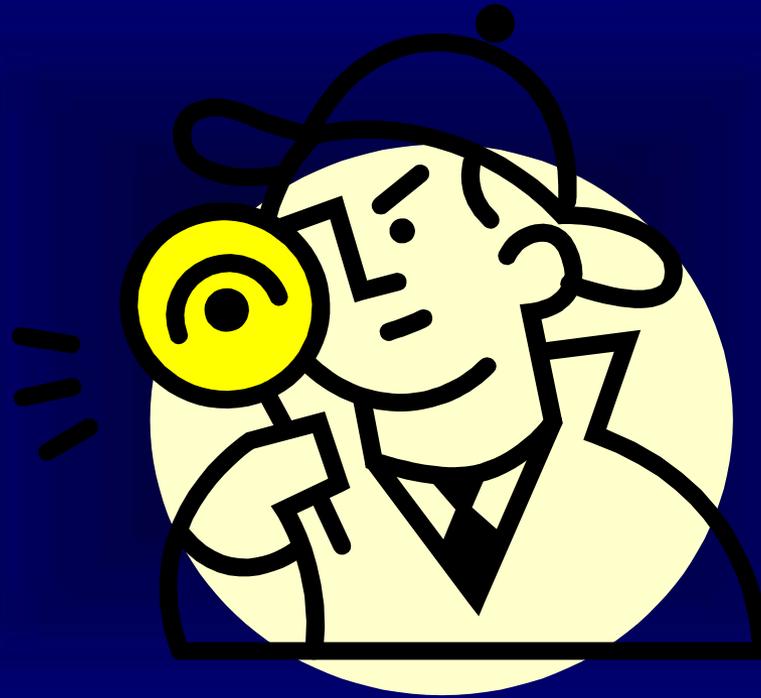


Auditing Concepts

Asst. Prof Yewale D.A



The Auditing Process

Definition:



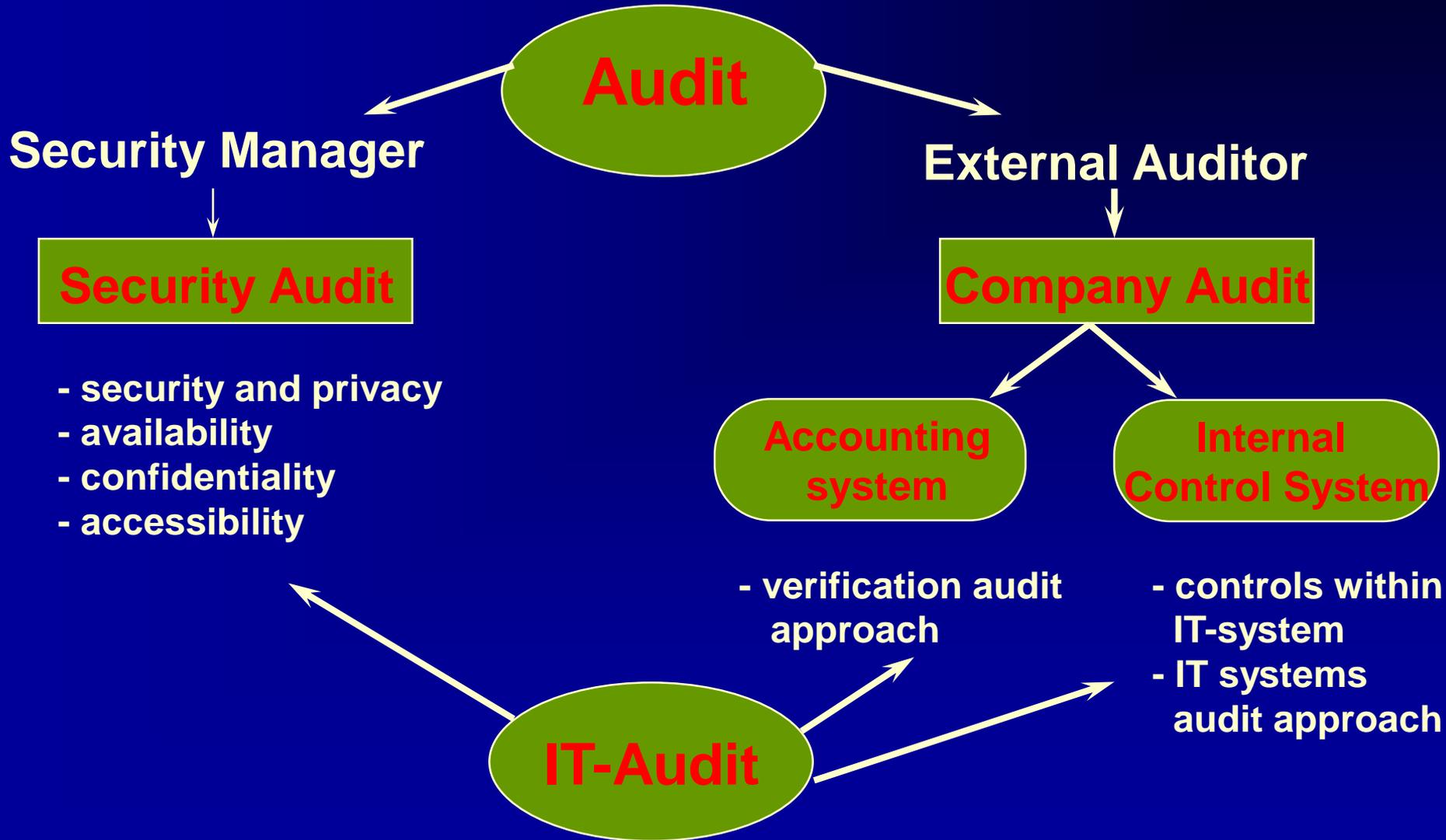
American Accounting Association (AAA)

Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria , and communicating the results to interested users.

