

# Audit Principles and Techniques

## Lesson 10

### KEY CONCEPTS

- Audit Techniques ■ Risk Assessment ■ Confirmation ■ Internal Control System ■ Enquiry ■ Sampling
- External Expert's opinion ■ Audit Trials ■ Audit Findings

### Learning Objectives

#### To understand:

- The Audit Principles as generally accepted rules which are commonly applicable for every type of Audit.
- How the Audit Techniques stand for the methods that are adopted by an auditor to obtain audit evidence and performance of the audit as per the scope of the audit.
- Various techniques of auditing which may be applied by the auditor under different circumstances of audit.
- There are five core testing methods that auditors use to confirm the facts and answers that a business wants to attain during an audit.
- To know about how Audit sampling is an investigative tool.
- Internal controls are rules and procedures established by a company to ensure business continuity, prevent fraud, and preserve the integrity and accuracy of financial reporting.

### Lesson Outline

- Introduction
- Audit Techniques, Examination and its Process
- Enquiry
- Confirmation
- Sampling
- Compliance test of Internal Control System
- Substantive Checking
- Verification of documents/ records
- Creation of Audit Trails
- Analysis of Audit findings
- Lesson Round-Up
- Glossary
- Test Yourself
- List of Further Readings
- Other References (Including Websites / Video Links)

## MEANING OF AUDITING

Auditing evaluate a company's internal controls, including its corporate governance and accounting processes. These types of audits ensure compliance with laws and regulations and help to maintain accurate and timely financial reporting and data collection. Internal auditors are hired by companies who work on behalf of their management teams. These audits also provide management with the tools necessary to attain operational efficiency by identifying problems and correcting lapses before they are discovered in an external audit. The individual assuming up the liability of the cycle is called an 'Auditor'.

In this procedure, it is checked on the off chance that the business is running productively or not. Auditing is a significant procedure for the organization, the financial backers, the public authority, investors, creditors, and so on. They especially depend on review reports to settle on significant business decisions.

## FUNDAMENTAL PRINCIPLES GOVERNING AN AUDIT

There are nine essential rules that administer the method of auditing. It rattles off the roles and obligations of the evaluator or auditor and his overall set of accepted rules while conducting an audit or review.

### A. Integrity, Independence, and Objectivity:

The inspector must be truthful and straightforward while during the inspection process; he can't be inclining toward the association. He should stay free from every kind of biasness all through the entire cycle, and his trustworthiness should not permit any negligence.

Another significant rule is autonomy or independence, and the examiner can't have any interest in the association he is inspecting, which permits him to be autonomous and fair-minded consistently.

**Integrity** – being trustworthy, straightforward, honest, fair and candid; complying with the spirit as well as the letter of applicable ethical principles, laws and regulations; behaving so as to maintain the public's trust in the auditing profession; and respecting confidentiality except where disclosure is in the public interest or is required to adhere to legal and professional responsibilities.

**Objectivity** – acting and making decisions and judgements impartially, fairly and on merit (having regard to all considerations relevant to the task in hand but no other), without discrimination, bias, or compromise because of commercial or personal self-interest, conflicts of interest or the undue influence of others, and having given due consideration to the best available evidence.

**Independence** – freedom from conditions and relationships which, in the context of an engagement, would compromise the integrity or objectivity of the firm or covered persons.

### B. Confidentiality:

The auditor comes across a great deal of sensitive monetary data of the association. It is significant that he regards the classified genre of such data and archives.

He can't uncover any delicate data to any outsider except if it is a necessity by law. What's more, he should likewise be extremely cautious with archives, authentications, and so forth that the association shares with him.

### C. Skill and Competence:

The examiner should be capable and prepared in the strategies of auditing, for example, he should be qualified as an examiner. Furthermore, as an expert, he should be aware and upgrade on the latest changes, declarations, rules, and so forth.

In the event that is important, he can go through preparing and prepare to keep up to date with the new accounting and auditing methodology. For instance, after GST was presented, auditors needed to refresh their insight.

**D. Work Performed by Others:**

The extent of an audit on occasion can be extremely immense. So an auditor can utilise his representatives, delegates, and others who work under him.

Be that as it may, the reviewer will keep on being completely liable for the work done by these individuals working for him. So the evaluator should cautiously oversee and audit such work and be sensibly certain of the precision of such work.

**E. Documentation:**

Much of the time, the examiner keeps a review notepad, a review or audit plan, and an evaluating document or an audit file. It is significant the auditor tracks significant reports for his review work, as it is proof of the work the evaluator has completed. Also, the customer is leaned to these reports and records, assuming he wishes to examine the work.

**F. Planning:**

A review plan permits the inspector to arrange his work and empowers him to be more proficient and ideal. Each review plan is distinctive as it must be redone as indicated by the type of association, the sort of business they lead, the extent of the review, the productivity of the inside controls, and so forth.

**G. Audit Evidence:**

The auditor should gather sufficient proof to help him in his last assessment. This assortment of such proof is finished by substantive and consistency systems. There are two origins of this proof – inward or internal and outer or external. Likewise, external resources of proof are, in every case, more dependable.

**H. Accounting Systems and Internal Controls:**

The inspector needs to guarantee that the records of the association are exact and address a valid and reasonable image of the monetary status of the organisation. Likewise, the examiner should guarantee that all material data has been recorded in the accounting records. Testing the inside controls framework is likewise significant as it decides something very similar.

**I. Audit Conclusions and Reporting:**

After the examiner gathers all proof, he should now shape his viewpoint based on the accompanying standards:

- All applicable bookkeeping guidelines were applied consistently.
- Budget reports are consistent with all guidelines and legal prerequisites.
- All material data has been revealed.

**CASE STUDIES****Materiality:**

An auditor is conducting an audit of a company's financial statements. The auditor determines that a certain error in the financial statements is immaterial and does not need to be corrected. However, the error is later discovered to be material and the company faces legal action as a result. This case highlights the importance of properly assessing materiality and the potential consequences of misjudging it.

**Risk Assessment:**

An auditor is conducting an audit of a manufacturing company. During the risk assessment process, the auditor identifies a significant risk related to inventory management. The auditor then designs audit procedures to test the controls related to inventory management and discovers that there are significant weaknesses in the company's internal controls. This case highlights the importance of proper risk assessment and the need to design appropriate audit procedures based on the identified risks.

**Lehman Brothers:**

Lehman Brothers' bankruptcy in 2008 is another example of the failure of audit principles and techniques. The company's financial statements did not accurately reflect its true financial position, and its auditors failed to identify the risks associated with the company's mortgage-backed securities.

**AUDIT TECHNIQUES**

Audit techniques are the methods and procedures used by auditors to obtain sufficient and appropriate audit evidence to support their audit opinion. Here are some common audit techniques used by auditors:

**1. Examination of Record :-**

This technique is commonly used by the auditors, the inspection of books and documents is made to verify the validity of data.

**2. Inquiry :-**

The auditor can also use the technique of inquiry. He can get the information from resource persons inside or outside the enterprise.

**3. Sampling :-**

Auditor can select few items from whole accounting information. This technique enables the auditor to obtain and evaluate the evidence of some characteristics of the whole class. It is helpful in forming the conclusion.

**4. Confirmation :-**

To ensure the accuracy of the data auditor can collect the information from the debtor. Confirmation is response to an inquiry to prove certain data recorded in the books.

**5. Compliance :-**

To check the arithmetical accuracy of accounting record, the balancing accounts can be compared with the vouchers to test the reliability of data.

**6. Compliance Test :-**

These tests are designed to check the effectiveness and compliance of internal control. In obtaining the audit evidence, auditor is concerned with the existence of effective internal control.

**7. Use of Computer Techniques :-**

There are large number of audit techniques like audit software, test packs and mapping which can be used by the auditor to test the accuracy of the data.

**8. Substantive Test :-**

These are designed to obtain evidence that data produced by accounting system is accurate or not. It has two kinds :

- a) Test of detail transaction.
- b) Test of significant ratios and trends.

#### 9. Dependence on Experts and Auditors :-

The auditor has to rely on the internal and other auditors to complete his work. He has also to rely on other experts like lawyers, engineers and doctors for their expert opinion about the business.

#### 10. Analytical Review :-

It consists of studying significant ratios, trends and investigating different changes. This review procedure is based on the expectations of relationship among the past and present data.

These are just a few of the many audit techniques that auditors may use to obtain sufficient and appropriate audit evidence. The selection of techniques depends on the auditor's judgment and the nature of the entity being audited.

### CASE STUDY

#### A case study on Audit Techniques:

ABC Corporation is a manufacturing company that produces and sells widgets. The Company has recently undergone a change in management, and the new CEO has expressed concerns about the accuracy of the financial statements prepared by the previous management team. The company has engaged an independent auditor to perform an audit of its financial statements.

The auditor begins the audit by performing an initial assessment of the company's internal controls. The auditor reviews the company's accounting policies and procedures, interviews key personnel, and performs walkthroughs of the accounting system to identify any weaknesses or deficiencies in the internal control system.

Based on the initial assessment, the auditor decides to use a combination of audit techniques to obtain sufficient and appropriate evidence to support the audit opinion.

First, the auditor decides to perform analytical procedures. The auditor compares the company's current year financial statements to the prior year financial statements to identify any significant changes or trends. The auditor also performs ratio analysis to assess the company's liquidity, profitability, and financial stability.

Next, the auditor decides to use sampling. The auditor selects a sample of sales transactions from the company's sales ledger and tests them to verify that the sales were properly recorded in the accounting records. The auditor also selects a sample of inventory items and performs a physical count to ensure that the inventory quantities and values are accurately reflected in the financial statements.

