

# STANDARDS ON AUDITING

*Audit Evidence*  
*Audit Planning*



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## Risk

Potential of gaining or losing something of value.

Intentional interaction with uncertainty

Action taken in spite of uncertainty (potential, unpredictable & uncontrollable outcome)

Possibility of actual rate of return being lower than expected rate of return.

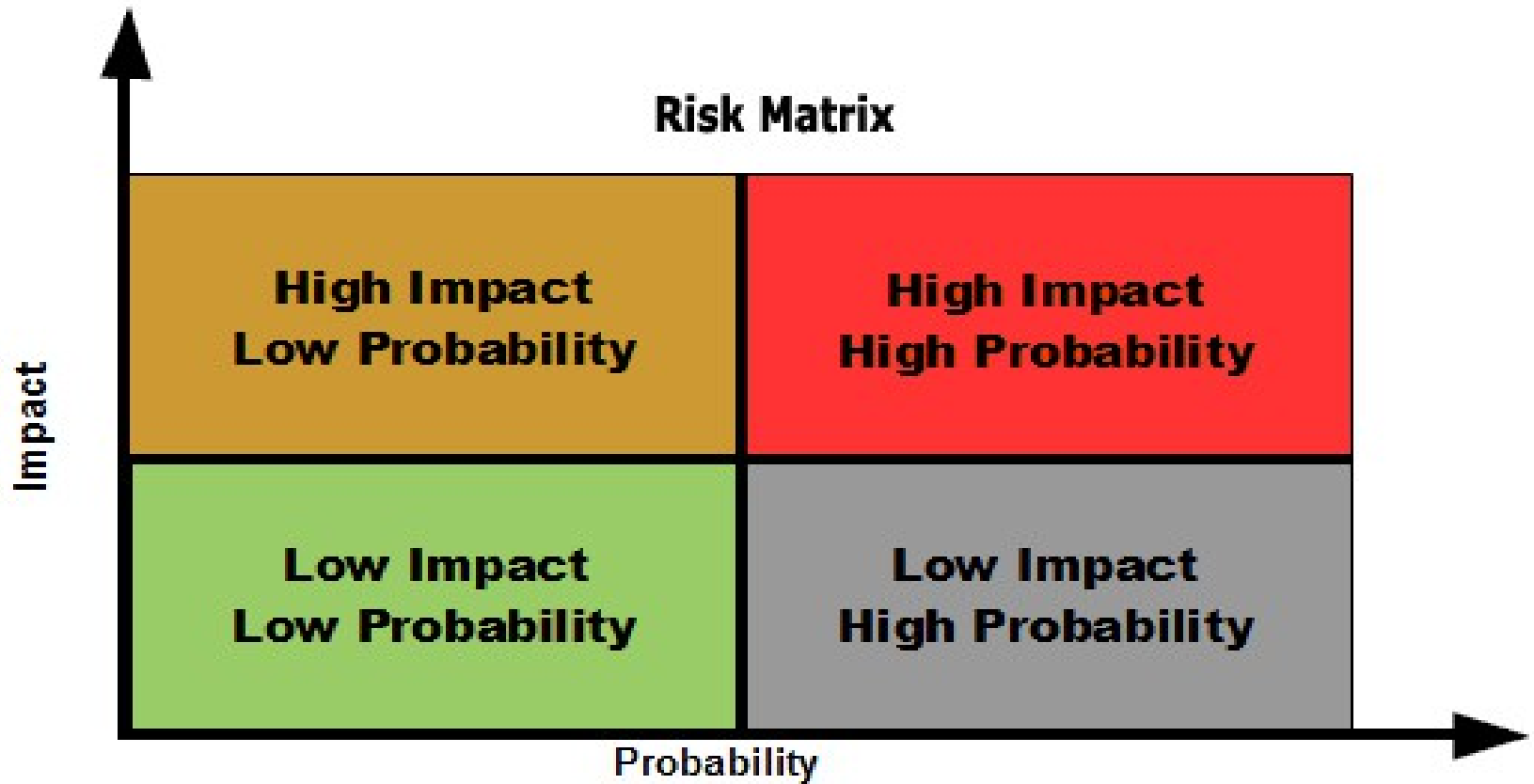
Threat of quantifiable damage, loss, liability or any negative occurrence due to external  
/internal vulnerabilities avoidable by pre-emptive action.

