

Special Audit Techniques

Question 1

Describe the principal methods of selection of samples. (4 Marks, November, 2014)

Answer

Principle Methods of Selection of Samples: According to SA 530 "Audit Sampling", the principal methods of selecting samples are the use of random selection, systematic selection, monetary unit sampling selection, haphazard selection and block selection. Each of these methods is discussed below-

- (i) **Random selection:** This method is applied through random number generators, for example, random number tables.
- (ii) **Systematic selection:** In this method the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables.
- (iii) **Monetary Unit sampling:** This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (iv) **Haphazard selection:** In this method the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- (v) **Block selection:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Question 2

In the audit of Hotel Great Stay Ltd. its auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done. (4 Marks, November, 2013)

Answer

Analytical Procedure as Substantive Procedure: As per SA 520 on "Analytical Procedures", in some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

In case of Payroll cost- Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

In case of Room Rental Income of Hotel- Different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of Hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.

Question 3

M Ltd. intends to intensify its advertisement strategy of hoarding advertisements to increase its sale during the impending festival season. You have been appointed as the special auditor to examine the expenditure under this head. What will be usual evidence you will look for in this case to justify the expenditure? (4 Marks, November, 2013)

Answer

Hoarding Advertisement Expenses: The following would be the usual evidence to justify the expenditure-

- (i) Copy of Resolution passed by the Company authorizing expenditure.
- (ii) Examination of Quotations received from various advertising agencies.
- (iii) Permission letter from the Municipal authorities.
- (iv) Copies of contracts with advertising agencies.
- (v) Bill/Invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.
- (vi) Receipts issued by the advertising agencies.

Question 4

Write a short note on Statistical and Non-Statistical Sampling. (4 Marks, May, 2012)

Answer

Statistical and Non-statistical Sampling: Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

As per SA 530, "Audit Sampling", 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 of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

- (i) **Statistical sampling:** This is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- (ii) **Non-statistical sampling:** Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

Question 5

In the audit planning process of X Ltd., you would like to consider audit risk at the financial statement level. What factors can influence your decision? (3 Marks, May, 2010)

Answer

Audit Risk at Financial Statement Level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management

override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- (i) Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- (ii) Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

Question 6

What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client. (6 Marks, June, 2009)

Answer

Performing Analytical Procedures: As per SA 520 "Analytical Procedure", when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following-

- (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
- (ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
- (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and if analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
 - (1) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
 - (2) Performing other audit procedures as necessary in the circumstances.

Question 7

What is Haphazard Sampling?

(6 Marks, May, 2008)

Answer

Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.