The auditor also decides to use computer-assisted audit techniques (CAATs). The auditor uses data analysis software to scan the company's accounting records for any anomalies or trends that may indicate errors or fraud. The auditor also uses the software to test the completeness and accuracy of the inventory and accounts payable balances.

Throughout the audit process, the auditor maintains open communication with the company's management team and informs them of any findings or concerns. At the conclusion of the audit, the auditor issues an audit opinion based on the evidence obtained through the various audit techniques used.

In this case study, the auditor used a combination of audit techniques to obtain sufficient and appropriate evidence to support the audit opinion. The auditor's use of analytical procedures, sampling, and computer-assisted audit techniques helped to identify any potential risks or concerns in the financial statements, which allowed the company to address these issues and improve its financial reporting process.

**PRELIMINARY PREPARATION**

Preliminary preparation is an essential step in the audit process. It involves planning and preparing for the audit to ensure that the audit is conducted effectively and efficiently. Here are some of the activities that auditors typically undertake during the preliminary preparation phase:

1. **Understanding the entity:** The auditor needs to obtain a good understanding of the entity's business operations, industry, and environment. This includes understanding the entity's organizational structure, key personnel, accounting policies and procedures, and risk management processes.
2. **Assessing risk:** The auditor needs to assess the risks associated with the entity's business operations and financial reporting. This includes identifying the risks of material misstatement, evaluating the effectiveness of internal controls, and determining the materiality threshold for the audit.
3. **Developing an audit plan:** The auditor needs to develop an audit plan that outlines the scope and objectives of the audit, the audit approach, the timeline, and the budget for the audit. The audit plan should be based on the understanding of the entity and the risks identified.
4. **Assigning audit team members:** The auditor needs to assign audit team members based on their experience, skills, and knowledge of the entity's business operations and industry.
5. **Communicating with the entity:** The auditor needs to communicate with the entity's management team to discuss the audit plan, obtain necessary information, and establish a timeline for the audit. This includes obtaining a representation letter from the entity's management team.
6. **Developing audit programs:** The auditor needs to develop audit programs that outline the specific audit procedures to be performed during the audit. The audit programs should be based on the audit plan and the risks identified.
7. **Establishing an audit file:** The auditor needs to establish an audit file to document the audit plan, the audit programs, and the evidence obtained during the audit.

After the preparation of the audit manual the detailed audit programme should be prepared by the audit team, the audit programme should contain the role of team members in the performance of the chosen audit procedures.

**CASE STUDY**

XYZ Limited is a small manufacturing company that produces and sells widgets. The company has engaged an independent auditor to conduct an audit of its financial statements. The auditor begins by conducting preliminary preparation activities to ensure that the audit is conducted effectively and efficiently.

The auditor obtains a good understanding of XYZ Limited's business operations, industry, and environment. This includes understanding the Company's organizational structure, key personnel, accounting policies and procedures, and risk management processes. The auditor also assesses the Company's financial performance and identifies any unusual or complex transactions. The auditor assesses the risks associated with XYZ Company's business operations and financial reporting. This includes identifying the risks of material misstatement, evaluating the effectiveness of internal controls, and determining the materiality threshold for the audit.

Based on the assessment, the auditor determines the scope of the audit and the audit approach to be taken. The auditor develops an audit plan that outlines the scope and objectives of the audit, the audit approach, the timeline, and the budget for the audit. The audit plan is based on the understanding of the company and the risks identified. The auditor also consults with the company's management team to obtain their input on the audit plan and to establish a timeline for the audit. The auditor assigns audit team members based on their experience, skills, and knowledge of XYZ Limited's business operations and industry. The auditor communicates with the company's management team to discuss the audit plan, obtain necessary

information, and establish a timeline for the audit. The auditor also obtains a representation letter from the company's management team. The auditor develops audit programs that outline the specific audit procedures to be performed during the audit. The audit programs are based on the audit plan and the risks identified. The auditor also ensures that the audit programs are updated to reflect any changes in the audit plan or risks identified during the audit. The auditor establishes an audit file to document the audit plan, the audit programs, and the evidence obtained during the audit. The audit file is organized to facilitate the review of the audit work by the auditor's supervisor or peer reviewers.

By conducting these preliminary preparation activities, the auditor is able to plan and execute the audit effectively and efficiently. The auditor's understanding of XYZ Company's business operations, industry, and environment, along with the assessment of risks, enables the auditor to develop an appropriate audit plan and select the appropriate audit procedures to obtain sufficient and appropriate audit evidence.

## QUESTIONNAIRE

Questionnaire is a comprehensive series of questions concerning internal control. This is the most widely used from for collecting information about the existence, operation and efficiency of internal control in an organisation. An important advantage of the questionnaire approach is that the oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an internal basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review the detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness.

Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not applicable' reply is given. The questionnaire is annually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditors with the client for a clear picture and accordingly the auditor prepares a report of deficiencies and recommendation for improvements.

A questionnaire can be a useful tool for auditors to gather information from the auditee (the organization being audited) in order to gain a better understanding of the organization's operations, processes, and risks.

Here are certain points to be kept in mind as to how a questionnaire may be used in an audit:

1. **Planning the audit:** The auditor reviews the auditee's documentation and identifies areas of potential risk. The auditor then designs a questionnaire that is tailored to the specific risks and issues identified.
2. **Administering the questionnaire:** The questionnaire is sent to the auditee to complete. The auditee is given a deadline to complete and return the questionnaire.
3. **Analyzing the responses:** The auditor analyzes the responses to the questionnaire to identify areas of concern and potential risk. The responses can also help the auditor to identify areas where additional information or documentation is needed.
4. **Conducting follow-up interviews:** Based on the responses to the questionnaire, the auditor may conduct follow-up interviews with key personnel to gather additional information and clarify any areas of concern.

### Problem

As a Practicing Company Secretary, you have been appointed for conducting Secretarial Audit of XYZ Ltd. Prepare Questionnaire for the company including the questions relating to Related Party Transactions, Insider Trading, non-appointment of KMPs, CSR Remuneration of Directors. Assume necessary facts.

5. **Reporting the findings:** The auditor prepares a report that summarizes the findings of the audit, including any areas of concern identified through the questionnaire and follow-up interviews.

Using a questionnaire in an audit can be a useful way for auditors to gather information in a standardized and systematic manner. However, it is important for the auditor to design the questionnaire carefully and to ensure that it is tailored to the specific risks and issues identified in the audit planning process. The auditor should also follow up with key personnel to gather additional information and to ensure that the responses to the questionnaire are accurate and complete.

### CASE STUDY

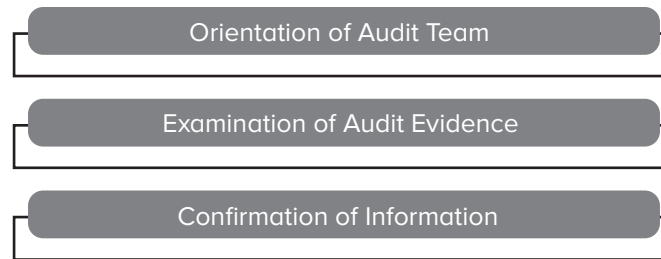
XYZ Company Ltd is a manufacturing company that specializes in producing high-tech electronics. The company has recently experienced a decline in sales and profits, and the management team has requested an audit to identify the root cause of the problem. The auditor decides to use a questionnaire to gather information from the auditee (the company) to gain a better understanding of the company's operations, processes, and risks.

1. **Designing the questionnaire:** The auditor designs a questionnaire that is tailored to the specific risks and issues identified in the audit planning process. The questionnaire includes questions about the company's sales and marketing strategies, production processes, supply chain management, financial management, and risk management practices.
2. **Administering the questionnaire:** The questionnaire is sent to key personnel within the company, including the sales and marketing team, the production team, the supply chain management team, and the finance team. The auditee is given a deadline to complete and return the questionnaire.
3. **Analyzing the responses:** The auditor analyzes the responses to the questionnaire to identify areas of concern and potential risk. The responses reveal that the company has been experiencing quality control issues in its production processes, which has resulted in a high rate of defective products. The auditor also identifies weaknesses in the company's supply chain management practices, including inadequate supplier vetting and a lack of contingency planning.
4. **Conducting follow-up interviews:** Based on the responses to the questionnaire, the auditor conducts follow-up interviews with key personnel to gather additional information and clarify any areas of concern. The auditor also requests additional documentation to support the auditee's responses to the questionnaire.
5. **Reporting the findings:** The auditor prepares a report that summarizes the findings of the audit, including the areas of concern identified through the questionnaire and follow-up interviews. The report includes recommendations for improvement in the company's production processes and supply chain management practices.

Using a questionnaire in the audit of XYZ Company Ltd allowed the auditor to gather information in a standardized and systematic manner. The questionnaire revealed important information about the company's quality control issues and weaknesses in its supply chain management practices. The findings from the questionnaire and follow-up interviews were used to develop recommendations for improvement, which the company can use to address the root cause of the decline in sales and profits.

### INTERACTION THROUGH INTERVIEWS

The main purposes for an interview in context of an audit are orientation, examination and confirmation. An interview can have one or two of these purposes, but normally not all three at the same time.



**Orientation** is normally part of the audit team's learning process during the planning phase. It aims at exploring and giving an overview of a specific area or function, e.g., by asking for presentations of activities, explanations of formal or informal networks or interpretation of documents (reports, instructions or, budgets). The objective could be to identify possible audit subjects or to find out about other available sources of information, such as key persons or documentation.

**Examination** aims at more specific issues with a view to establishing new information, often to be used as audit evidence. In some cases, such information has not been previously recorded at all but is embodied in the interviewee through personal experiences, particular references, opinions, etc. In other cases, the knowledge can be retrieved for example by (joint) interpretation of internal documents, reports or records.