Explanation of the Definition

- **Systematic process**
 - ⇒ structured as a dynamic activity in a logical manner
 - ⇒ an unplanned approach to computer auditing may result in bypassing important segments of processing or the related files
- **Obtaining and evaluating evidence**
 - ⇒ reliability of the control structure
 - tests to verify whether the control function is working as prescribed
 - ⇒ contents of the files
 - substantive testing coherency between files and company transactions
- **Ascertain correspondence between assertion and established criteria**
- **Communicating results to interested users**
 - ⇒ other members of audit team , client

Security Audit and general Audit Schema



IT auditing

- **Problems specific for computer auditing :**
 - ⇒ **Concentration of the data processing**
 - ⇒ **Data consultancy via computer or IT-personnel**
 - ⇒ **Data can be erased**
 - ⇒ **Data are very much compacted (can be lost , stolen , ...)**
 - ⇒ **Basic documents disappear (telephone , EDI , ...)**
 - ⇒ **Automated decisions**
 - ⇒ **More complexity**
 - ⇒ **More vulnerable (network)**



IT-audit: high degree of specialization , fast evolution

Understanding internal control structure

- **Necessary to plan the audit**

- ⇒ identify the types of potential misstatements that could occur
- ⇒ consider the factors that affect the risk of material misstatements
- ⇒ design substantive tests

- **The auditor must understand the three elements of the internal control structure**

- ⇒ the control environment
- ⇒ the accounting system
- ⇒ the control procedures



Assessment of Control Risk

Purpose

The purpose of control risk assessment is to evaluate the effectiveness of an entity's internal control structure policies in preventing or detecting material misstatements in the financial statements.

Control Risk

⇒ the likelihood that misstatements in accounting data will not be prevented or detected and corrected

Control structure

⇒ those policies and procedures established by the entity to provide reasonable assurance that its established objectives will be achieved

The Control Environment

The collective effect of various factors on establishing , enhancing, or mitigating the effectiveness of specific policies and procedures.

- ⇒ **managers philosophy and operating style**
- ⇒ **entity's organizational structure**
- ⇒ **functioning BoD and its committees (audit committee)**
- ⇒ **methods of assigning authority and responsibility**
- ⇒ **performance control and internal auditing methods**
- ⇒ **personnel policies and practices**
- ⇒ **various external factors**

Reflects overall attitude, awareness and actions concerning the importance of control

The Accounting System

- **The accounting system consists of the methods and records established to identify , assemble, analyze, classify , record and report an entity's transactions and to maintain accountability for the related assets and liabilities. It includes an ability to:**
 - ⇒ identify and record all valid transactions
 - ⇒ describe the transactions in sufficient detail to permit proper classification of transactions for financial reporting
 - ⇒ measure the value of transactions in a manner that permits recording their proper monetary value
 - ⇒ determine the time period in which transactions occurred
 - ⇒ present properly the transactions and related disclosures in financial statements

The Control Procedures

Those policies and procedures that management has established to provide reasonable assurance that specific entity objectives will be achieved. It includes provision for:

- ⇒ proper authorization of transactions and activities**
- ⇒ segregation of duties**
- ⇒ design of adequate safeguards over access to and use of assets and records**
- ⇒ independent checks on performance and proper valuation of recorded amounts**

Understand the Control Structure

In order to obtain an understanding of the control structure , the auditor needs information about:

- ⇒ the classes of transactions that are significant**
- ⇒ how the transactions are initiated**
- ⇒ the accounting records, supporting documents, machine-readable information and specific accounts involved in the processing and reporting of transactions**
- ⇒ the accounting processing involved from the initiation of transactions, including how the computer is used to process data**
- ⇒ the financial reporting process used to prepare the financial statements , including accounting estimates and disclosures**

Control Risk Assessment Conclusions

- **If Control structure is weak**

- ⇒ additional audit effort in control structure area is inappropriate
- ⇒ control risk is high
- ⇒ significant substantive testing will be necessary

- **If Control structure seems to be strong**

- ⇒ efficiency of audit might be improved if control risk can be assessed at a low level , allowing reliance on the control structure
 - tests of controls might demonstrate that they are functioning properly and substantive testing can be reduced
 - tests of controls might demonstrate that they are not functioning properly and substantive testing cannot be reduced

Effects of IT on Accounting Control

Examples of effects:

- ⇒ **decentralized activities performed by several clerks may be centralized into one computer program, omitting internal control**
- ⇒ **with lack of documentation the audit trail may disappear**
- ⇒ **although the total number of employees increases , there is typically a decrease in human involvement in the actual processing of accounting data invoking the loss of visual checking**
- ⇒ **instead of random errors there are systematic errors**
- ⇒ **specialized knowledge needed to audit effectively**
- ⇒ **the IT-auditor must be involved in the early stages of system design in order to build-in accounting controls**
- ⇒ **problems for the auditor sometimes worse in smaller companies**
- ⇒ **computer fraud (unauthorized checks or policies, ...)**

Audit Trail in an IT System

The audit trail are those records that enable a transaction to be traced from its source forward to a summarized total in a financial statement or the other way around.

The IT system can affect the audit trail in several ways:

- ⇒ source documents filed in a difficult-to-access manner**
- ⇒ traditional source documents may be eliminated**
- ⇒ ledger summaries replaced by master files not showing summarized values**
- ⇒ sometimes no standard transaction listing or journal**
- ⇒ paper reports only for exceptions**
- ⇒ always computer and programs needed to read data**
- ⇒ sequence of data and activities difficult to observe**