

AUDITING

Chapter 2

AUDIT PLANNING

Meaning: Planning is required to complete the audit effectively within the specified time. Audit planning is a process of deciding in advance what is to be done, who is to do it, how it is to be done and when it is to be done by the auditor in order to have efficient and effective completion of work. Audit planning can be done only when, the auditor is having knowledge of the business of the client. It helps in accomplishment of objectives of audit and enables the auditor to cover different aspects of audit work in a systematic manner within a preset time frame. It enhances the quality of audit work. Audit plans should cover knowledge about client's accounting systems and policies, internal control procedures and coordinating the work to be performed. Plans should be flexible so that they can be developed or revised as and when required by the auditor.

Advantages of Audit Planning

1. ***Accomplishment of Objectives:*** Audit plan ensures that it provides right means to accomplish audit objectives. Further it also ensures that appropriate attention is devoted to important areas of audit.
2. ***Identification of Problems:*** A well drawn and established audit plan helps in identifying potential problems.
3. ***Timely Completion of Work:*** It ensures that work is completed properly within the specified time and no important area is left out. It also ensures that all important areas of management receive attention.
4. ***Facilitates Coordination:*** It facilitates coordination of the audit work done by auditors and other experts.
5. ***Better Audit Work:*** It helps in improving the quality of audit work and provides promptness and perfection in audit performance.

Factors Affecting Audit Planning

The following factors should receive due consideration while planning:

- Size of the company and nature of its operations.
- Accounting system, internal control and adherence to standard.
- Environment in which the company operates.
- Previous experience with the client; and
- Knowledge of client's business.

AUDIT PROGRAMME

Meaning: An audit programme is a detailed, written statement designed by the auditor indicating the work to be performed by the audit assistants, specifying the time limit for completion of work, instructions and guidance to the audit staff. In short, it is a tool for planning, directing and controlling the audit work. An audit programme is a detailed plan of the auditing work to be performed. It specifies the procedures to be followed in the conduct of audit more efficiently. The auditor outlines the whole procedure of audit from beginning till the finalization of audit report. Audit programme is generally contained in the audit notebook.

Definition Prof. Meigs defines an audit programme as, "an audit programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item and the financial statements and giving the estimated time required."

Advantages of an Audit Programme

An audit programme can give the following advantages:

1. *Helps in Estimation and Division of Work:* Audit Programme helps in estimating the quantum of audit work in advance and also helps in dividing the work among the audit assistants based on their capabilities.
2. *Helps in Fixation of Responsibility:* It enables to fix responsibility on the audit assistants by clearly defining the scope of work.

3. *Helps in Future Planning*: Audit programme serves as a basis for planning the audit work for subsequent year.

4. *Serves as a Guide*: It serves as a valuable guide for the audit staff in execution of the audit work for succeeding years.

5. *Valuable Evidence*: It serves as an evidence for the work done as initials of those who have done the particular work are appended to it. The auditor can produce the audit programme as a proof when a charge of negligence being brought upon him.

6. *Uniformity*: It provides for uniformity in audit work as the same work will be done every year.

7. *Continuity*: When an audit staff goes on leave others can continue the work by referring to the audit programme, hence, audit programme provides for continuity of work.

Contents of an Audit Programme

The following are the details of an audit programme:

1. Name of the client.
2. Nature of operations and business of client.
3. Review of system of internal check. g
4. Date of commencement of audit work.
5. Duration of audit work.
6. Accounting system followed in client organization.
7. Review the report of the previous auditor.
8. Review the remarks, instructions or objections raised in the previous audit report.
9. Examine the various ledger accounts and subsidiary books.

Limitations of Audit Programme

Audit Programme, however, has the following limitations

1. Makes the work almost mechanical - sometimes the work is done without understanding the objectives behind it.
- 2 Gives rigidity of approach - the required flexibility to devote additional attention to some critical areas becomes difficult.
- 3 Discourages personal initiatives or efficiency on matters which demand some, more time or energy.
- 4 Disclose to the company's staff the tests being performed and the part of the work which has already been completed.

Yet it must be appreciated that the concept of Audit Programme has enough usefulness ,in the process of audit. A realistic assessment of the situation and a careful planning of affairs, therefore, can very well remove the above limitations of the Audit Programme.

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DOCUMENTATION

In the process of audit, the auditor should document matters which are important in providing sufficient evidence that the audit was carried out in accordance with the basic principles governing an audit. The records maintained and preserved in the audit process are called as Documentation. Documentation in this connection refers to audit note book and audit working papers. Working papers are prepared or obtained by the auditor. It may be in the form of extracts, photocopy of documents, representation and explanation from the management.

