordingly the samples are selected.

ii) SYSTEMATIC SELECTION

Under this method, samples are selected using a constant. interval between two samples.
Eg: Selecting every 5th debtor for scrutiny. So, if there are 100 debtors, the debtor no. 5, 10, 15....... will be selected as samples.
The auditor has to ensure that population from which the sample is to be selected is not structured in a specific manner.
Eg: In the above example, suppose all the debtors are arranged in such a manner that debtors outstanding for more than 3 months fall in number 91-100, then the auditor would have verified only 2 such debtors (i.e. 95 and 100). However, in this case, it would be more appropriate for the auditor to verify the ledge accounts of all the ten debtors.

iii) HAPHAZARD SELECTION

Under this method, the auditor selects the sample in a haphazard manner. There is no particular pattern that is followed. However, care should be taken to avoid any kind of bias. This method is similar to random sampling only with respect to the fact that every item is open and has equal chance of selection.

Q.5. What are the factors determining sample size?
Ans: Audit sampling involves selection of a sample from the entire population in order to perform various audit procedures. There is no fixed guideline or criteria for

determining the sample size. It depends on the professional judgement of the auditor. However, he may consider the following factors while determining the sample size

1. SAMPLING RISK

Sampling risk is basically the probability that the auditor may arrive at a different conclusion had he audited the entire population instead of the sample. Sample size and sample risk have an inverse relation. The lower the risk the auditor is willing to accept, the greater will be the sample size.

Eg: On audit of the sample, the auditor arrives at a conclusion that the books of accounts give a true and fair view of the affairs of the company. However, had he audited all the transaction, his opinion would have been otherwise. So, this is a risk for the auditor and he will decide his sample size depending on the risk he is willing to take

NOTE: Sampling Risk has been explained in detail in Q.7.

2. TOLERABLE ERROR

It refers to the maximum error that the auditor would be willing to accept in the population and still conclude from the sample that the books of accounts give a true and fair view. The smaller the tolerable error, the greater the sample size will need to be. Tolerable error is decided at the planning stage

Eg: M/S Varun Transport has a total turnover of RS. 3.6 crores for the F.Y. 2014-15 having uniform sales in every month of RS. 30 lacs. The auditor plans to test check the sales of the firm (i.e. vouching of the invoices raised). The auditor is willing to accept that bills of RS. 2 lacs per month may be wrongly recorded. Therefore, this is the tolerable error of the auditor. Since, the tolerable error of the auditor is relatively high, the sample size may be smaller. If the tolerable error of the auditor would have been Rs. 0.5 lacs per month, then the sample size may need to be bigger.

3. EXPECTED ERROR

If the auditor expects errors to be present in the population, then the sample size would need to be larger to prove (satisfy himself) that the actual error is not greater than the tolerable error. The auditor needs to consider the following for determining the expected error in the population:

a. Error levels identified in previous audits
b. Changes in the entity's procedures
c. Evidence available from other procedures.

4. TIME AVAILABILITY

The sample size is also affected by the time available for the audit. If the auditor has to conduct the audit in a very short period of time, then the sample size also will be small and vice versa.

5. NATURE AND VOLUME OF BUSINESS

There are companies where the volume of business may be very high and the transactions may be similar (identical) to each other. At such times, the auditor may decide to have a relatively smaller sample size.

Eg:

1. Kaytee Trading Pvt Ltd. is a cloth trading company. They buy cloth from three suppliers based in Tirupur (Tamil Nadu) and export it to five companies based in Europe. This is the only business of the company and hence the auditor

may decide to have a relatively smaller sample size because the transactions are similar to each other.
2. In case of Reliance Industries Ltd. or Bharti Airtel Ltd. or Infosys Technologies Ltd., it will not be practically possible to audit all the transactions. In such cases, the auditor has to select a small sample for the purpose of audit.

6. AUDIT OBJECTIVE

The primary object of audit is to enable the auditor to express an opinion whether the books of accounts show a true and fair view of the affairs of the company. Therefore, the auditor may select a small sample. However, if the objective of the audit is to verify whether the books of accounts are true and correct, then all the transactions will have to be checked.

7. INTERNAL CONTROL SYSTEM

The sample size also depends on the internal control system. If the auditor is of the opinion that the internal control system is strong, then the may select a small sample size and vice versa

Q.6. How can the auditor evaluate sample results? What is the auditor's liability in conducting audit based on sample?

Ans: The auditor should evaluate sample results in the following manner:

1) ANALYSIS OF ERRORS IN THE SAMPLE

Prior to designing a sample, the auditor would have defined what an 'error' is. Therefore, the first step when the auditor encounters a prima facie error is to find out

if the error so found is actually an error.
Secondly, the auditor may consider the qualitative aspects of the error which includes the following:
i) Nature of error
ii) Cause of error
iii) Possible effect of the error on other areas of the audit.

If he comes across certain transactions in which errors are found, then he may apply audit procedures on the all the transactions of that type.
Eg: An auditor finds an 'error' in 2 or 3 transactions relating to 'bad debts written off'. In that case, he would prefer to scrutinize all transactions of bad debts written off.

ii) PROJECTION OF ERRORS
On audit of the sample, the auditor will arrive at the errors in the sample. Through the errors in the sample, the auditor will be able to project the errors in the total population. The auditor needs to keep in mind the qualitative aspects of the error while projecting the errors.

iii) REASSESSING SAMPLING RISK
After projection of errors, the auditor needs to consider whether errors in the population might exceed the tolerable error. The auditor may compare the tolerable error and projected error for the same. If the projected error exceeds tolerable error, then the auditor needs to reassess sampling risk and if that risk is unacceptable, he would consider extending audit procedures or performing alternative audit procedures.

The auditor's liability in conducting audit based on sample can be explained with the help of the following points:

1. In the eyes of law, the auditor's liability remains the same whether he undertakes routine audit or test check (auditing sample transactions).
2. The auditor has to take due care, exercise his skill & judgement and be extremely diligent while conducting an audit.
3. The selection of the sample has to be done in a scientific and logical manner. In case the errors found in the sample exceed his tolerable error, then he should increase the sample size
4. The auditor should maintain proper documentation of the audit process which could be used by him as a proof in the court of law.

Q.7. Write a short note on "Sampling Risk"?

Ans: Sampling risk is basically the probability that the auditor may arrive at a different conclusion had he audited the entire population instead of the sample. Sample size and sample risk have an inverse relation. The lower the risk the auditor is willing to accept, the greater will be the sample size

Eg: On audit of the sample, the auditor arrives at a conclusion that the books of accounts give a true and fair view of the affairs of the company. However, had he audited all the transaction, his opinion would have been otherwise. So, this is a risk for the auditor and he will decide his sample size depending on the risk he is willing to take

The auditor may have face sampling risk while carrying out both compliance as well as substantive procedures

SAMPLING RISK IN COMPLIANCE PROCEDURES OR TESTS OF CONTROL

a. RISK OF UNDER RELIANCE

The risk that when the auditor carries out test of control on the sample, the auditor is of the opinion that the internal controls of the company are not existent, efficient and operating during the year. However, had he audited the entire population, he would be of the opinion that the internal controls of the company are existent, efficient and operating during the year.

b. RISK OF OVER-RELIANCE

The risk that when the auditor carries out test of control on the sample, the auditor is of the opinion that the internal controls of the company are existent, efficient and operating during the year whereas the opinion would have been otherwise if the entire population would have been tested.

SAMPLING RISK IN SUBSTANTIVE PROCEDURES

a. RISK OF INCORRECT REJECTION

The risk that when the auditor carries out substantive procedures on the sample, he is of the opinion that the recorded account balance or class of transactions is materially misstated. However, had he carried out substantive procedures on the entire population, his view would have been that there is no misstatement.

b. RISK OF INCORRECT ACCEPTANCE

The risk that when the auditor carries out substantive procedures on the sample, he is of the opinion that the recorded account balance or class of transactions is not materially misstated. However, had he carried out substantive procedures on the entire population, his view would have been that the recorded account balance or class of transactions is materially misstated.

EFFECT OF SAMPLING RISK ON THE AUDIT

The following is the effect of sampling risk on the audit:

i. Risk of over reliance and risk of incorrect acceptance affect can lead to the auditor expressing an incorrect opinion about the financial statements.
ii. Risk of under reliance and risk of incorrect rejection will lead to additional work being performed by the auditor.

Q.8. What is internal control? What are the advantages of internal control? How can the auditor review internal controls?

Ans: Internal control refers to all the policies & procedures that are adopted by the management to ensure:

i) Smooth & efficient operations of the business.
ii) Optimum utilization of resources
iii) Prevention of errors and frauds.

INTERNAL CONTROL = INTERNAL AUDIT + INTERNAL CHECK + OTHER FORMS OF CONTROL.

The following are the objectives or advantages of internal control:

1. Ensuring that all accounting transactions are properly recorded, authorized, complete and upto date.
2. Accounting policies adopted by the management are followed

3. The fixed assets of the company are safeguarded from any external or internal threat.
4. The final accounts are ready in time.
5. The operations are carried out as per the organization manuals and there is constant improvement in processes to increase efficiency.
6. All legal compliances are complied with, without any delay.
7. Prevention, detection and corrections of errors, frauds & material misstatements on timely basis.

The effectiveness of internal control has an influence on the nature, timing and extent of the audit procedures to be applied by the auditor. Therefore, it is important for the auditor to review the internal control before he plans his audit.
In order to review internal control, it is most important to understand the business of the organization.
This can be done by :
a. Visiting the factory and offices
b. Discussion with employees and management
c. Reading operation manuals, flow charts, previous audit reports etc

During the process of understanding the business, the auditor should ascertain the various internal controls that should ideally be set and this should be compared with the internal controls actually existing in the organization.

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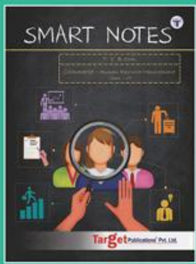

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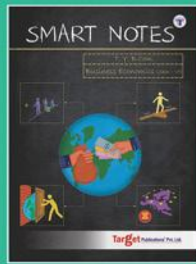

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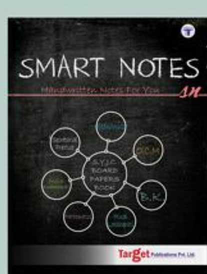

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