Chapter- 3 Auditing Techniques
3.1 Test Checking

1.Meaning :

Test checking is a substitute for detailed checking. It involves only a partial checking. The auditor normally does not check completely all the records made into the books of accounts but, through a process of sampling, selects a few items and if they are found correct, he presumes that the remaining entries would also be correct likewise.

Thus, test checking is based on a simple theme that" if a representative number of transactions, so selected at random by the auditor for test checking, is found to be correct, the remaining ones would also be correct."

Thus, the whole system of test checking implies selecting and checking only a few selected transactions so as to enable the auditor to form his final judgment as to the whole set of transactions.

In applying 'test check', the selection of transactions is made by the auditor at random and no specific principles are followed in it. The choice for adoption of testing methods is fully dependent on the discretion and judgment of the auditor who will depend on the situation of individual cases.

The use of test checking is, however, dependent upon the system of internal check in operation. If this system is satisfactory, test checking can be of immense help to the auditor.

Where there is an efficient system of internal check and the business maintains a separate staff for internal audit, test checking can be a very reliable device to carry on the work of audit.

But it should be kept in mind that if the system is reliable and test check is applied but mistakes are detected, a thorough checking of books would provide an answer. Thus, given an efficient system of internal check in operation, test checking can reduce the volume of work involved in audit.

Test checking should be applied and carried out intelligently and carefully, otherwise, it may lead to dangerous consequences. But much will depend on the system of internal check and the intelligence of the auditor.

2. Following points are to be taken into consideration while applying test check*:*

1. Sample should be selected from the various books of account and of different times.

2. Transactions related to beginning and ending period of particular year should be checked in detail.

3. Transaction related to cash and stock should be checked in detail.

4. Sample selection is to be made in random basis, not in planned way.

5. Detail check of Bank Reconciliation Statement is necessary.
6. There should be no bias in selecting sample.
7. Sytem of Internal control of organistion should be studied before selecting sample this will give clear idea as what should be the size of sample.

3. Advantages of Test Check

Following advantages can be obtained while applying test check:

1. Test check helps an auditor to complete work in less time because test of few transactions can be made.

2. An auditor can complete the work of audit of various organizations within stipulated time.

3. Test check saves labour, time and cost of man auditor. So, an auditor can check in detail the specific items rather than checking similar items.

4. Test check gives assurance of accuracy and reliability of transactions to some extent.

5. Accounting staffs remain alert and careful because auditor checks the transactions of various times in random basis.

4. Disadvantages of Test Check

1. There are chances of living errors and frauds because transactions with frauds may be left out from audit.

2. Result presented by income statement may be incorrect and report presented to the management may not be true due to the use of test check.

3. Test check increases the responsibility of auditor because an auditor should be responsible for the undetected errors and frauds due to application of test check.

4. Test check is not suitable method for the audit of small organizations.

3.2 Audit Sampling

1. Meaning

According to AAS-15 on ``Audit Sampling``, it means the application of audit procedures to less than 100% of items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of item selected in order to form or assist in forming a conclusion concerning the population.

It is important to recognize that certain testing procedures do not come within the definition of sampling .Test performed on 100% of items within a population do not solve sampling . Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

2. **Determination of sample size:**
   While determining the sample size, the auditor should consider risk, the tolerable error, and the error.

3. **Sampling Risk:** sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both test of control and substantive procedures as follows:
   (a) TEST of control :

   (i) Risk of Under Reliance: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

   (ii) Risk of Over Reliance: the risk that although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment.

   (b) Substantive Procedures:

   (i) Risk of Incorrect Rejection: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially mis-stated.

   (ii) Risk of incorrect Acceptance: the risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially mis-stated, in fact it is materially misstated.

   The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would be willing ordinarily lead to additional work being performed by the auditor, or the entity which would establish that the initial conclusion were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection. Sample size is affected by the level of sampling risk the auditor is willing to accept from the result of the sample.

The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Tolerable error: Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has ochieved the audit objective. Tolerable error is consider during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error the greater the sample size will need to be. In test of control, tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transaction that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statement are not materially misstated.

4.Selection of the sample: The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity available from other procedure.

While there are a number of selection methods, three methods commonly used are:

(i) **Random selection**, which ensures that all items in the population have an equal chance of selection, for example by use of random number tables.

(ii) **Systematic selection**, which involves selecting items using a constant interval between selections, the first selection having a random start. The interval might be based on a certain number of items (e.g. every 20th voucher number) or on monetary totals (e.g. ever Rs.1000 increase in the cumulative value of population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and sampling selected is 50, the result would be that the auditor have selected all, or none, of the sales of that particular branch.

(iii) **Haphazard selection**, which may be an acceptable alternative to random selection, provided that the auditors attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor attempts uses this method, care should be taken to guard against making a selection that is biased, for example, toward items which are easily located, as they may not be representative.