## Characteristics of Risk

- Uncertainty / Undesirable event
- Threat - Harm
- Vulnerability
- Hazard
- Unpredictable variability
- Volatility of returns
- Better or worse than expected
- Upside / downside
- Loss / Catastrophe
- Positive or Negative Impact
- Opportunity

- **Risk Tolerance** – Amount of acceptable risk
- **Risk Averse** – Someone who does not want to take risks
- **Risk Factors**
  - Probability of occurrence
  - Impact of event
  - Range of outcomes
  - Timing of event
- **Risk velocity** - Speed of risk travelling in an organization

*“Fear is the response to perceived danger”*



# Probability - Impact Matrix

Probability	Impact			
	Insignificant	Moderate	Critical	Catastrophic
Almost Certain	High	High	Extreme	Extreme
Likely	Moderate	High	High	Extreme
Possible	Low	Moderate	High	Extreme
Unlikely	Low	Low	Moderate	Extreme
Rare	Low	Low	Moderate	High

# Risk Control Matrix

<b>Control Activities</b>	<b>Probability</b>				
	Major Expected	Significant Likely	Moderate Possibility	Unlikely & Minor	Remote & Insignificant
Excessive	High	High	Moderate	Low	Low
Adequate	Extreme	High	Moderate	Low	Low
Refinement needed	Extreme	High	Moderate	Moderate	Low
Inadequate	Extreme	Extreme	Extreme	Extreme	Moderate

## Risk Maturity



- Risk Transfer - Insure / Outsource activity
- Risk Avoidance – Eliminate / Withdraw
- Risk Retention – Accept & Budget
- Risk Reduction – Optimize & Mitigate

‘Risk is the way we collectively measure & share fear, a fusion of rational doubt, irrational fear & a set of unquantified biases from our own experience’

# Risk Assessment Procedure

# Risk based Audit

- Resources diverted based on level of risks ( H / M / L)
- Design of Control – Control Effectiveness
- Dip sticks / Walk through
- Transaction audit is passé – Process based risk audits.
- Easy to give a negative opinion

# Stages of Risk planning

$$\mathbf{AR = IR \times CR \times DR}$$

- **AR - Allowable audit risk** that material misstatement remains undetected
- **IR - Inherent risk** of a material misstatement assuming no related controls.
- **CR - Control risk** that a material misstatement could occur & will not be prevented or detected on a timely basis by IC.
- **DR - Detection risk** that audit procedures will fail to detect a material misstatement if it exists.
- **Risk of Fraud**

# Internal Controls

Process implemented in an organization to help achieve specific goals.

Means of directing, monitoring & measuring resources for efficiency & effectiveness.

Reduces variations & leads to predictable outcomes

Assurance on -

- Reliability of financial reporting
- Compliance with policies, laws & regulations
- Safeguarding of assets
- Timely feedback on achievement of strategies or operational goals.

# COSO framework

- **Control Environment – Tone at the Top / Culture / Ethics / Zero Tolerance levels for errors**
- **Risk Monitoring**
- **Control Activities**
- **Information & Communication systems**
- **Monitoring activities**

## Auditing

- Systematic - independent examination of books, accounts, documents and vouchers of an organization to ascertain if the financial statements present a true and fair view.
- Ensure books of accounts are properly maintained as per law
- **Assurance** – unbiased independent service examining information or the process to improve it's quality for decision making
- **Attestation** – evaluation of an assertion



- Derived from Latin word "Forensic" meaning of or before the forum. Synonym for legal or related to courts.
- Suitable for use in court of law
- Application of specialized knowledge & investigative skills to collect, analyse & evaluate evidential matters, interpret & communicate findings in courtroom, boardroom or other legal, administrative venue.

- Standards of auditing - issued by Auditing and Assurance Standard Board of ICAI.
- Codification of best practices of the profession, which are already existing.
- Helps members in proper and optimum discharge of their profession duties.
- Promote uniformity in practice as also comparability.

- Duty of members of ICAI to ensure that auditing standards are followed in the audit of financial information covered by their audit reports.
- If for any reason a member is unable to perform an audit in accordance with the generally accepted auditing standards, report should draw attention to any material departures therefrom, failing which **he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949**

## Standards on Audit Planning

- SA 300 – Planning an audit of financial statements
- SA 315 – Identifying & assessing the risk of material mis-statement through understanding the entity & the environment
- SA 320 – Audit Materiality
- SA 330 – Auditor’s response to assessed risks

## SIA-1 Internal Audit Planning

- Objectives of planning
- Factors affecting planning process
- Scope of planning
- Planning process - knowledge of business / audit universe / establish objectives & scope of engagement / resource allocation / prepare audit program
- Effective date

## Planning Quotes

### ***Failing to plan is planning to fail***

- ❖ It is not the plan that is important, it is the planning.
- ❖ Planning is bringing the future into the present so that you can do something about it now
- ❖ Plans are only good intentions unless they immediately degenerate into hard work.
- ❖ A good plan today is better than a perfect plan tomorrow

- Developing a general strategy
- Detailed approach for expected nature, timing & extent (NTE) of audit.
- Perform audit in an efficient & timely manner.
- Continual & iterative process.

## Objectives

- Appropriate attention devoted to important areas of audit
- Potential problems promptly identified
- Work completed expeditiously
- Effective & efficient utilization of resources
- Co-ordinate work done by other auditors & experts

## Stages



- Obtain an understanding of the entity, its environment & internal control system
- Assess risk of material misstatement in financial statements
- Design audit procedures commensurate with assessed level of risk.

Performing procedures as per SA 220, “Quality Control for an Audit of Financial Statements” regarding continuance of client relationship & audit engagement

- Evaluate-
  - *Integrity of owners & those charged with governance.*
    - *Competency of engagement team*
    - *Significant matters in previous engagements*
  - *Compliance with ethical requirements like independence*
  
- SA 210 “ Agreeing Terms of Audit Engagement”.

- Identifying risk factors & exercising professional judgment to determine whether such factors, separately or in combination, are significant enough to require a special response.
- Determine whether high engagement risk is pervasive to the audit engagement as a whole, or due to one or more pervasive risks, or due to one or more specific risks.

## Knowledge of Clients Business-

- Previous experience
- Discussions with-
  - *People within entity*
  - *Internal auditor*
  - *Industry experts*
- Relevant publications
- Legislation & regulation
- Internal periodic reports
- Clients policy / procedure manual
- External reports

Sets scope, timing, direction of audit & guides development of audit plan.

### **Factors to be considered-**

- *Determination of characteristics of audit*
- *Reporting objectives*
- *Team's Effort*
- *Preliminary work*
- *Nature, timing & resources*

### **Benefits**

- *Employment of qualitative resources*
- *Timing of deployment of resources*
- *Management of resources*

NTE of planned risk assessment procedures as per SA 315 “Identifying & Assessing the Risks of Material Misstatement through Understanding the Entity & its Environment”.

NTE of planned further audit procedures at assertion level as per SA 330 “The Auditor’s Responses to Assessed Risks”.

Other planned audit procedures required to comply with other SAs.

Not possible to design a practical audit that eliminates all risk of misstatement.

Focus on areas having highest likelihood of containing material misstatements, & use methodologies providing reasonable assurance that misstatements do not exist.

2 key factors in planning & executing audits-

***Materiality & Audit Risk***

## Judging Materiality

SA 320 “Materiality in Planning & Performing an Audit”-

- Auditor makes judgments about the size of misstatements that will be considered material

Performance materiality –

*“Amount/s set by the auditor < materiality for financial statements as a whole to reduce to an appropriately low level probability that aggregate of uncorrected & undetected misstatements > materiality for the financial statements as a whole.*

*Amount/s set by the auditor < materiality level/s for particular classes of transactions,*



## Materiality

- Used to evaluate audit findings & determine if any uncorrected errors render financial statements materially inaccurate.
- Measures to judge materiality -

- Risk of auditor unknowingly failing to modify an opinion on financial statements that are materially misstated.

### A risk that-

- *Financial statements prepared by management are materially misstated i.e. **material misstatement risk***
- *Auditor will not detect such material misstatement i.e. **detection risk***
- **Misstatement risk & detection risk are inversely related.**
- Greater the material misstatement risk, lesser the detection risk auditor can accept & vice versa.
- If audit risk is high, design audits with more extensive testing, less reliance on work of others & less interim work.
- As that risk diminishes, lesser reliance on extensive testing & more on work of others, & perform more interim work during the audit risk.

## Evaluating Risk of Material Misstatement

- **Inherent risk**

Natural risk irrespective of internal controls

- **Control risk**

Risk that IC system will not prevent or detect a material misstatement

Perform compliance procedures to check design, operating effectiveness & continuity of IC system.

## SA 315 “Identifying & Assessing the Risks of Material Misstatement through Understanding the Entity & its Environment”

Evaluate existence of material weakness in design & implementation of IC by assessing-

- Control Environment
- Entity’s Risk Assessment Process
- Information System & Communication
- Control Activities relevant to audit
- Monitoring of Controls

Components	Key Notes
Control Environment	<ul style="list-style-type: none"><li>· Identifying entity level controls</li><li>· Using the work of others</li></ul>
Entity's Risk Assessment	<ul style="list-style-type: none"><li>· Role of Risk Assessment</li><li>· Addressing Risk of Fraud</li><li>· Selecting Controls to Test</li><li>· Relationship of risk to evidence obtained</li></ul>
Information Systems & Communication	<ul style="list-style-type: none"><li>· Process Flow Diagram</li><li>· Information produced by entity(IPE)</li><li>· IPE Diagrams</li></ul>
Control Activities	<ul style="list-style-type: none"><li>· Understanding likely sources of misstatement</li><li>· Selecting controls to test</li><li>· Understanding IT environment</li></ul>
Monitoring Activities	<ul style="list-style-type: none"><li>· Identifying entity level controls</li><li>· Indicators of material weakness</li></ul>

## Addressing the Risk of Frauds

- Evaluate controls to sufficiently address identified risks of material misstatement due to fraud & controls intended to address risk of management override of other controls.
- **Controls addressing these risks include-**
  - Controls over significant, unusual transactions & those resulting in late or unusual journal entries
  - Controls over journal entries & adjustments made in period-end financial reporting process
  - Controls over related party transactions
  - Controls related to significant management estimates
  - Controls mitigating incentives & pressures on management to falsify or inappropriately manage financial results

## Performing Audit Tests

- SA 330 “ Auditors Responses to Assessed Risks”
- Design & implement overall responses to address assessed risks of material misstatement at financial statement level.
- Financial Statement Assertion in following three areas-

## Performing Audit Tests (SA 330)



- SA 610 “Using the Work of Internal Auditors” & SA 620 “Using the Work of an Auditor’s Expert”
- Evaluate extent to which work of others will be used to reduce work the auditor might otherwise perform
- Assess competence & objectivity of persons whose work is planned to be used to determine extent of use of such work.
- Higher the degree of competence & objectivity, the greater use the auditor may make of the work.

- Performing procedures as per SA 220 “ Quality Control for an audit of financial statements” regarding acceptance of client relationship & specific audit engagement.
- Communicating with the predecessor auditor.
- SA 210 - “Agreeing Terms of Audit Engagements” – Documentation of engagement terms to prevent any confusion as to agreed terms.

- Covers all risks having reasonable possibility of materially affecting the financial statements.
- Focuses on effectiveness of IC system ability to mitigate risks with minimal time spent on controls whose failure is immaterial, or detected & corrected by other controls.
- Take appropriate advantage of work performed by others, especially internal audit, but not placing unwarranted reliance on such work.
- Appropriate Focus on areas of meaningful fraud risk

- Evidence of basis for a conclusion about achievement of overall objective of audit.
- Evidence that the audit was planned & performed in accordance with SAs & applicable legal & regulatory requirements.

## List of SA's on Audit Evidence

- SA 500- Audit evidence
- SA 505-External Confirmations
- SA 510- Initial Audit Engagements
- SA 520- Analytical Procedures
- SA 530- Audit Sampling
- SA 540 – Accounting estimates
- SA 550- Related Parties
- SA 560 – Subsequent Events
- SA 570 – Going Concern
- SA 580- Written Representation

- Any information obtained by an auditor to draw conclusions and express opinion on financial statements.
- Auditor should obtain **sufficient & appropriate** audit evidence

### **Sufficient & Appropriate audit evidence**

- ▷ Sufficiency refers to **Quantum** of Audit Evidence
- ▷ Appropriateness refers to **Quality** of Audit evidence

# Factors to determine sufficiency & appropriateness

- Degree of risk of misstatement
- Result of audit procedures i.e. any fraud or error detected by auditor
- Materiality
- Experience gained during previous audit
- Trend shown by accounting ratios

# Types of Audit Evidence

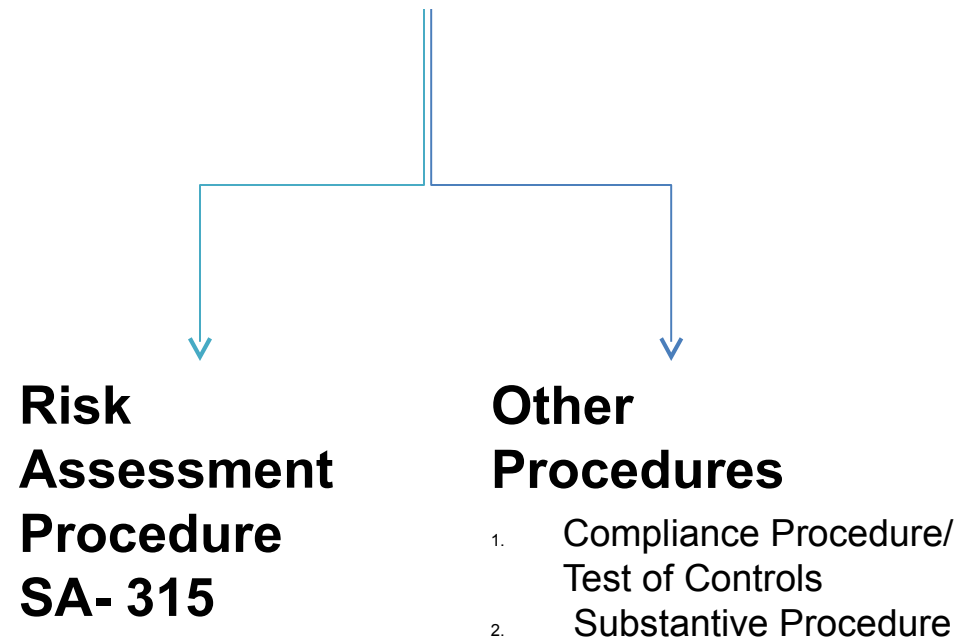




# Indian Evidence Act, 1872

Oral & Documentary  
Direct & Indirect (Circumstantial)  
Primary & Secondary  
Real & Hearsay  
Judicial & Non judicial

# Audit Procedures to obtain Audit evidence



# Other Procedures

Compliance Procedure/ Test of Controls - Whether IC is designed and operating effectively throughout the period

Substantive Procedure: Test of completeness, accuracy & validity of data produced by the accounting system

- Test of details includes vouching and verification
- Analytical review procedures - analysing significant ratios & trends

# How to obtain Audit evidence?



# SA 530-Audit Sampling

- Applying audit procedure to < 100% population – All about efficiency – maximum results with minimum resources
- Based on audit objective – Being smart & wise -
- Sufficient understanding of internal control structure to plan the audit & determine NTE of performed tests
- SA 530 – use of audit sampling in performing audit procedures - Deals with use of statistical & non statistical sampling in design & selection of audit sample.
- **State the sampling process & extent of sampling done**

# Sample selection

- Consider objectives of the audit procedure.
- Population characteristics
- Assist in effective & efficient sample design Stratification (Process of dividing a population into sub-populations) as appropriate.
- **Materiality** SA 320 – does it matter – does it influence the decision  
– Appropriateness to details

# Sampling Risk- Fear of the unknown

**Different Results if entire population considered**



*Risk that the results from the sample selected may not be representative of the entire population.*

- If error expected in the population, larger sample to be examined.
- Select sample such that it represents entire population.



# Analysing Audit Sample

- Investigate nature & cause of any deviation or misstatements identified & their possible effects.
- To conclude that a misstatement or deviation is an anomaly.
- Auditor to obtain a high level of certainty that misstatement or deviation is not representative of the population.

# Audit Techniques

- 1) Posting Verification
- 2) Vouching
- 3) Confirmation
- 4) Physical Examination
- 5) Reconciliation
- 6) Testing
- 7) Analyses of Financial Statements
- 8) Inspection
- 9) Observation

## A. Planning the Sample

Step 1	State the objectives of the audit test.
Step 2	Decide whether audit sampling applies.
Step 3	Define attributes and exception conditions.
Step 4	Define the population.
Step 5	Define the sampling unit.

# Audit Techniques

- 10) Documentary examination
- 11) Scanning
- 12) Electronic Data processing
- 13) Enquiry
- 14) Computation
- 15) Analytical Review
- 16) Compliance test
- 17) Substantive test
- 18) Use of computer Assisted audit techniques



Total Sampled )	Audited	Under Observation	Need Clarification
92 ( 11 )		1	2
40	3	2	5
26		2	2
9	2	1	1
12	1		1

# SA 520- Analytical Procedures

Evaluation of financial information through analysis of relationship among both financial & non- financial data.

**Nature of analytical Procedure** - Comparison with :

- Comparable information for prior periods
- Anticipated results
- Similar Industry information

## **Objectives**

- Obtain relevant & reliable audit evidence when using substantive analytical procedures;
- Design & perform analytical procedures near the end of the audit to assist in forming an overall conclusion.

# Substantive Analytical Procedures

In designing and performing substantive analytical procedures –

- (a) **Determine suitability**
- (b) **Evaluate reliability of data**
- (c) **Develop an expectation**
- (d) **Determine amount of any difference of recorded amounts from expected values acceptable without further investigation**

# Important Points (SA 520)

- Analytical procedures assist in forming overall conclusion
- Design and perform analytical procedures near end of audit .
- To conclude whether financial statements are consistent with understanding of the entity

# SA 580- Written Representation

Taken from –Those Charged With Governance (TCWG) w.r.t items affecting Financial Statement

Although WR from management provide necessary audit evidence, they **do not provide sufficient and appropriate audit evidence on their own** about any of the matters in which they deal .

## Matters of WR -

- Preparation & presentation of financial statement
- Proper recording of all transactions
- Proper disclosure of all information to the auditor

# Important Points (580)

- Does not include Financial statements - supporting records etc
- Should be obtained before/ at date of Auditors report
- Management public statement w.r.t its responsibilities to be included.
- Reliability in doubt based on management integrity & competence
- If inconsistent with other evidence then perform extended procedures - Note its effect on Auditors report.



# SA 505- External Confirmation

Audit evidence obtained by direct written response from a 3rd party in paper, electronic or other form.

# Important Points (SA 505)

- If Management refuses for external confirmation & reason is not justified then auditor can communicate to TCWG & consider impact on his report.
- If response is unreliable , it may indicate fraud risk factor.
- Consider its effect on NTE of other procedures.

# SA510- Initial Audit Engagements- Opening Balances

Audit responsibilities wrt opening balances when conducting an initial audit engagement.

## Objectives

- Whether opening balances contain misstatements that materially affect current period
- Appropriate accounting policies reflected in opening balances are consistently applied, or changes properly accounted, presented & disclosed.

# Audit Procedures

## Opening balances – OB

- Read prior year's Financial Statements and Audit Reports
- Whether correctly brought forward
- Any adjustments disclosed as prior period adjustment
- Co-relate opening balance with procedures performed in current year
- Perform additional evidence for opening balances.
- If doubts as to misstatement in OB communicate with TCWG

# Audit Procedures

## **Consistency of accounting policies**

- Check accounting policies are consistent
- In case of change check compliance with Financial reporting Framework

## **Predecessors Audit Report**

- If modification in predecessor audit Report, evaluate effect of matter wrt current years financial statement.

# Conclusion & Reporting

## **Opening Balance –**

Qualifications / Disclaimers to be given if -

Unable to obtain evidence

Misstatement not properly adjusted /disclosed in CY financial Statements

## **Consistency of Accounting Policy**

- Consistently not applied as per FRF or Change in accounting policy not adjusted/ disclosed as per FRF - Qualified/adverse opinion

**Modification in Predecessors Audit Report - Relevant and material to current years financial statements then modify CY audit report**

# Definition of Related Party

Person or an entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity.

- Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries
- Another entity that is under common control with the reporting entity through having

Common controlling ownership

Owners who are close family; or

Common key management

# SA 550-Related Parties

Auditors responsibilities regarding related party transactions when performing an audit of financial statements.

- Expands on SA 315,330, and SA240 application in relation to risk of material misstatement w.r.t. related party relationships and transaction



# Risk Assessment Procedures

- Enquire with management
- Related party & changes since previous years
- Nature of relation
- Transactions
- Understand IC over Related party transactions
- Maintain Professional Scepticism
- Share information within engagement team

Identification of some undisclosed Related party

# Responses to risk

## If previously undisclosed Related party is identified –

- Communicate within team
- Adopt more substantial procedure
- Consider risk of other such related party
- Reconsider reliability of Written representation

## Related party transaction not as per normal business consideration

- Inspect contract
- Consider fraud risk factor
- Consider accounting & disclosure in financial statement

## Related party transaction being arms length transaction

- Obtain Sufficient & appropriate audit evidences wrt such transaction
- Obtain WR from TCWG

# Pointers

- Audit at the speed of Risk
- Audit of Organizational Culture / Ethics / Governance Process
- Audit of Risk Assessment process / Conflict of interest / Independence
- Audit of Effectiveness of Marketing
- Audit effectiveness of Board Performance
- Audit of effectiveness of first 2 lines of Defense
- Audit of Tone at the Top / Business Strategy
- Audit of E-mail etiquettes / Corporate Communications

# Pointers

- Integrated GRC
- Compliance embedded in operations
- Doing Things right first time
- Conceptual consistent understanding of risk appetite at all levels in the organization
- Risk centric Organizational culture – Risk appreciation
- Hindsight – Insight – Foresight
- Data – Information – Knowledge – Wisdom

# Auditing Trends

- Aim of IA is to eventually be a validating function – make itself redundant
- Internal Controls over Internal Financial Reporting
- Mystery Shopping
- Use of subject matter financial experts
- Continuous Control Monitoring – Surveillance audits
- IA as a trusted business partner
- Off site audits
- Flexible risk based audit plans

# Success Trains – Failure Complains

- People are losing curiosity & the desire to learn & improve themselves & that in complacency & self satisfaction lies a low descent into mediocrity.
- The more you learn you learn that you still have a lot to learn – Learn – Unlearn – Relearn -
- We can not solve our problems with the same level of thinking that created them – Albert Einstein
- If you want something you have never had, then you got to do something that you never did



Thanks