It should be noted that evidence obtained from interviews often needs to be corroborated, i.e. supported by evidence from other data collection methods.

**Confirmation**, finally, often goes together with either orientation or examination, but deserves to be mentioned as a separate purpose because of its fundamental importance. Confirmation, by definition, is typically based on information that has already been gathered. However, in this context the information can also be gathered and confirmed simultaneously. Not least in the planning phase, it is important to have basic conditions and facts explicitly confirmed by stakeholders. However, in the execution phase there might also be a need to confirm facts and findings. If data is incorrectly understood, the quality of the whole audit may suffer and a lot of work may be in vain.

The interview techniques can be gainfully used in a structured or unstructured manner to elicit information from the entity both in the planning as well as execution phase. The Auditor can use the interview mode to obtain both qualitative and quantitative information.

The aim in the planning phase is to develop a comprehensive and correct understanding of the audited activity or the auditee's business in order to facilitate the identification of significant audit issues, there is therefore a need to get orientation as well as confirmation. An interview can very well be justified by a combination of these purposes. Orientation requires a more unstructured approach, with the auditor having maximum flexibility where necessary to explore themes that have not previously been considered and to deeply probe the responses that are given. In this phase, the auditor generally does not have a prior hypotheses or deep knowledge of the project or activity. Confirmation, on the other hand, needs a fairly structured approach in order to have important facts and conditions verified.

In the execution phase of the audit, when the objective is often a more focused examination of an area, in order to capture simple, factual data, to document or clarify certain points or to test hypotheses, interviews will typically have a more structured form. The aim is often to obtain evidence (documents, opinions and ideas) that relate to the audit's objectives, to confirm facts and to collaborate data from other sources. The auditor has a firm grasp of the issues he wants to cover and should know in advance what type of data he wants.

## AUDIT PROGRAMME

Most of the time audit is conducted by a team instead of just an individual. If business is small or if there is not much to be done then it might be possible to conduct the whole engagement easily by an individual. But usually amount of work, time constraints and other factors require the audit engagement to be conducted by more than one person. In order to properly assign work to each individual and what is required to be done by

whom there must be some kind of instructions set and work profile, otherwise, more than one member might be auditing the same area or in other case some areas may be left completely unaudited. To ensure efficient and effective conduct of audit assignment, audit programmes or audit programmes are used.

Audit programme contains step by step instructions to be carried out by team members i.e. it is simply a list of audit procedures to be executed by team members. Even though audit programme sets out the whole agenda for every member of the team but the main users are the audit executives for whom it acts as a direction to be followed. The main purpose of audit programme is that every material area has been audited appropriately and sufficient appropriate audit evidence has been obtained in respect of every important areas of audit.

Audit programmes are prepared on the basis of audit plan usually by the auditor who is signing the Audit Report of the company. But sometimes, auditors have a basic audit programme and the same is used by the auditor after making some modifications to it to make it according the audit engagement in hand. Mostly it is in the form of a checklist which can be used by the Audit executives to make sure every required procedure has been implemented. This can also help in monitoring the work of Audit executives in specific or assistants in general.

Audit programmes may be laid down in advance for the whole year for some aspects of the audit which auditor expects to be audited after regular intervals of time or when needed. For understandability and convenience, audit programmes are written for each audit area separately and then assigned to specific team members.

An audit programme is a set of instructions which are to be followed for proper execution of audit. After the development of audit plan a detailed written audit programme containing the various steps and procedures shall be required. The audit programme contains the measures that are generally employed to determine what, and how much evidence must be collected and evaluated. It also lays down the responsibilities for the whole audit team for carrying out different tasks.

The prepared audit program may be revised if needed in accordance with the prevailing circumstances. An audit program largely depends on the size of the organization and other relevant factors. Minimum essential work to be done is Standard Programme and rest is according to circumstances. There is no standard audit programme applicable for all situations. Audit programme is documented in the Audit Working Papers, which are the official record that contains the planning and execution of the audit agreement.

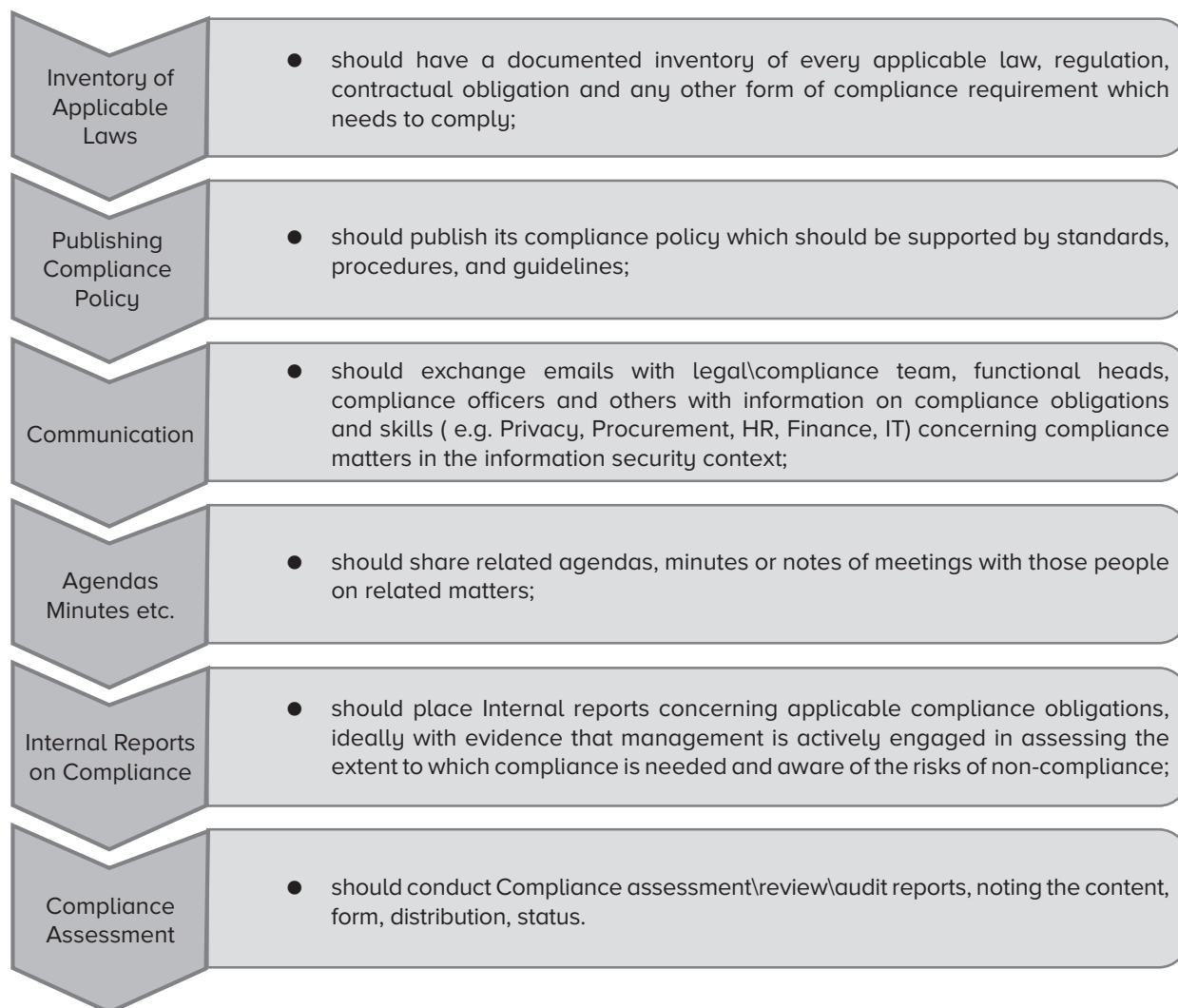
#### Difference between Audit Plan and Audit Programme

Audit Plan	Audit Programme
Audit Plan lays down the audit strategies to be followed for conducting an audit such as identifying the areas where special audit consideration and skills may be necessary, obtain the knowledge of business etc.	Audit programme is an outline of how the audit is to be done, who is to do what work and within what time
Plans should be made to cover the following among other things: (i) Acquiring knowledge of accounting systems, policies and internal control procedures (ii) Establishing the expected degree of reliance to be placed on the internal control (iii) Determining the nature, timing and extent of the audit procedures to be performed (iv) Co-ordinating the work to be done	It lays down the following audit procedure to be followed: (i) Evaluation process (ii) Ascertaining accuracy (iii) Verification of Document (iv) Scrutiny of supporting Documents (v) Checking of overall disclosure and presentation of all items in the audit completion. (vi) Preparation and submission of audit report.

## IDENTIFICATION OF APPLICABLE LAWS

In India, Every mode of business needs to obey various laws, rules, regulations, orders etc. depending on the manner of doing business, business activities and areas of doing business. Sometimes, this may include laws from multiple countries and sometimes such laws have conflicting requirements on each other. In such situations, the best approach is to work with legal team or with an expert to create an outline of all the regulations and contractual obligations. Identify which requirements may impact the organization and discuss the results with management to determine and development of suitable measures which are sufficient for compliance.

Further, the identification of the compliance requirements under applicable laws is just one part of the auditor, but for the management of the company it is necessary to make sure there is sufficient evidence that the company is compliant with each and every one of them. For ensuring the compliance of the applicable laws the company:



For an auditor and the company it is required to identify the applicable legal requirement of act, regulation but should also identify the sections applicable under such regulation.

Further, the legal compliance for a holding company/subsidiary company/joint venture company with diverse operations, the compliance requirement will vary from operation to operation based on the nature of the operations and the locations of the different operation and also based on the applicable legal instruments, and the applicable sections of the relevant laws referred in those legal instruments. The diverse operation and different geographical location may create a complexity in compliance.