5. **The advantages of statistical techniques, properly applied, over judgement sampling are:**

(a) Conclusion about the total population can be stated with a known confidence and precision;

(b) Sample size is objectively determined;

(c) Time and money may be saved by limiting sample size to that required to achieve a given result.

For these reason, whenever the size and homogeneity of the group to be checked permits, statistical sampling is generally to be preferred to judgement sampling. Statistically sampling is most likely to be successful when the following conditions are present:

(a) A large population to be checked;

(b) The population consists of similar items;

(c) Items for checked easily selected and located;

(d) The error rate is reasonably low (e.g. good system of internal control in force).

The sample results may be evaluated as follows:

(a) Analysis of error in sample: -The auditor should judge whether an item is error or not. If audit evidence regarding a specific sample cannot be obtained, the auditor may adopt alternative audit procedures. The auditors should analyse cause of the error and its impact on the others phases of the audit. If there is some common features in the error, extended procedures may be carried out.

(b) Projection of errors- The auditor should project the possibility of error to the entire population by a suitable method and consider the qualitative aspects of error found.

(c) Reassessing sampling risk- The auditors needs to consider whether errors in population exceed the tolerable error. If it is so, either the sampling risk may be revised or extended procedures or alternate procedures may be performed.

3.3 Internal Control

1. **Meaning**

   Internal Control is a process designed by management of an entity to provide reasonable assurance that an entity achieves its objectives in the following categories:
   - Reliability of financial reporting
   - Effectiveness and efficiency of operations,
   - Compliance with applicable laws and regulations.

2. **Review of Internal Control**

   1. ***Understanding the system:*** At first the auditor should understand the internal control system with the purpose to have an idea of the flow of transactions and the various controls procedures. This will help him to pinpoint those internal controls on which he might base in doing his audit. To understand the internal control system, it may be useful to choose a few transactions through the system. The auditor should also

ascertain whether the internal controls were effective and efficient throughout the period under audit.

Organization charts, procedure manuals, job description, and flow charts etc. are some of the tools to have an idea about internal controls system. The auditor can also discuss with different officials of organization. Sometimes, he may have to rely on direct observations and inquiry only. The auditor should, especially in the case of first audit, maintain a detailed written record of his observations on the internal controls system.

2. ***Test through compliance procedures:*** Having reviewed the system, the auditor may select the specific controls on which he intends to rely and which, therefore, need to be tested through compliance procedures. He may decide not to rely on certain internal controls which are defective in design, or reliance on which may not be cost effective. It is important to test the application of internal controls in practice.

   For example, an auditor may take up a few sales bills at random and examine all the related documents right from the order of the customer to the payment received from the customer. At each stage, the auditor would see whether the transaction has taken place as stipulated in the flow chart or in the procedure manual. Thus, if the flow chart prescribes that the detail terms and condition of each order of customer has to be verified by a particular manager, the auditor should examine whether or not this has been done in practice.

   The objective of compliance tests is to provide a fair confidence to the auditor that the internal controls procedures are being effective as prescribed. The auditor should carry out such tests in case of all procedures on which audit reliance is intended to be placed. Tests of compliance are concerned primarily with the following questions:
   - Were the necessary procedures complied with?
   - How were they complied with?
   - By whom they were complied with?

3. ***Evaluating the system:*** Based on his observation during the tests made by him, the auditor has to make an estimate of how far he can depend on various internal controls. Normally, he should have a reasonable confidence that the system is such that the errors and fraud can be discovered automatically. He has to ascertain whether the control procedures as designed to implement are in practice and competent in preventing or detecting material errors and fraud in the accounting system. This is essentially a question of individual judgment in a particular situation. If he finds certain errors or weaknesses in the system, he should try to evaluate the impact of the same on various transactions. Let us suppose he finds weaknesses in the system of maintaining debtors‟ ledger. Since this is a material item, he should ask for independent confirmations from the debtors. Thus, the auditors evaluation of internal control system will determine the nature, timing and extent of his substantive procedures.

3. **Techniques of Evaluation**

Different techniques may be used by an auditor to have an idea and assessing the effectiveness of an internal control system. The selection of a particular technique is a matter of the auditor‟s judgment. Two most common techniques of internal control evaluation are the flow charts and the internal control questionnaires. The auditor may prepare flow charts of the various categories of transactions in order to have a quick grasp of the system. An internal control questionnaire lists a series of questions which an auditor may wish to ask in order to understand and evaluate an internal control system.

4. Inherent Limitations of Internal Control

1. Management’s consideration that a control be cost effective.
2. The fact that most controls do not tend to be directed at transactions of unusual nature.
3. The potential for human error.
4. The possibility of circumvention of controls through collusion with parties outside the entity or with employee of the entity.
5. The possibility that a person responsible for exercising control could abuse that authority for example, a member of management overriding a control.
6. The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.

7. Manipulations by management with respect to transactions or estimates and judgments required in the preparation of financial statements.