Audit Documentation includes:

1. Audit Programme
2. Analysis
3. Issues memorandum
4. Summaries of significant matters

5. Letters of confirmation and representation
6. Checklists
7. Correspondences concerning significant matters

Audit working paper: Audit working papers are those papers which contain essential facts about accounts, which are being audited. Its defined as the file of analysis, summaries, comments and correspondence build up by the auditor during the course of audit. The auditor maintains papers as supporting evidence to the audit work. The institute of chartered accountants of India states that “an auditor is expected to maintain evidence of work done by him and his staff”. Usually, audit working papers contains a copy of the trial balances, schedule of debtors and creditors, reconciliation statements important correspondence etc.

IMPORTANCE OF AUDIT WORKING PAPERS:

- I. IT provides guidance to the audit staff regard to the manner of checking the schedules.
- II. The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.
- III. It acts as an evidence in the court in the court of law when a charge of negligence is brought against the auditor.
- IV. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retained them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention

Purpose of maintaining working paper:

1. They show the extent to which accounting principles and auditing standards have adhered to.
2. They provide the required support for the auditor’s report.

3. They also reveal the efficiency with which the audit work was done.
4. They can be used as evidence in the court to defend himself against negligence in his duty.
5. They help the auditor in finalizing his report quickly.
6. They help the auditor to understand the efficiency of the accounting system, internal check system etc.

Working papers should be clear complete, and contain the necessary information so that they may be of maximum utility. They should be properly organized, documented and signed. In this regard it's said that "an auditor is often judged by the quality of the working paper prepared by him under his guidance". Working papers are confidential documents hence he should not disclose the facts to others. Doing so results in professional misconduct. Working papers should be preserved properly because they are important documents.

OWNERSHIP OF WORKING PAPERS

The auditors who collect information through working papers for his audit work, usually claims that he is the owner of the working papers. On the other hand the company claims that the auditor was appointed by and he only acts as its agent. Hence, all the documents that the auditor had collected should belong to the company several cases have been referred to the courts regarding the ownership in one of the cases it was decided that the working papers belong to the auditor because he was an independent professional and not an agent of the client. In another case also, it was held that the working papers belong to the auditor.

Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. Audit working papers are the property of the auditor and he is entitled to retain them.

Audit Note Book

Audit Note Book is a register maintained by the audit staff to record important points observed, errors, doubtful queries, explanations and clarifications to be received from the clients. It also contains definite information regarding the day-to-day work performed by the audit clerks. In short, audit note book is usually a bound note book in which a large variety of matters observed during the course of audit are recorded. The note book should be maintained clearly, completely and systematically. It serves as authentic evidence in support of work done to protect the auditor against any legal charge initiated against him for negligence. It is of immense help to the auditor in preparing audit report. It also acts as a valuable guide for conducting audit for future years

Contents of Audit Note Book

The following matters should have been incorporated in an Audit Note Book.

1. A list of the account books normally used and maintained.
2. Names of the principal officers, their duties and responsibilities.
3. Nature of business carried on and important documents relating to the constitution of business like Memorandum of Association, Articles of Association, Partnership deed etc.,
4. Extracts of minutes and contracts affecting the accounts.
5. Extracts of correspondence with statutory authorities.
6. Copy of audit programme.
7. Accounting methods, internal control and internal check system in operation.
8. Routine queries like missing receipts and vouchers etc.
9. Details of errors and frauds discovered during the course of audit.
10. Points to be included in audit report.
11. Details of all important information to be used as reference for future audits.
12. Date of commencement and completion of audit.

Advantages of Audit Note Book

1. *Facilitates Audit Work:* It facilitates the work of an auditor as all important details about the audit are recorded in the note book which the audit clerk cannot remember everything at all the time. It helps in remembering and recalling the important matters relating to the audit work.
2. *Preparation of Audit Report:* Audit note book helps in providing required data for preparing the audit report. An auditor examines the audit note book before preparing and finalizing the audit report.
3. *Serves as Documentary Evidence:* Audit note book serves as a documentary evidence in the court of law when a suit is filed against the auditor for his negligence.
4. *Serves as a Guide:* When an audit assistant is changed before the completion of audit work, audit note book serves as a guide in completion of balance work. It also acts as a guide for carrying on subsequent audits.
5. *Evaluating Work of Audit Staff:* It helps to assess the work performed by the audit staff and helps in evaluating their level of efficiency.
6. *Fixation of Responsibility:* Audit note book helps in fixing responsibility on concerned clerk who is responsible for any undetected errors and frauds in the course of audit.
7. *No Dislocation of Audit Work:* An audit note book contains all important details about audit hence any change in the audit staff will not disturb or dislocate the audit work.

Disadvantages of Audit Note Book

1. *Fault-finding Attitude:* It leads to development of a fault-finding attitude in the minds of the staff.
2. *Misunderstanding:* Very often maintenance of audit note book creates misunderstanding between the client's staff and the audit staff.
3. *Improper Preparation:* Since it serves as evidence in the court of law, it needs to be prepared with great caution. When the note book is prepared without due care it cannot be used as evidence against the auditor for negligence.