Dealing with the amendment in the laws is another concern in fulfilling compliance requirement, which requires that the company should keep up to date information on the compliance requirement with an information of the changes in the laws and regulations. Further, the legal team of the company should continuously communicate the effect of such changes on the Company, its holding, subsidiary, Joint Venture Company or any of the geographical area where the company operates.

Some of the regulators like MCA, RBI, SEBI, on time to time issue the Master Circulars, and Master Direction, Removal of Difficulties Order etc., which helps in identifying and figure out the actual requirement of the law which needs to be complied with.

### CREATION OF MASTER CHECKLIST

The Audit is not a process of the collecting data and checking the checkbox, it is the postmortem of the affairs of the company, the data and evidence collected during the execution of the audit shall be independently reviewed by the auditor and submit its report to the shareholders. Unless the auditor independently reviews the facts & data, the auditor is not able to give his independent opinion.

The truth is that collecting data and checking the box is just not good enough. The mere existence of a control chart does not ensure the compliance and equate to sustained, significant process improvement and complete the audit.

In general, an audit checklist can be divided in to the following headings according to their significance in the audit scope.



**1. Entity operation and organizations:** This checklist contains the matters relating to:

- Product manufactured/ service delivered/ operation performed by the company
- Statutory status basis for these operations
- Objects of the company as per the memorandum of association
- Capital structure of the company and funding status
- Details of the promoters and directors of the company
- Details of subsidiaries, joint ventures and associate companies
- Transactions with the related parties
- Material changes took place during the audit period
- Recipient of the products/services of the company
- Details of the key managerial personnel
- Details of the functional head responsible for audit
- Details of the audit committee and its term of references
- Details of the geographical location where the company operates
- Audit observations of the previous year's etc.

## 2. Financial & Non-financial Reporting Requirement

The company's financial statement, directors' report, annual return, websites, filing with the regulators are the primary source of information about the company. The financial statements are the focus of financial audit, the audit team should familiarize itself with the format of financial statement which needs to be submitted to the regulators. This checklist generally covers the points relating to changes in laws, regulations, accounting standards, accounting rules or accounting policies since the last audit, new heads of accounts introduced since the last audit, changes in the format of accounts or any such item which require exercising of judgement or estimation.

In case of the non-financial disclosures and reporting requirement the audit team should have the detailed requirements under legal and regulatory framework along with the procedural requirements of the same. The auditor should check the limits, eligibility, criteria etc. on the various dates to understand the compliance requirement.

## 3. Legal and Regulatory requirement

The legal and regulatory requirement of every company differs according to the nature and status of the company, its business activity, area of operation, geographical location etc. depending on the relevant central, state and local laws, rules & regulations. It is the most important for the auditor to have the detailed compliance requirement applicable to the company and such checklist should cover the section wise compliance requirement highlighting the amendment during the audit period.

## 4. Matter of Shareholder and public interest

The audit team should identify the extent of the shareholder and public interest in the company's activities and the financial statement. The factors which might indicate such interest includes the public deposit, loan and advances dividend, corporate social responsibility, small shareholders interest, high level of comment in media etc.

## 5. Review of Control Environment

The control environment comprises the conditions under which the various process of the entity are designed, implemented and functions and based on that the audit team should seek to arrive at a conclusion as to whether the control environment is reliable and justifiable in accordance with the size and operations of the company. After the review of the control systems, the auditor determines the specific component increase or decrease, the effectiveness of some or all application systems and controls. If based on the understanding of the control environment, the audit team has fundamental doubts about the effectiveness of the prevailing systems and controls, the same should be reported to the entity and should be kept in mind while carrying the audit. The checklist shall contain the checkpoints relating to management characteristic, philosophy, operation style and commitment, accurate disclosures and reporting, along with:

- The operating environment and culture
- Management commitment to designing and maintaining reliable accounting systems
- The ability of management to control the operations
- The organizational structure of the entity
- Methods of assigning authority and responsibility
- Supervision and monitoring
- Senior management control methods.

### Test Yourself:

As a Practising Company Secretary, prepare a master checklist for Secretarial Audit for a Listed Company engaged in the Business of Manufacturing automobiles with a Paid up capital of Rs. 500 Crore.

**WORKING PAPERS AND MAINTENANCE OF WORK SHEET****Working Papers**

Audit working papers are the outcome of the documentation process. Working papers are the record of various audit procedures performed, audit evidence obtained, allocation of work between audit team members etc. Audit working papers are the documents and evidence that an auditor collects and retains with himself during the audit.

In the working papers document the auditor's conclusions and the reasons as to why those conclusions were reached should be documented. The disposition of each audit finding identified during the audit and its related corrective action should be documented.

Audit working papers are the documents prepared or obtained by the auditors and retained by him in connection with the audit. Audit working papers are used to support the audit work done in order to provide assurance that the audit was performed in accordance with the applicable standards. Working papers include all the evidence gathered by auditor indicating what work has been done by him and the procedure he has followed in verifying a particular asset or a liability and also provide information that whether:

- audit was properly planned;
- audit was carried out;
- audit was adequately supervised;
- the appropriate review was undertaken;
- the evidence is sufficient and appropriate to support the audit opinion.

Working papers should be completed throughout the audit and working papers should be economical to prepare and to review. It is easy to include every scrap of information and every form into the working papers. However, the working papers then become a confused mixture of data that is difficult to assimilate and use.

Working papers should be complete and concise, they should be considered as a usable record of work performed. Auditors should include in their working papers only what is essential; and, they should ensure that each work paper included serves a purpose that relates to an audit procedure. Working papers which are created during the audit and later determined to be unnecessary should be deleted/removed. The working papers may include:

- (a) Planning documents and audit programs.
- (b) Internal control questionnaires, flowcharts, checklists and narratives.
- (c) Notes and minutes resulting from interviews.
- (d) Organizational data, such as charts with job descriptions, process chart.
- (e) Copies of important documents.
- (f) Information about operating and financial policies.
- (g) Results of control evaluations.
- (h) Letters of confirmation and representation.
- (i) Analysis and test of transactions, processes.
- (j) Results of analytical review procedures.
- (k) Audit reports and management responses.
- (l) Audit correspondence that documents the audit conclusions reached.

### Scanned Documents as working papers

Scanned documents should include a reference to the source and the purpose of the document which is relevant to understand or appreciating the actual audit work performed. Such information needs to be included only when it is not provided elsewhere in the working papers.

### Tick marks

Tick marks do not need to be standardized throughout the set of working papers, but must be consistent throughout a particular work paper. Tick mark explanations must be a part of the working paper or included in a separate tick mark legend work paper.

### Cross Referencing

Working papers should be prepared using the appropriate cross referencing. A cross reference from the Audit Procedures to the primary working paper provides a reference to where the work was performed. It is not necessary to cross refer all work papers to the Audit Procedures - only the primary work paper should be cross referred. The primary work paper will then contain cross-references to other, supporting working papers, which provide additional information regarding the audit procedures performed, results and conclusions reached.

Cross-references should be used to refer information useful in more than one place or to other relevant information including the source of information, composition of summary totals, or other documents or examples of transactions. To encourage conciseness, documents/information only single copy of the working papers should be placed in working file for cross referencing.

**Question:** Which of the following is not a benefit of Cross referencing ?

**Options:** (A) Time saving (B) Cost saving (C) Conciseness (D) All information in one document

**Answer: (D)**

Cross referencing is an audit technique used to compare and match data from different sources to ensure accuracy and completeness

Question arise that whether the working papers are the property of the client or auditor. Whether the client can demand custody of such working papers?

Answer: – Working papers are the record of various audit procedures performed, audit evidence obtained, allocation of work between audit team members etc. Audit working papers are the documents and evidence that an auditor collects and retains with himself during the audit. Thus, the audit working papers are the property of auditor and not of the client. No, client cannot demand custody of such working papers. The auditor may on his discretion make portions of or extracts of working papers available to his client. But the client cannot ask the auditor for the custody of working papers.

### CASE STUDY

An auditor is conducting an audit of a company's financial statements. As part of the audit, the auditor is reviewing the company's bank statements to ensure that all transactions are accurately recorded in the company's financial records. The auditor notices a payment of Rs 10 Lacs to a vendor that does not match any of the vendor payments recorded in the company's accounting system.

To investigate this discrepancy, the auditor uses cross referencing to compare the bank statement with the company's accounting records. The auditor identifies the check number on the bank statement and searches for it in the company's check register. The auditor finds that the check was issued to a different vendor for a different purpose than the one recorded on the bank statement.

The auditor then reviews the company's invoices and purchase orders to determine if there were any other payments made to the vendor listed on the bank statement. The auditor discovers that the vendor did provide services to the company, but the payment was not recorded in the accounting system.

Based on these findings, the auditor concludes that the payment was made to the vendor for services rendered and that the payment should be recorded in the company's financial statements. The auditor then makes the necessary adjustments to the financial statements to reflect the correct amount of the payment.

In this case, cross referencing helped the auditor to identify a discrepancy between the bank statement and the accounting records, and to investigate the cause of the discrepancy. By comparing and matching data from different sources, the auditor was able to ensure the accuracy and completeness of the financial statements, and to identify any errors or omissions that needed to be corrected.

### Standard Working papers

A standard set of working papers will include at least the following documents:

- (a) **General File:** The General File contains key information through the various phases of the audit including planning (audit objectives, planning comments including etc.), reporting process, audit programs and comments for the next audit. The General File will include the draft and final reports. Audit responses will also be included in the file.
 