5.Internal Control system for Purchase and creditors

Basic considerations for having an effective internal control system for Purchase and Creditors are as follows:

1. The procedure for issuing purchase requisitions should be specified.
2. Where tenders are invited, the procedure for opening and acceptance thereof should be laid down.
3. The preparation and authorization of purchase orders should be under a senior manager.
4. Predetermine guidelines should exist for inspection of goods received, especially with regard to quantity and quality.
5. Documents showing the receipt and acceptance of goods should also be send to the accounts department.
6. The goods receipt documents should be cross checked with final purchase orders.
7. An authorize official from the accounts department should be made responsible for checking suppliers‟ invoices, documents regarding purchase returns, purchase records, payments to suppliers, maintenance of ledger accounts and reconciliation of statements sent by suppliers.
8. Before payments are made to suppliers, payment documents duly authorized by a senior official, showing that the goods have been received as specified in the purchase order should be verified by the accounts department.
9. Adequate procedures should be established with regard to purchase returns, discounts on account of inferior quality of goods, and other similar adjustments.
10. Lawful policies and procedures should be implemented with regard to purchases from the companies under the same group and from the employees.
11. The accounts of various suppliers should be confirmed periodically from statements received from them.

6. Internal control for Sales and Debtors

Basic considerations for having an effective internal control system for Sales and Debtors are as follows:

1. The policies and procedure for accepting customers‟ orders should be laid down. The authority for negotiating the various terms like prices, discounts, delivery schedules etc. should be clearly fixed.
2. The documentation processes between acceptance of the order and dispatch of goods should be well established.
3. A senior official should be made responsible for granting credit or special discounts to customers. An approved credit policy by competent authority should be circulated to all concerned.
4. An effective internal check regarding records of outward goods, customers‟ orders, challans and invoices should be implemented.
5. The sales ledger staff should not have access to cash, cash book or stocks. As far as practicable, duties should be so segregated that recording sales, maintaining accounts of customers, procuring orders from customers, and dispatching goods are performed by different officials.
6. Appropriate control procedures should be designed for inspecting the quality of the goods before dispatch.
7. There should be a periodic review of overdue accounts. Urgent action should be taken against defaulting customers as per credit policy.
8. The procedures for writing off bad debts should be clearly defined and approved by the competent authority.
9. Various other controls over sales and debtors are similar to those applicable to purchases and creditors.

7.Internal control system for Wages and Salaries

Basic considerations for having an effective internal control system for wages and salaries are as follows:

1. All appointments, removal and fixation or revision of wages rates and salaries should be in writing and authorized by a designated official authorized by the board.
2. The jobs of preparation of wages and salary sheet should be divided among different s clerks and it should be ensure that the prepared wages and salaries sheets of clerks gets automatically checked by another clerk under their due signatures.
3. Records regarding time and piece wages of permanent and casual workers should be checked by internal audit department.
4. The clerks must have rules and regulations, in writing, about the methods of calculation of wages and salaries, deductions there from (if any)

5. All the prepared wages and salaries sheets must be checked and authenticated by the internal audit department before any payment being made.
6. The shift in charge should counter sign the records as to time and piece wages amount, number of hours worked, number of pieces manufactures, overtime etc.
7. The number of employees shown in wages and salary sheet should be checked with the official list of employees with the personnel department and so also the rates of wages and salaries by internal audit department, before making any payment.
8. Close focus is needed for overtime payments which in any case should be allowed only in exceptional circumstances and after duly approved by the General Manager of the unit, in writing.
9. The Accounts department, after receiving the wages and salaries sheet, must carefully check the totals, both gross and net, of wages and salaries payable to individual employees and also ensure that deductions on account of provident fund, pension funds, insurance, income tax etc are properly made.
10. Separate arrangement should be made for withdrawing wages and salaries amount from the bank which must be equal to the net total in the wages and salaries sheet.
11. Wage and salaries payments should be made by persons who are in no way connected with the preparation of wages and salaries sheet.
12. In writing instructions should be given to pay clerks for unclaimed wages and salaries. These should include preparation of a list of unclaimed amounts and immediate deposit of the sum in the Bank in a separate account.
13. Subsequent payment of unclaimed wages and salaries should be made only after properly authorization by personnel department and accounts department.
14. An advance against wages and salaries register should be maintained by the accounts department.
15. Internal audit department should made surprise checking of wages and salaries sheets and wage and salaries payment to ensure that:
    a) False names are not shown in wages and salaries sheets;
    b) Wage and salaries rates are not overstated or deductions are not understated;
    c) False overtime payments are not recorded;
    d) Wages and salaries are paid to persons concerned only and no substitutes are allowed.

15.3 Difference between internal check and Test check

Internal check	**Test Check**
It is an arrangement of duties in such a way that work of one employee is checked by another employee.	It means to select and examine a representative sample from large number of similar items.
To prevent errors and frauds.	To detect errors and frauds without checking all transaction.
By management.	By statutory auditor.
Management change, review and control internal check.	Management does not have any control over test check.
In early detection of errors and frauds.	To reduce workload and saves time.

Exercise: