

STANDARDS ON AUDITING

(SA 500, SA 520 & SA 530)

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Standards on Auditing

500-Audit Evidence

Scope:

This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and 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 auditor's opinion. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective:

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 be able to draw reasonable conclusions on which to base the auditor's opinion.

Definitions

For purposes of the SA s, the following terms have the meanings attributed below:

a. **Accounting records** – The records of initial accounting entries and supporting records, such as checks 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 worksheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

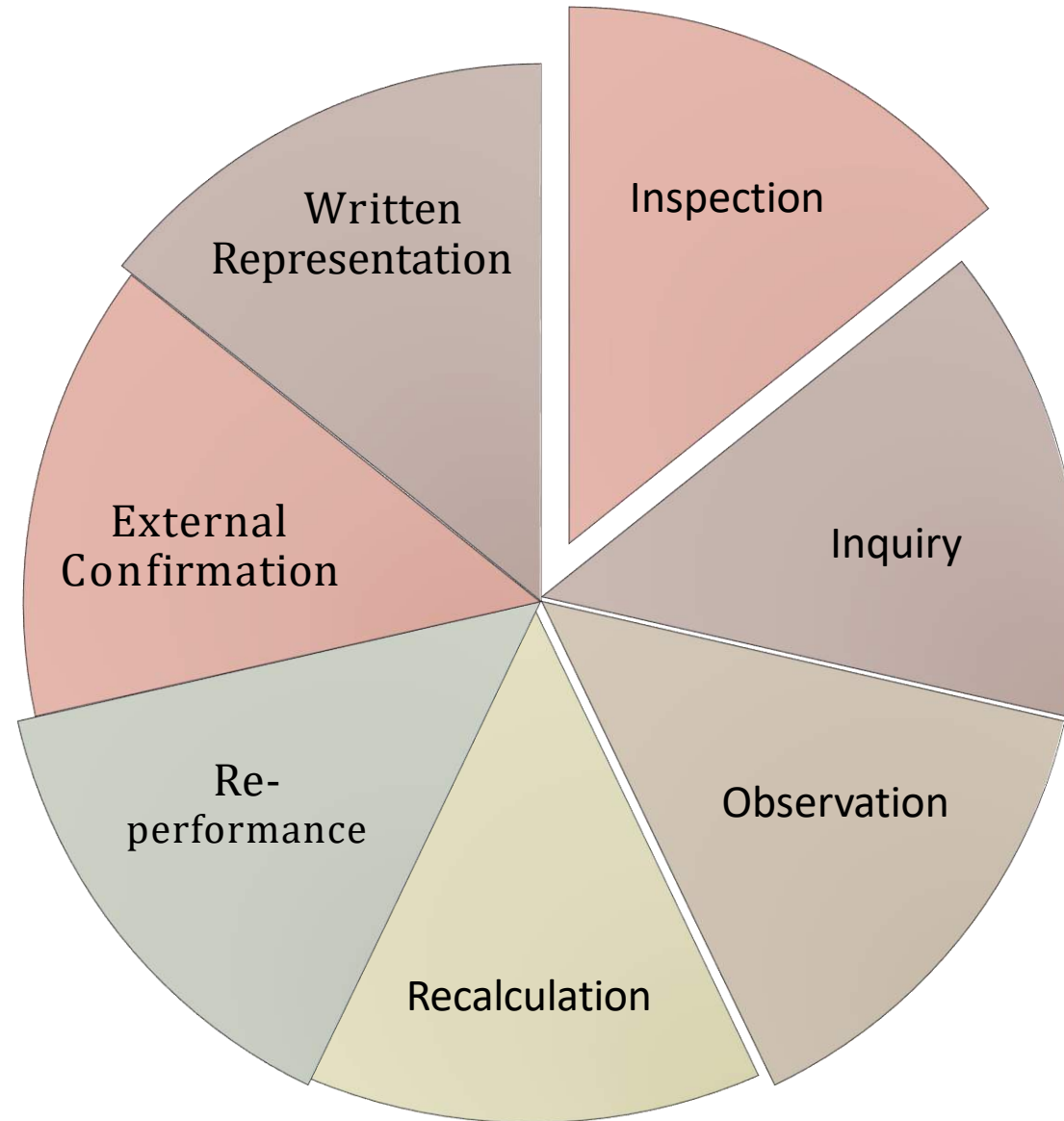
b. **Appropriateness (of audit evidence)** – The measure of the quality of audit evidence; that is, its **relevance and its reliability** in providing support for the conclusions on which the auditor's opinion is based.

c. **Audit evidence** – 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.**

d. **Management's expert** – An individual or organization 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.

e. **Sufficiency (of audit evidence)** – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Types of Audit Evidence based on the means of collection:



Types of Audit Evidence based on the means of collection:

1. Inspection

Inspection is done by the auditor of books of accounts and other relevant records. **Inspection can be done internally or externally** and types of evidence may be in paper form, electronic form etc. Even auditor may prefer to do a **physical examination** of an asset for getting conclusive view about the asset appearing on the balance sheet. In this case, it is said to be more reliable audit evidence. Its **reliability depends on the nature and source of audit evidence.**

2. Observation

The auditor when watches the internal processes or procedure being performed within the organization of the client, it is said to be observation. It is the close verification of the processes or procedure performed by the client. i.e observation of inventory counting by the entity's personnel, or of the performance of control activities.

3. External confirmation

To check the genuineness of the transactions appearing in the books of accounts, auditor prefers to obtain external confirmation directly from the third party. It is always said that external evidence is more reliable than internal evidence because it is obtained externally without clients involvement and hence more reliable. We can take the instance of balance confirmation in this case, for example, Cash & Bank Balance, debtors balance confirmation and creditors balance confirmation.

4. Recalculation

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

5. Reperformance

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

6. 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.

7. 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.

Factors from which reliability of audit evidence is increased.

- Evidence if the source is from outside the entity.
- Internal evidence reliability increases when internal control is effective.
- External evidence is more reliable than internal evidence as of the absence of the involvement of the client.
- Written form evidence is more reliable
- If the audit evidence is obtained from original documents then they are more reliable rather than photocopies of it.

The nature, timing, and extent of audit procedures in relation to the requirement of this SA, may be affected by such matters as:

- 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 control 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.

What is sufficiency and appropriateness of the audit evidence?

Sufficient Audit evidence represents **quantum of audit evidence obtained** by the auditor and its **appropriateness** tells about its relevance. These **two terms are interrelated**. Auditor decides to obtain more quantity of audit evidence is when there are chances of the risk of material misstatement as per auditors assessment. Appropriateness refers to the **reliability and relevance**.

Its reliability, in turn, depends upon the **source and nature** of audit evidence. Also, the quantum of evidence depends upon the **quality of evidence**, the higher the quality of audit evidence obtained the less it is required.

There can be different factors which **influence sufficiency and appropriateness** of audit evidence, it may be affected by the **nature of the evidence**, whether the internal control is sufficient or not etc. Also, auditor is required to know about the **materiality** of the item. Other factors affecting sufficiency and appropriateness are the **size of the business, Previous audit experience**.

Standards on Auditing

520-Analytical Procedures

Scope:

This Standard on Auditing (SA) 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. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective:

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

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.

Step of Analytical Procedures



Step 1 – Studying suitable plausible (probable) interrelationship in financial and non-financial data.

Step 2 – Collecting reliable data.

Step 3 – May or may not performing calculations, computing ratios percentage etc.

Step 4 – Then comparing them with relevant data or expected values and investigating unusual differences.

Example

Analytical methods can be carried out in a variety of ways. These exercises cover everything from making straightforward comparisons to carrying out intricate analyses using cutting-edge statistical methods. Analytical procedure may be applied to consolidated financial statements, components and certain informational components.

Consequently, we can state that analytical methods may be separated into these type as comparisons of client and industry data, comparisons of client data with similar period data, comparisons of client data with client-determined expected results, comparisons of client data with auditor-determined expected results and comparison of client data with expected results, using non-financial data.

Particular	Client		Industry	
	2020-21	2021-22	2020-21	2021-22
Year	2020-21	2021-22	2020-21	2021-22
Inventory Turnover	2.8	2.9	3.1	2.8
Gross Margin	22.50%	22.70%	23.60%	22.20%

Purposes of Analytically applied Procedure

Analysis processes compare and relate data to see whether account balances or other data appear logical. The auditor's goals are to:

- To acquire pertinent and trustworthy audit evidence, when employing a substantive analytical technique.
- To plan and carry out analytical procedures that aid the auditor in determining whether the financial statements are accurate and consistent with their understanding of the entity near the end of the audit.

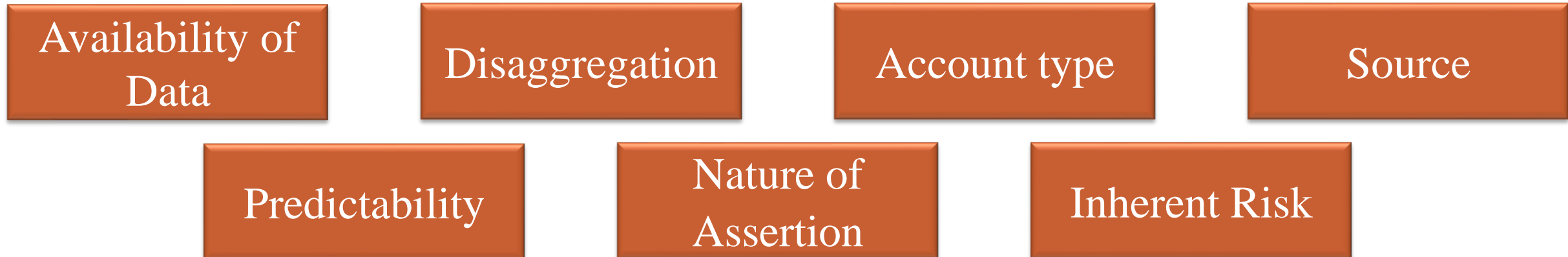
Timing of Analytical Procedure

- **At Planning Stage:** At planning stage, the auditor obtains understanding about the client business and identifies the risk of material misstatement.
- **While performing the audit:** At this stage, the auditor applies substantive analytical procedure.
- **Near the end of audit:** The auditor performs analytical procedures when forming an overall conclusion to ascertain whether financial statements are consistent with the understanding of audit.

Substantive Analytical Procedures

The auditor's substantive procedure at the assertion level may be tests of details (TOD), substantives analytical procedure or a combination of both. The auditor could inquire of management regarding the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedure by the entity.

Factors to be considered for substantive audit procedures:



Different forms of analytical procedures

- **Data comparison with previous year**
 - i. **Trend Analysis:** This trend uses to compare of current data with prior period balance or with trend in two or more prior period balance. Auditor check whether current balance of an account moves in the line with trend established with previous balance for that account or based on an understanding of factors that may cause the account to change.
- **Ratio comparison with other firms, Like Inter Firm Analysis**
 - i. **Ratio Analysis:** Ratio analysis used to compare line item of assets and liability accounts as well as revenue and expenses. (E.g., Debtor balance related to sales.)

- **Correlation, Regression to construct equation and the use it to predict current year**
 - i. **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**)
- **Comparison with expected Data, Like Predictive Analysis**
 - i. **Reasonableness Tests:** Unlike trend analysis, this analytical procedure does not Count on event of prior periods, but upon non-financial data for the periods, but upon non-financial data for the audit period under consideration.
(E.g., occupancy rate to estimate rental income or interest rates to estimate interest income or expense)

Factors Affecting Reliability of Data/Extent of Reliance on analytical procedures

SA 520 on 'Analytical procedures' concludes that the honesty of data is judged on the basis of its **origin and nature**. Also, it depends on the situation under which it is obtained. Accordingly, the following are relevant criteria when determining whether the data is reliable for purpose of designing substantive analytical procedure:

- **Source of information Available :**

For example, information may be more reliable when it is obtained from independent sources outside the entity;

- **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 specialized products;

Factors Affecting Reliability of Data/Extent of Reliance on analytical procedures

- **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
- **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

Standards on Auditing

530-AUDIT SAMPLING

Scope:

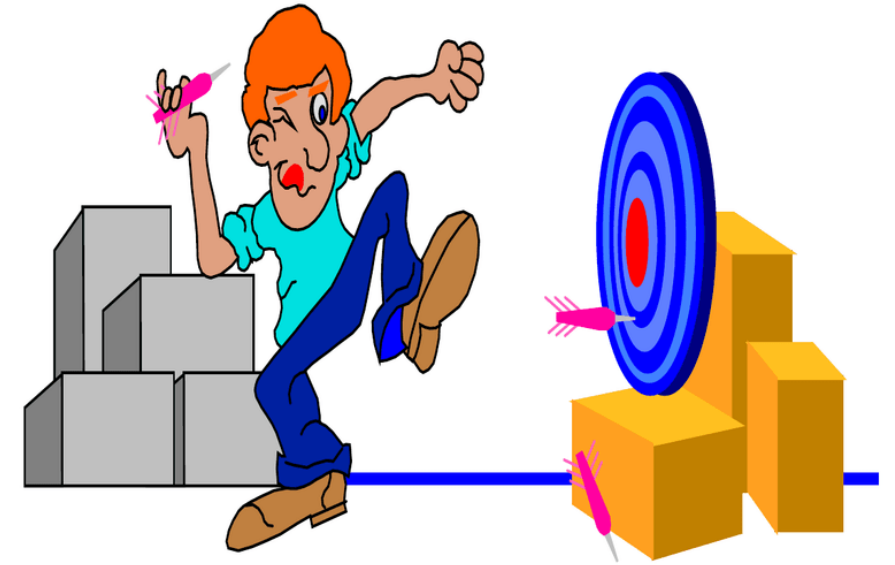
This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the **auditor's use of statistical and non-statistical sampling** when designing and selecting the audit sample, performing tests of controls (TOC) and tests of details (TOD), and evaluating the results from the sample. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009

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.

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 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**.



Population

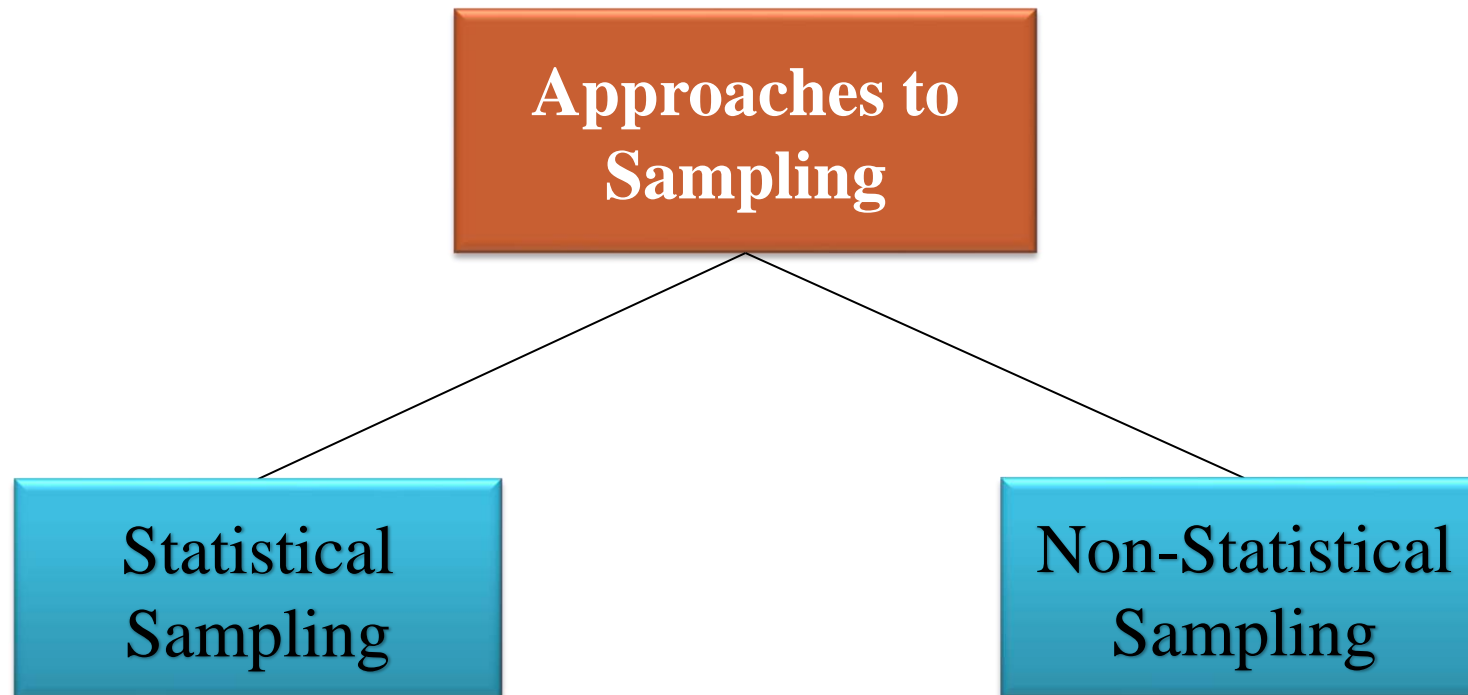
Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

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**. 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.
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 operated effectively during the financial reporting period, the population needs to include all relevant items **from throughout the entire period**.
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**.

Approaches to 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 concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches



Statistical Sampling - More Scientific

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. 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.

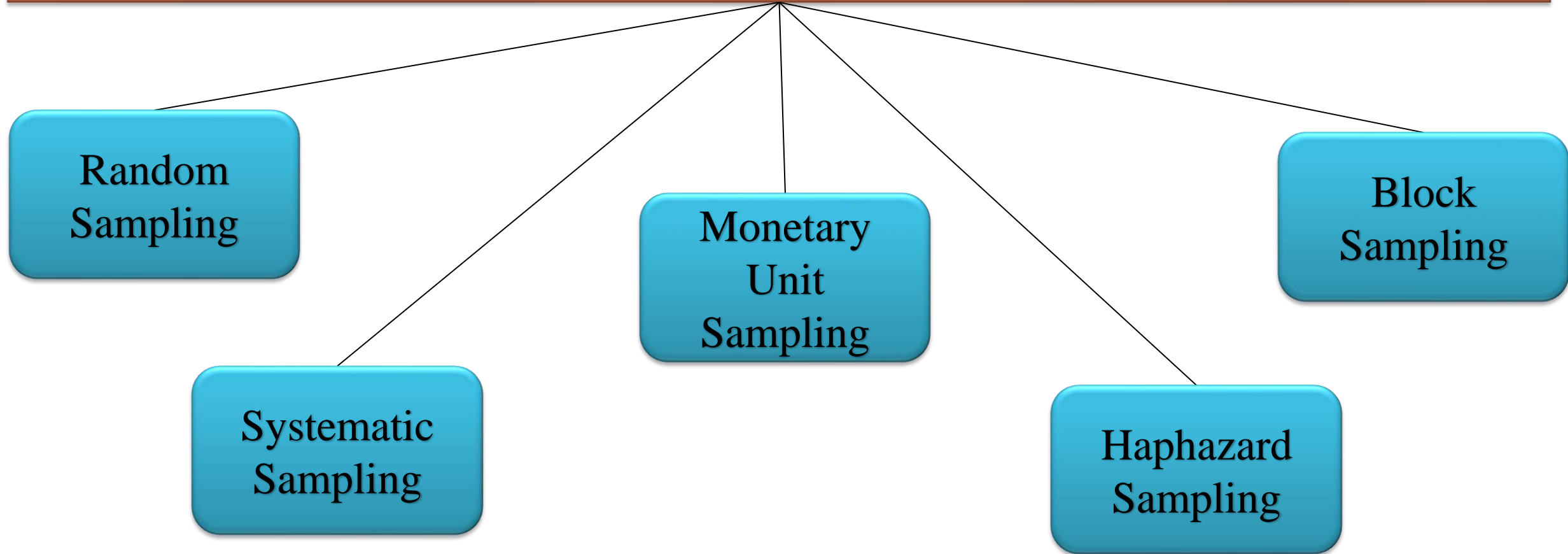
Non - Statistical Sampling

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

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

1. Size of the organization under audit.
2. State of the internal control.
3. Adequacy and reliability of books and records.
4. Tolerable error range.
5. Degree of the desired confidence.

Sample Selection Method



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. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum.
 - 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.

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.

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.

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.

Sampling & Non-sampling Risk

Sampling Risk. 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:

1. In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist 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.
2. In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test 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.

Non-Sampling Risk. The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Sources of Non Sampling risk are :

Human Mistakes	Misinterpreting the sample results
Applying audit procedures not appropriate to the objectives of audit	Relying on erroneous information e.g. erroneous confirmation

Non sampling risk can never be mathematically measured.

Evaluating Results of Audit Sampling

The auditor shall evaluate:

1. The results of the sample; and
2. Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Performing Audit Procedures

The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. 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.

An example of when it is necessary to perform the procedure on a replacement item is when a voided check is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation, an appropriately chosen replacement is examined.

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.

Performing Audit Procedures

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. 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.**

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. 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.** 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.

Projecting Misstatements

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. 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.

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.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement.

Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

THANK YOU!

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