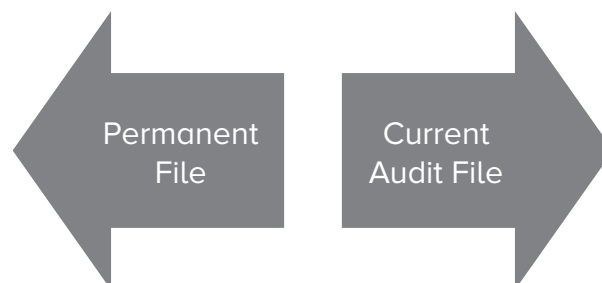
General file provides almost all the relevant information at one place.

Work paper file can direct the Audit in right direction and may ensure the completion of work with in timelines.

Comments for next audit can improve the quality of work by Auditors.
- (b) **Work paper File:** This file should contain the detailed audit procedures and detailed audit working papers. Detailed audit procedures provide detailed audit steps of the audit work to be performed during fieldwork that will achieve the specific audit objectives outlined in the audit program.
- (c) **Future Audit Considerations:** Auditors are encouraged to develop and document future audit ideas during the course of their work. These should be included in the "Comments for next audit" section of the general file.

Working papers are the connecting link between the client's records and the audited records. These provide permanent historical record. These also serve as a great guide to the staff to whom the work of audit has been assigned after the previous year audit. These would come to the help of the auditor in future in case the client files a suit against the auditor's negligence. The working papers are the property of the auditor and the client cannot ask the auditor for their custody. However it is the duty of the auditor to maintain confidentiality of the client information. Further, if audit working papers are disclosed then it may amount to professional misconduct.

### Types of Working Papers



The auditor's working papers are divided into two parts:

**(i) Permanent File**

The permanent file usually contains documents and matters of continuing importance of clients' business which will be required for more than one audit. The data in these files are the information, which is of continuous interest and relevant to succeeding audits. Data in this file can include the following:

- A. Statutory Documents
- B. The rules and regulations of the company :
  - (a) Memorandum of Association.
  - (b) Articles of Association.
  - (c) Certificate of Incorporation/Commencement of Business.
  - (d) Registration documents under various statutory bodies.
- C. Copies of documents of continuing importance and relevance to the auditor:
  - (a) Letter of engagement and Board Resolution for appointment of the auditor.
  - (b) Record of communication with the retiring auditor.
  - (c) Royalty Agreement/Technical collaboration.
  - (d) Copies of important legal documents/contracts.
- D. Addresses of the registered office and business -The Company's registered office address and all other units/premises, with a short description of the work carried on at such places.
- E. An organization chart - Details of all departments and sub-divisions thereof showing hierarchy of management.
- F. List of books and records with location - List of books and records maintained by the company and place of their location. Names, positions, specimens of signatures and initials of persons responsible for books and document should also be included.
- G. An outline history of the organization.
- H. Analysis of significant ratios and trends.
- I. Internal Controls - Notes on internal control with Details of study & evaluation of internal controls in the form of narrative record, questionnaires or flow charts etc.
- J. The business structure within a group and associated companies - List of all holding, subsidiary and associate companies.
- K. Company's advisors - list of the company's advisors such as bankers, merchant bankers, stockbrokers, solicitors, valuers, insurance brokers etc.

**(ii) Current Audit File**

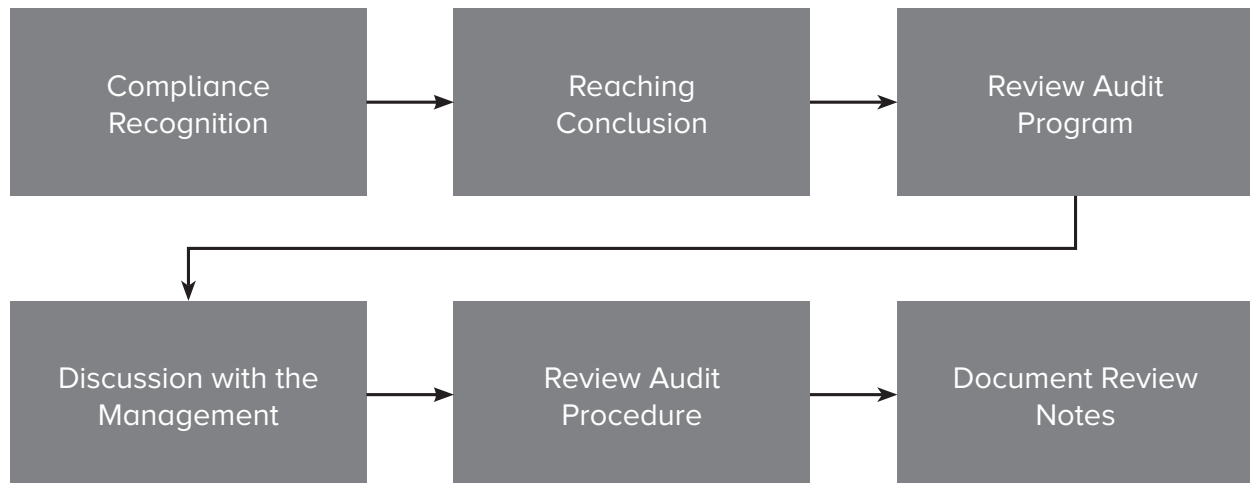
These file contains information relating to the audit of the current period. Information included in the current file should be information for the period under audit. The indicative list of current file can be as follows:

- A. Appointment letter for the Current Year, along with the defined scope of Audit;
- B. Extracts of important board/management meetings;
- C. List of responsible persons with their designation and contact details;

- D. Secretarial Audit Report/Financial Audit Report for current year as well as previous year;
- E. Actions initiated by company towards Secretarial Auditor's observations and suggestions in previous years reports;
- F. Audit Plan/Audit Program;
- G. Current year's Secretarial Records ;
- H. Communications with the company/management team;
- I. Letters of representations, confirmations received from company;
- J. Audit review points and highlights of analysis.

### Working Paper Review

The auditor should review all working papers to determine whether they are relevant and have a useful purpose, evidence the audit work performed and sufficiently support the audit findings. In addition, the auditor should ensure the conclusions reached were reasonable and valid, and that the office working paper standards were followed. The auditor should review all audit review notes to be certain that all notes have been resolved within the working papers. Documentation obtained and not relevant to the audit should be returned/destroyed upon the completion of the audit. The review will consist of:



- (a) Determining compliance with working paper guidelines.
- (b) Reviewing the audit program that outlines the major objectives of the audit, and ensure that the procedures accomplish the objective(s).
- (c) Reviewing the audit procedures and the referenced working papers to ensure the working papers support the procedures performed and all procedures have been completed.
- (d) Determine that the working papers adequately are documented and the conclusions reached in the report.
- (e) Ensuring that all findings prepared have been discussed with the appropriate member of management, and that the disposition of the audit concerned is documented.
- (f) Documenting review notes.

### Filing and Protection of Working papers

All working papers that are considered confidential, are the property of the Auditor, and are to be kept under adequate control. Working papers often contain sensitive information or data that must be protected from unauthorized use or review.

Working papers in process also need to be controlled by the Auditor. While conducting field work away from the Auditor's office, the auditors should control the working papers to ensure that information is neither removed, nor substituted nor altered.

### Retention Policy

All working papers pertaining to an audit belong to the Auditor. All such data is to be kept by the Auditor and is subject to the retention requirements as required by law.

## IDENTIFICATION OF THE EVENT AND CORPORATE ACTIONS

During the Audit planning stage the auditors should go through the various filings with statutory bodies etc. to understanding the company affairs, the following points considered as events/information on which the auditor should specifically verify the compliance required under applicable laws.

1. Acquisition(s) (including agreement to acquire), Scheme of Arrangement (amalgamation/ merger/ demerger/ restructuring), or sale or disposal of any unit(s), division(s) or subsidiary of the Company or any other restructuring.
2. Issuance or forfeiture of securities, split or consolidation of shares, buyback of securities, any restriction on transferability of securities or alteration in terms or structure of existing securities including forfeiture, reissue of forfeited securities, alteration of calls, redemption of securities etc.
3. Revision in Rating(s).
4. Outcome of Meetings of the board of director relating to :
  - dividends and/or cash bonuses recommended or declared or the decision to pass any dividend and the date on which dividend shall be paid/dispatched;
  - any cancellation of dividend with reasons thereof;
  - the decision on buyback of securities;
  - the decision with respect to fund raising proposed to be undertaken;
  - increase in capital by issue of bonus shares through capitalization including the date on which such bonus shares shall be credited/dispatched;
  - reissue of forfeited shares or securities, or the issue of shares or securities held in reserve for future issue or the creation in any form or manner of new shares or securities or any other rights, privileges or benefits to subscribe to;
  - short particulars of any other alterations of capital, including calls;
  - financial results;
  - decision on voluntary delisting by the listed entity from stock exchange(s).
5. Agreements (viz. shareholder agreement(s), joint venture agreement(s), family settlement agreement(s) impacting management and control of the Company, agreement(s)/treaty(ies)/contract(s) with media companies) which are binding and not in normal course of business, revision(s) or amendment(s) and termination(s) thereof.