4. Adverse Effects on Subsequent Audits: Since audit note book is used in performing subsequent audits, any mistakes in the note book may have adverse impacts on the next audit.

AUDIT FILE

A Permanent Audit File

A permanent audit file normally includes

- ◆ Information concerning the legal and organizational structure of the entity. In case of a company, this includes the memorandum and Article of association. In the case of a statutory corporation, this includes the act and regulations under which the corporation functions.
- ◆ Extracts or copies of important legal documents, agreements and minute relevant to the audit.
- ◆ A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- ◆ Copies of audited financial statements for previous years.
- ◆ Analysis of significant ratios and trends.
- ◆ Copies of management letters issued by the auditor, if any.
- ◆ Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- ◆ Notes regarding significant accounting policies.
- ◆ Significant audit observations of earlier years.

The Current File

The current file normally includes

- ◆ Correspondence relating to acceptance of annual reappointment.
- ◆ Extracts of important matters in the minutes of board meetings and general meetings as relevant to audit.
- ◆ Evidence of the planning of the audit and audit programme.
- ◆ Analysis of transactions and balances.

- ◆ A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- ◆ Evidence that the work performed by assistants was supervised and reviewed.
- ◆ Copies of communication with other auditors, experts and other third parties.
- ◆ Letters of representation or confirmation received from the client.
- ◆ Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- ◆ Copies of the financial information being reported on the related audit reports.

AUDIT EVIDENCE

Concept of Audit Evidence

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to examine all information that may exist. Audit evidence, which is cumulative in nature, includes audit evidence obtained from audit procedures performed during the course of the audit and may include audit evidence obtained from other sources, such as previous audits and a firm's quality control procedures for client acceptance and continuance.

TECHNIQUES OF OBTAINING EVIDENCE

- (i) Inspection: Inspecting the documentary evidence like deed papers, certificates etc relating to the audit whether in possession of the entity or the third parties.
- (ii) Observation: Observing the process or procedure being performed by others. Like physical verification and counting of inventory.
- (iii) Enquiry: Enquiring from the client, his staff or third parties having knowledge about a particular item or activity.

- (iv) Confirmation: Seeking information from third party having knowledge about a particular transaction.
- (v) Computation: It involves checking of the arithmetical accuracy of a source documents and accounting records.
- (vi) Analytical Review Procedures: Analysis of significant ratios and trends for investigating unusual fluctuation and items.
- (vii) Independent Execution: In this auditor performs the procedure and controls that were originally performed as part of entity's internal control system.

Important factors to be considered while obtaining audit evidence: –

- The quality of the evidence (its relevance, reliability and validity);
- the level of materiality (Rupees terms) or the significance of the observation or conclusion (in general, the higher the level of significance or materiality, the higher the standard that evidence will have to meet);
- whether an audit level of assurance (high) or a review level of assurance (moderate) is required (for example, a higher level of assurance is required for evidence to support observations than is required to support contextual information included in the report);
- the risk involved in making an incorrect observation or reaching an invalid conclusion (as an example, if any risk of legal action against the auditee results from reporting an observation, the standard of evidence demanded will be high); and
- the cost of obtaining additional evidence relative to likely benefits in terms of supporting observations and conclusions (as in most things, diminishing returns apply in gathering audit evidence at some point, incurring the cost of obtaining more evidence will not be justified by changes in the persuasiveness of the total body of evidence)

Essentials of good audit evidence

- (a) Sufficient: The audit evidence are said to be sufficient when they are in adequate quantity. The audit evidence enables the auditor to form an opinion on the financial information. Sufficient evidence can be obtained by test checking instead of 100% checking.

(b) Reliable: Evidences obtained by auditor are persuasive rather than conclusive in nature therefore evidence cannot be 100% reliable. The reliability of audit evidence depends upon:

(i) Source: whether the evidence obtained within the organisation i.e. internal and obtained from outside i.e. external (confirmation by third party)
(ii) Nature: whether the evidence is verbal (explanation from clients staff), visual (physical verification of stock) or documentary (bills attached to vouchers)

(c) Relevant: The obtained audit evidence must be relevant to the matter being checked. For e.g. the balance stock in hand to be checked then the relevant evidence shall be the physical verification. The following rules of thumb have proven helpful in judging the appropriateness of evidence

(a) documentary evidence is usually better than testimonial evidence;

(b) audit evidence is more reliable when the auditor obtains consistent evidence from different sources or of a different nature.

(c) original documents are better than photocopies;

(d) evidence from credible third parties may be better than evidence generated within the audited organization;

(e) the quality of information generated by the audited organization is directly related to the strength of the organization's internal controls (the auditors should have a good understanding of internal controls as they relate to the objectives of the audit); and

(f) evidence generated through the auditor's direct observation, inspection and computation is usually better than evidence obtained indirectly.