6. Fraud/defaults by promoter or key managerial personnel or by Company or arrest of key managerial personnel or promoter.
7. Change in directors, key managerial personnel (Managing Director, Chief Executive Officer, Chief Financial Officer, Company Secretary etc.), Auditor and Compliance Officer.
8. Appointment or discontinuation of share transfer agent.
9. Corporate debt restructuring.
10. One time settlement with a bank.
11. Reference to IBC, 2016 and winding-up petition filed by any party/creditors.
12. Issuance of Notices, call letters, resolutions and circulars sent to shareholders, debenture holders or creditors or any class of them or advertised in the media by the Company.
13. Proceedings of Annual and extraordinary general meetings.
14. Amendments to memorandum and articles of association.
15. Commencement or any postponement in the date of commencement of commercial production or commercial operations of any unit/division.
16. Change in the general character or nature of business brought about by arrangements for strategic, technical, manufacturing, or marketing tie-up, adoption of new lines of business or closure of operations of any unit/ division (entirety or piecemeal).
17. Capacity addition or product launch.
18. Awarding, bagging/receiving, amendment or termination of awarded/bagged orders/contracts not in the normal course of business.
19. Agreements (viz. loan agreement(s) (as a borrower) or any other agreement(s) which are binding and not in normal course of business) and revision(s) or amendment(s) or termination(s) thereof.
20. Disruption of operations of any one or more units or division of the Company due to natural calamity (earthquake, flood, fire etc.), force majeure or events such as strikes, lockouts etc.
21. Effect(s) arising out of change in the regulatory framework applicable to the Company.
22. Litigation(s)/dispute(s)/regulatory action(s) with impact.
23. Fraud/defaults etc. by directors (other than key managerial personnel) or employees of Company.
24. Options to purchase securities including any ESOP/ESPS Scheme.
25. Giving of guarantees or indemnity or becoming a surety for any third party.
26. Granting, withdrawal, surrender, cancellation or suspension of key licenses or regulatory approvals.
27. Any other information/event viz. major development that is likely to affect business, e.g. emergence of new technologies, expiry of patents, any change of accounting policy that may have a significant impact on the accounts, etc. and brief details thereof and any other information which is exclusively known to the Company and which may be necessary to enable the holders of securities of the Company to appraise its position and to avoid the establishment of a false market in such securities.

**Question:** Which of the following can not be considered as an event for Corporate Action?

**Option:** (A) Corporate debt restructuring (B) Reference to IBC (C) Amendment to MOA (D) Prosecution of Member in a Fraud case.

**Answer: (D)**

## TESTING METHODS USED DURING AUDIT PROCEDURES

There are five core testing methods that auditors use to confirm the facts and answers that a business wants to attain during an audit. The nature of these test methods focuses on everything from asking probing questions to inspecting documents and re-performing calculations.

Each testing method helps the auditor issue a well-informed opinion, based on evidence. Further, it provides the auditor with the information needed to provide qualified conclusions, whether the business is operating optimally, and managing risks properly.

These are the five types of testing methods used during audits.

- Inquiry
- Observation
- Examination or Inspection of Evidence
- Re-performance
- Computer Assisted Audit Technique (CAAT)

### Inquiry

Inquiry is a fairly straightforward testing method, using interview-style questioning with the point of contact for certain controls. Because the quality of the information gained from inquiry depends on the accuracy and truthfulness of the interviewee, it is considered a weaker form of evidence. With the inquiry method, auditors ask questions of the organization's managers, accountants and any other key staff to help determine some relevant information. The auditor may ask about business processes and the appropriate recording of financial transactions to make sure the company is doing everything possible to avoid risks.

One example of inquiry commonly used is asking the business owner how the company's financial and data security records are stored. The auditor takes the responses into account—but does not accept the answers alone as confirmation—to establish additional testing criteria since this method is often used in conjunction with other, more reliable methods.

### Observation

Another simple, basic and effective testing method involves an auditor's observation of tasks, procedures and conditions. This testing method is most often used when there is no documentation of the operation of a control.

Traditionally, observation has been performed on-site during the evidence-gather phase of a Systems and Organisation Control audit. For example, management at an audited organization may state that certain noted records have been appropriately secured in a locked drawer. Then, in order to verify that certain stated records have been securely stored in locked cabinets, the auditor will watch an employee unlock the specified drawer during normal daily activities and take out the records.

Observation, even done remotely, can ensure that a company has an air conditioning system capable of keeping their servers cool by checking the thermostat in the equipment room. Or, for example, we can observe the configuration of IT systems to make sure that requirements are met.

### Examination or Inspection of Evidence

This testing method helps auditors determine whether manual controls are being consistently performed and properly documented. Inspection can be used to verify the implementation of control measures, and to test certain attributes of policies and procedures.

For example, an auditor may check to make sure that backups are scheduled to run on a regular basis or that data classification controls. In these cases, the auditor can use inspection to verify that the control has been designed and is operating effectively. He or she will check to see if forms are being filled out correctly.

Examination of evidence also includes the review of written documentation and records that might include visitor logs, employee manuals and system databases.

### Re-performance

Re-performance is used when inquiry, observation, and physical examination and inspection have failed to provide the requisite assurance that a control is operating effectively. It's also the method that is used least frequently in the field. Re-performance requires the auditor to manually execute the control in question, such as re-performing a calculation that is usually automated. The auditor can leverage work done by an internal auditor and documented in work papers, so that only a sample of the work needs to be re-tested to verify.

The re-performance method is helpful in decreasing the workload for auditors and determining whether automated controls are operating effectively. It is the strongest type of testing to highlight the operating effectiveness of a control.

### Computer-Assisted Audit Technique (CAAT)

The CAAT method of testing is often used to analyze large volumes of data or a sample of compiled data. Using special software, CAAT testing runs a script over a ledger, spreadsheet, or an entire database, to spot trends, irregularities, and potentially fraudulent entries.

## AUDIT SAMPLING

Audit sampling is an investigative tool in which less than 100% of the total items within the population of items are selected to be audited. It is an auditing technique that provides supporting evidence that allows auditors to issue audit opinions without having to audit every single item and transaction.

### Purpose of Audit Sampling

No matter what kind of audit is being performed – internal, external, or government – audit sampling needs to be used so that auditors can complete their audits without wasting resources in checking every single item. The objectives of audit sampling are as follows:

- Gather enough evidence to conclude an audit opinion
- Reduce the number of resources used
- Provide the basis for auditors to issue a conclusive audit opinion
- Detect any errors or fraud that can occur
- Prove that auditors have completed their audit fully in accordance with auditing standards
- Used as a tool for investigating
- Audit Sampling Importance.

When auditing financial statements, it is not feasible to audit and check every single item within the financial statements. It will be very costly and will take a lot of resources and time to do so.

Audit sampling enables auditors to make conclusions and express fair opinions based on predetermined objectives without having to check all of the items within financial statements. The auditors will only verify selected items, and through sampling, can infer their opinion on the entire population of items.

There are two forms of sampling:

#### 1. Statistical audit sampling

Statistical audit sampling involves a sampling approach where the auditor utilizes statistical methods such as random sampling to select items to be verified. Random sampling is used when there are many items or transactions on record.

Consider a company with more than 100 inventory transactions on its records. Using statistical sampling is recommended due to the high number of transactions.

For example, with statistical sampling, ten items are selected from the total population randomly. Every single item within the 100 has an equal probability of being selected and tested for accuracy as a result. Again, it benefits auditors since they can still make an audit opinion but do not have to check all 100 transactions.

## 2. Non-statistical audit sampling

In contrast to statistical audit sampling, non-statistical audit sampling items are not chosen randomly. Instead, they are chosen based on the auditor's judgment, and the result of the testing from the selections is not used to infer the conclusion for the entire population.

In the example earlier, ten inventory transactions can be used to infer the opinion on all 100 transactions. In non-statistical audit sampling, the auditors may choose to select items based on criteria such as:

The value of items (e.g., items greater than Rs 10 lacs)

Items with specific information (e.g., items related to a certain company)

### CASE STUDY

An external auditor was engaged to conduct an audit of a manufacturing company's financial statements. As part of the audit, the auditor used statistical sampling techniques to select a sample of transactions to test for accuracy and completeness.

The auditor used a combination of random sampling and systematic sampling to select the sample. The sample was selected from the company's sales and purchases transactions, as these transactions were considered to be material and had a high risk of misstatement.

After selecting the sample, the auditor examined the transactions to verify their accuracy and completeness. The auditor found that a few of the transactions in the sample were not properly documented, and there were some discrepancies in the amounts recorded in the company's records compared to the supporting documents.

Based on the results of the sample, the auditor projected the findings to the entire population of sales and purchases transactions and concluded that there were material misstatements in the financial statements. The auditor then communicated the findings to the company's management and recommended adjustments to the financial statements.

The management of the company agreed with the auditor's findings and made the necessary adjustments to the financial statements. The auditor then issued an unqualified opinion on the financial statements, indicating that the financial statements were fairly presented in all material respects.

This case study demonstrates the importance of audit sampling in conducting an effective audit. By using statistical sampling techniques, the auditor was able to select a representative sample of transactions and test them for accuracy and completeness. The results of the sample allowed the auditor to draw conclusions about the entire population of transactions and detect material misstatements in the financial statements.

### TESTS OF INTERNAL CONTROLS

Internal controls are rules and procedures established by a company to ensure business continuity, prevent fraud, and preserve the integrity and accuracy of financial reporting. A test of internal controls is an evaluation of the existing controls, either as part of an official audit or in preparation for an audit, to see if the controls are in place and identify weaknesses.

The purpose of internal controls testing is to see if the controls are properly detecting or preventing material errors or purposeful misstatement in financial reports.

Although control audits cannot completely detect all fraud, auditors can use controls testing to test operational controls for gaps, which can significantly reduce risk. Testing reveals what situation the company is in:

If controls are found to be effective, control risk is low.

If controls are identified as vulnerable or ineffective, control risk is high. Auditors may need to perform additional tests or take further actions, as specified by the relevant regulation or compliance standard.

### Purpose of Internal Controls Testing

There are two primary purposes for internal controls testing:

1. **Shortening the audit process** – if a controls test shows that internal controls are effective, and are able to prevent errors or fraud in financial statements, this can eliminate the need for additional audit actions.
2. **Providing additional audit evidence** to demonstrate compliance, in situations where individual substantive procedures cannot provide sufficient evidence on their own.

### Types of Audit Tests of Internal Controls

As discussed earlier about testing methods used during audit procedures. There are below types of internal control tests, each one is progressive and more comprehensive:

1. **Inquiry**—auditors ask managers and employees about the controls they are implementing. This is usually combined with more reliable testing methods—controls objectives or criteria should never rely only on an inquiry.
2. **Observation**—auditors observe activities and operations to see how controls are implemented. This is useful in cases where there is no documentation on how to operate the control unit. For example, if there is no formal procedure to ensure security cameras are installed, the auditor can simply observe if there are security cameras at the facility.
3. **Examination or inspection**—auditors determine if controls are really operational, using existing documentation and logs. For example, a test of controls can involve visiting a secured facility and ensuring that doors are locked and equipped with access control devices.
4. **Re-performance**—the previous three methods cannot fully guarantee the effective operation of the control. Re-performance involves the auditors actually trying to perform the control to see if it is effective. For example, the audit can run backups and try to restore the system to normal operation, or manually perform a financial calculation to ensure it is correct.
5. **Computer-aided audit tools (CAAT)**—auditors use technology to analyze large amounts of data automatically. A simple CAAT can be a spreadsheet, but there are specialized tools available that can test various types of internal controls. Most CAAT solutions are focused on export based, point in time sample testing across a complete inventory of all transactions.

#### CASE STUDY

An external auditor was engaged to conduct an audit of a retail company's financial statements. As part of the audit, the auditor reviewed the company's internal controls to assess their effectiveness in preventing and detecting errors and fraud.

The auditor found that the company had several weaknesses in its internal controls. Specifically, the company lacked proper segregation of duties, which meant that a single employee had control over several critical functions, including approving and recording transactions, and reconciling accounts.

The company also had inadequate documentation of transactions and did not have policies and procedures in place to ensure that transactions were properly authorized and recorded. In addition, the company did not perform regular physical inventory counts to ensure that inventory was accurately recorded in the financial statements.

As a result of these weaknesses, the auditor was unable to rely on the company's internal controls to support the accuracy and completeness of the financial statements. The auditor communicated the weaknesses to the company's management and recommended improvements to the internal controls.

The management of the company agreed with the auditor's findings and took corrective action to strengthen the internal controls. The company implemented a new policy of segregation of duties, ensuring that critical functions were assigned to different employees. The company also established policies and procedures for authorizing and recording transactions and performed regular physical inventory counts.

The auditor then re-assessed the internal controls and found that the improvements made by the company were effective in addressing the weaknesses identified in the audit. The auditor was then able to rely on the internal controls to support the accuracy and completeness of the financial statements.

This case study highlights the importance of strong internal controls in preventing and detecting errors and fraud in financial reporting. By identifying weaknesses in the internal controls and recommending improvements, the auditor helped the company to strengthen its financial reporting processes and provide accurate and reliable financial statements.

## SUBSTANTIVE TESTING

Substantive testing is an auditing technique that checks for any errors or material misstatements in a company's accounts, financial statements or supporting documents. When a company claims that their financial records are accurate, complete and valid, substantive testing supports this claim as evidence that there are no errors. This traditional auditing method also helps an auditor to form an overall opinion about the company's financial statements. Substantive testing includes a wide variety of different auditing procedures and tests that an auditor can use depending on the situation.

### Who does substantive testing?

Either a company's internal audit staff or hired external auditors can conduct substantive testing for a company. Using the company's internal audit staff may provide confirmation for whether their internal record systems are performing correctly. If the internal record systems are not performing properly, the internal audit staff can improve the system or eliminate the problem, so the company performs better in the next audit. Internal auditors typically conduct substantive testing at regular intervals throughout the year. External auditors often get hired to conduct substantive testing once a year, usually at the end of the year.

### How do substantive tests work?

Here are the steps elucidating how substantive auditing works:

#### 1. A company makes assertions

A company's management team makes implicit or explicit claims about their financial situation, and these auditing assertions get presented to an auditor. There are five general categories of assertions that companies make during audits, which are:

**Occurrence or existence:** This assertion states that financial statements listing assets, liabilities and shareholder equity exist when the accounting period is over.

**Disclosure and presentation:** This is an assertion that the financial statements will include and present all financial information and financial disclosures in a clear manner that auditors can easily understand.

**Obligations and rights:** This assertion states that the company has usage rights or ownership of all the assets listed in the financial statements and that all liabilities belong to the company, not a third party.

**Accuracy or valuation:** This assertion states that all the calculations in the financial statements are accurate, classified appropriately and based on a proper valuation of balances, liabilities and assets.

**Completeness:** An assertion that the financial statements include and present all the required items, transactions and inventory, including third parties with temporary possession.

## 2. The auditor creates a plan

The auditor creates a structured audit plan for the company based on the assertions. The auditor identifies which auditing processes, including substantive tests, will best determine any errors or misstatements in the assertions. Categories of auditing processes that auditors can choose include analytical procedures, inquiry and confirmation, inspection, observation and recalculation. For example, to evaluate fixed assets, an auditor could observe a procedure and then analyze the paper records for accuracy.

There are three general activities that an auditor includes in their audit plan for substantive testing, which are:

- Examine physical adjustments and journal entries the company made while the company prepared the financial statements.
- Match the underlying accounting records with the company's financial statements and their supporting documents.
- Test the different classes of account balances, transactions and disclosures.

## 3. An auditor shares audit results with a company

The auditor writes an official report listing any errors or material misstatements that the audit found, shares the report with management and requests further audit testing if it's warranted. The auditor also provides their overall opinion about the company's financial statements.

### What happens when substantive testing finds an error?

If an auditor finds any errors in a company's financial statements or the supporting documents, the auditor may require the company to do further audit testing. The auditor writes a management letter with a summary of the errors they found and shares the letter with the company and the audit committee. Usually, there are only errors or misstatements if:

- External auditors don't detect an error during audit procedures, which is called detection risk.
- Internal auditors or the internal record systems don't identify or fix an error, which is called control risk.
- The company or auditor doesn't detect initial errors when the financial process and reporting begin.

### Examples of substantive testing

Each substantive procedure should have enough documentation that it allows for collection, review and repetition. The documentation should be thorough enough that more than one auditor can independently test for accuracy and come to the same conclusion. Here is a list of common substantive auditing procedures and tests that auditors do:

- Verify that approved dividends exist by reviewing board minutes from the board of directors;
- Confirm that the balances in accounts payable are correct by contacting suppliers;
- Confirm that the balances in accounts receivable are correct by contacting customers;
- Check that assets obtained from a business combination have fair values assigned to them by confirming with experts;

- Watch the physical inventory count as it happens for each ending period;
- Test ending cash balances by issuing a bank confirmation;
- Contact lenders to confirm that loan balances are correct;
- Take fixed asset records and physically match them to fixed assets;
- Use inventory valuation calculations to confirm if inventory is valid;
- Recalculate the calculations that were already made by the client;
- Re-perform a company's procedures to make sure they perform as planned;
- Confirm loan balances are correct by contacting lenders;
- Test end cash balances by getting bank confirmation.

## AUDIT TRAILS

The audit can be done internally by the company itself to make sure that the books have been maintained correctly. They can bring in an external auditor to go through the records to find anything amiss. The auditor usually also provides a report with their own analysis and suggestions about the company's status. There is also a government audit where governments can look into a company's records to check for mismanagement of funds or tax evasions. This is why an audit trail is helpful. It is useful to trace all events right from transactions entered into the books of accounts to all the changes such as alteration, deletion, etc. that may take place.

Audit trail rule for businesses using accounting software from 1st April, 2023. The Ministry of Company Affairs through its notification issued on 24th March, 2021, relating to Audit Trail and the same is applicable on all companies (*except Proprietorship concerns, Partnership firms and Limited Liability Partnership*).

According to the same notification, businesses that fall under the purview of MCA and use accounting software for maintaining books of accounts should have an audit trail feature. The accounting software used by such businesses should create an edit log of each and every transaction with changes made in the books of accounts. The software should capture the date details when such changes (edits) are made and ensure the edit trail cannot be disabled.

In simple words, the expectation is to maintain the edit log of every transition right from recording to tracking the changes that may take place.

According to the recent notification, the new audit trail rule in accounting software will now be implemented from 1st April, 2023. Rule 3 (Manner of Books of Account to be Kept in Electronic Mode) of the Companies (Accounts) Rules, 2014, specifies that for the financial year commencing on or after the 1st day of April, 2023, every company which uses accounting software for maintaining its books of account, shall use only such accounting software which has a feature of recording audit trail of each and every transaction, creating an edit log of each change made in books of account along with the date when such changes were made and ensuring that the audit trail cannot be disabled.

## How does audit trail work?

Audit trails must have a few key details to provide comprehensive information about a transaction. To get these details at an enterprise level, however, a certain audit trail framework must be set up. Every access made to the accounts and records of the company should be tracked. Every edit made to any information must be recorded with the name of the person who did it and the time it was done. If any information was deleted, that also should be recorded.

Following are the key financial details to track as part of the audit trail:

- Any changes involved in the transaction
- The person who part took in the transaction
- The time at which the transaction took place
- The time at which the modification or edit took place
- Example of audit trail.

Accounting software provides the ideal example for audit trails. Once you enter a transaction in the software, the software will maintain a record of it. Any further edits made to the details, such as a change in the amount or change in the name against which the entry is made, will also be tracked by the software along with the user who made the changes and the time it was changed. Even if some transaction were to be deleted, the software will track that as well and keep the record of everything since the original entry was made.

This means that every transaction can be checked from its entry to its deletion. Basically, Audit trail based on Triple 'W' Approach i.e. When, Who What! 1. => when changes were made i.e, Date and Time (Time Stamp) 2. => who made those changes i.e., User ID 3. => what data was changed i.e., transaction reference; success/failure

### What is the purpose of an audit trail?

The main reason for documenting everything that a company or its employees do is to have a record that can be revisited if the need arises. In case of any discrepancy, you have a pathway that can lead to the erring or fraudulent transaction which is causing the discrepancy. The trail is basically a way to ensure that there are no gaps in data that may lead to a blind spot, making it impossible to determine the cause of the error. It also enables the company to locate external breaches and interference. It is also a mandatory requirement for notified companies to stay compliant.

### What are the benefits of an audit trail?

The MCA audit trail system requires companies to maintain electronic records of all transactions and to provide access to these records to the MCA and other regulatory authorities upon request. The system also requires companies to maintain a detailed audit trail of all changes made to electronic records, including the date, time, and person making the change.

The MCA audit trail system has several benefits, including:

1. **Increased transparency:** The audit trail system provides a detailed record of all transactions, making it easier for regulators and stakeholders to monitor the activities of companies and to detect any irregularities.
2. **Improved accuracy:** By requiring companies to maintain accurate electronic records, the audit trail system helps to prevent errors and omissions in financial reporting.
3. **Greater accountability:** The audit trail system holds companies and their employees accountable for their actions by providing a detailed record of all changes made to electronic records.
4. **Enhanced regulatory compliance:** The audit trail system helps to ensure that companies comply with various laws and regulations related to corporate governance and financial reporting.
5. **Foolproof:** There is also the advantage of proving that the company books are clean and in a healthy state which gives a big boost in the valuation of the company as well as generating funds through loans or by raising capital.

Overall, the MCA audit trail system is a powerful tool for improving transparency and accountability in corporate reporting and for preventing fraud and misconduct. By requiring companies to maintain accurate electronic records and providing a detailed audit trail of all changes, the system helps to promote good corporate governance and to protect the interests of stakeholders.

**CASE STUDY**

An auditor was conducting an audit of a large manufacturing company in India. As part of the audit, the auditor reviewed the electronic records maintained by the company, as required by the Audit Trail system implemented by the MCA.

During the review, the auditor noticed that there were several entries in the electronic records that did not match the company's financial statements. The auditor also observed that there were multiple changes made to the electronic records, but there was no documentation explaining the reasons for the changes.

To investigate the discrepancies, the auditor used the Audit Trail system to review the changes made to the electronic records. The system provided a detailed record of all changes, including the date, time, and person making the change. The auditor also reviewed the company's financial statements to identify the source of the discrepancies.

The auditor found that the company had understated its revenues by recording them in a different financial year than when they were actually earned. The auditor also discovered that there were several unauthorized changes made to the electronic records to conceal the irregularities.

The auditor reported the findings to the company's management and recommended that the discrepancies be corrected and the electronic records be updated accordingly. The company's management cooperated with the auditor and took corrective action to address the issues identified.

As a result of the audit, the company improved its internal controls and financial reporting processes to prevent similar issues in the future. The Audit Trail system implemented by the MCA was instrumental in uncovering the irregularities and ensuring that the company took corrective action.

This case study demonstrates the importance of the Audit Trail system implemented by the MCA in promoting transparency and accountability in corporate reporting and detecting financial irregularities. The system provides a powerful tool for auditors to identify discrepancies in electronic records and to investigate the causes of those discrepancies. It also helps to promote good corporate governance and protect the interests of stakeholders.

**ANALYSIS OF AUDIT FINDINGS**

Audit finding means a written summary of all instances of non-conformance with the requisite provisions, and all areas of concern identified during the course of the audit that, in the Consultant Auditor's judgement, merits further review or evaluation.

The lead auditor will then take the completed audit report and review the contents with the affected department head. Upon acceptance by the department head, the final audit report should then be signed by the department head verifying acceptance and responsibility for any change(s) required.

**Determine Plan of Action**

The entire reason for conducting internal management system audits is to verify conformance and continually improve on the management system. Therefore, it is extremely important that all identified non-conformances are corrected in a timely manner.

Some companies place all audited non-conformances into their corrective/preventive action process for tracking purposes. Others place only critical non-conformances into the corrective/preventive action process. Regardless of the mechanics of tracking the identified audited non-conformances, it is imperative that corrective action is taken.

Once the corrective action is in place, the auditors should review the actions taken and verify the root cause was identified properly and resolved. An accept or reject decision can then be rendered for the change action.

If acceptable, no further action is required, and the issue is considered resolved. If unacceptable, the department head must complete a new root cause analysis, develop a new action plan, and put the new action plan into place. The auditors will now review the new action plan and make a determination of acceptance or rejection.

**CASE STUDY**

An auditor is conducting an audit of a bank. The auditor uses statistical sampling to test a sample of loan transactions. The auditor discovers that there are several instances where the bank has not properly assessed the creditworthiness of the borrowers. This case highlights the importance of using appropriate sampling techniques to ensure that audit evidence is representative of the population being tested.

An external auditor was engaged to conduct an audit of a technology company's financial statements. As part of the audit, the auditor performed a series of tests on the company's revenue recognition policies and procedures.

During the audit, the auditor found that the company had recognized revenue prematurely for a number of contracts. Specifically, the company had recognized revenue before it had fully delivered the goods or services to the customer, or before it had received full payment from the customer.

The auditor also found that the company had not properly documented the terms of the contracts, making it difficult to determine the correct revenue recognition policies to apply.

As a result of these findings, the auditor communicated the issues to the company's management and recommended adjustments to the financial statements. The management of the company agreed with the auditor's findings and made the necessary adjustments to the financial statements.

The auditor then issued a modified opinion on the financial statements, indicating that there were material misstatements due to premature revenue recognition. The auditor also issued a management letter, outlining the weaknesses in the company's revenue recognition policies and procedures, and recommending improvements.

The management of the company took corrective action to improve the revenue recognition policies and procedures. The company implemented a new system to document the terms of contracts and trained employees on the proper revenue recognition policies to apply.

In the subsequent year, the auditor performed follow-up procedures to test the effectiveness of the improvements made by the company. The auditor found that the improvements were effective in addressing the weaknesses identified in the audit, and the auditor was able to issue an unqualified opinion on the financial statements.

This case study highlights the importance of audit findings in identifying weaknesses in financial reporting processes. By communicating the findings and recommendations to the company's management, the auditor helped the company to make necessary adjustments and improvements to strengthen its financial reporting processes and provide accurate and reliable financial statements.

**LESSON ROUND-UP**

- Auditing evaluate a company's internal controls, including its corporate governance and accounting processes. These types of audits ensure compliance with laws and regulations and help to maintain accurate and timely financial reporting and data collection.
- There are nine essential rules that administer the method of auditing. 1. Integrity, Independence, and Objectivity. 2. Confidentiality. 3. Skill and Competence. 4. Work Performed by Others. 5. Documentation 6. Planning. 7. Audit Evidence. 8. Accounting Systems and Internal Controls. 9. Audit Conclusions and Reporting
- Techniques of auditing means the procedure and method which is adopted by the auditor in checking the accounts.
- There are five core testing methods that auditors use to confirm the facts and answers that a business wants to attain during an audit. The nature of these test methods focuses on everything from asking probing questions to inspecting documents and re-performing calculations. 1. Inquiry 2. Observation 3. Examination or Inspection of Evidence 4. Re-performance 5. Computer Assisted Audit Technique (CAAT)
- Audit sampling is an investigative tool in which less than 100% of the total items within the population of items are selected to be audited. It is an auditing technique that provides supporting evidence that allows auditors to issue audit opinions without having to audit every single item and transaction.

- Substantive testing is an auditing technique that checks for any errors or material misstatements in a company's accounts, financial statements or supporting documents. When a company claims that their financial records are accurate, complete and valid, substantive testing supports this claim as evidence that there are no errors.
- Audit finding means a written summary of all instances of non-conformance with the requisite provisions, and all areas of concern identified during the course of the audit that, in the Consultant Auditor's judgement, merits further review or evaluation.

### GLOSSARY

**Auditing Techniques:** The Audit techniques stand for the methods that are adopted by an auditor to obtain audit evidence and performance of the Audit as per the scope of the audit.

**Audit Planning:** The Audit plan, describes the processes and activities that are to be carried out in connection with a particular audit and for the improving the quality of audit.

**Documents:** Documents includes board resolutions, agenda and minutes, notices, registers, cash books and accounting records, procedure manuals, reports etc.

**Confirmation:** Confirmation is a type of inquiry and involves obtaining, independently of the auditable entity, a reply from a third party with regard to some particular information. For example, confirmation of balances from the banks.

**Audit Plan:** A description and schedule of audits to be performed over a certain period of time (typically three years); includes areas to be audited, type and scope of work, and high-level objectives.

**Audit Program:** Policies and procedures that govern the audit process.

**Governance:** Processes and structures implemented to communicate, manage, and monitor organizational activities.

**Internal Audit:** The process of providing independent assurance that an organization's risk management, governance, and internal control processes are operating effectively.

**Mitigation Actions:** The necessary steps, or action items, to reduce the likelihood and/or impact of a potential risk.

**Risk:** A potential event or action that would have an adverse effect on the organization.

**Workpapers:** Documents that summarize and record all the activities and evidence obtained during an audit or investigation.

### TEST YOURSELF

*(These are meant for recapitulation only, Answer to these questions are not to be submitted for evaluation)*

1. List down various Audit Techniques.
2. Define testing Methods used during audit procedures.
3. What is Audit Sampling? What is the purpose of Audit Sampling?

