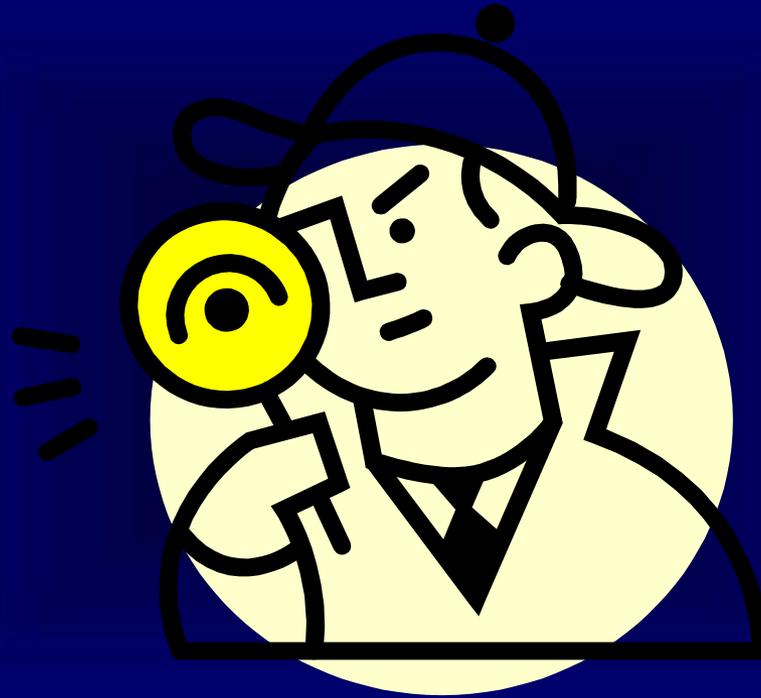


# ***Auditing Concepts***

***Asst. Prof Yewale D.A***

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# *The Auditing Process*

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## Definition:



**American Accounting Association (AAA)**

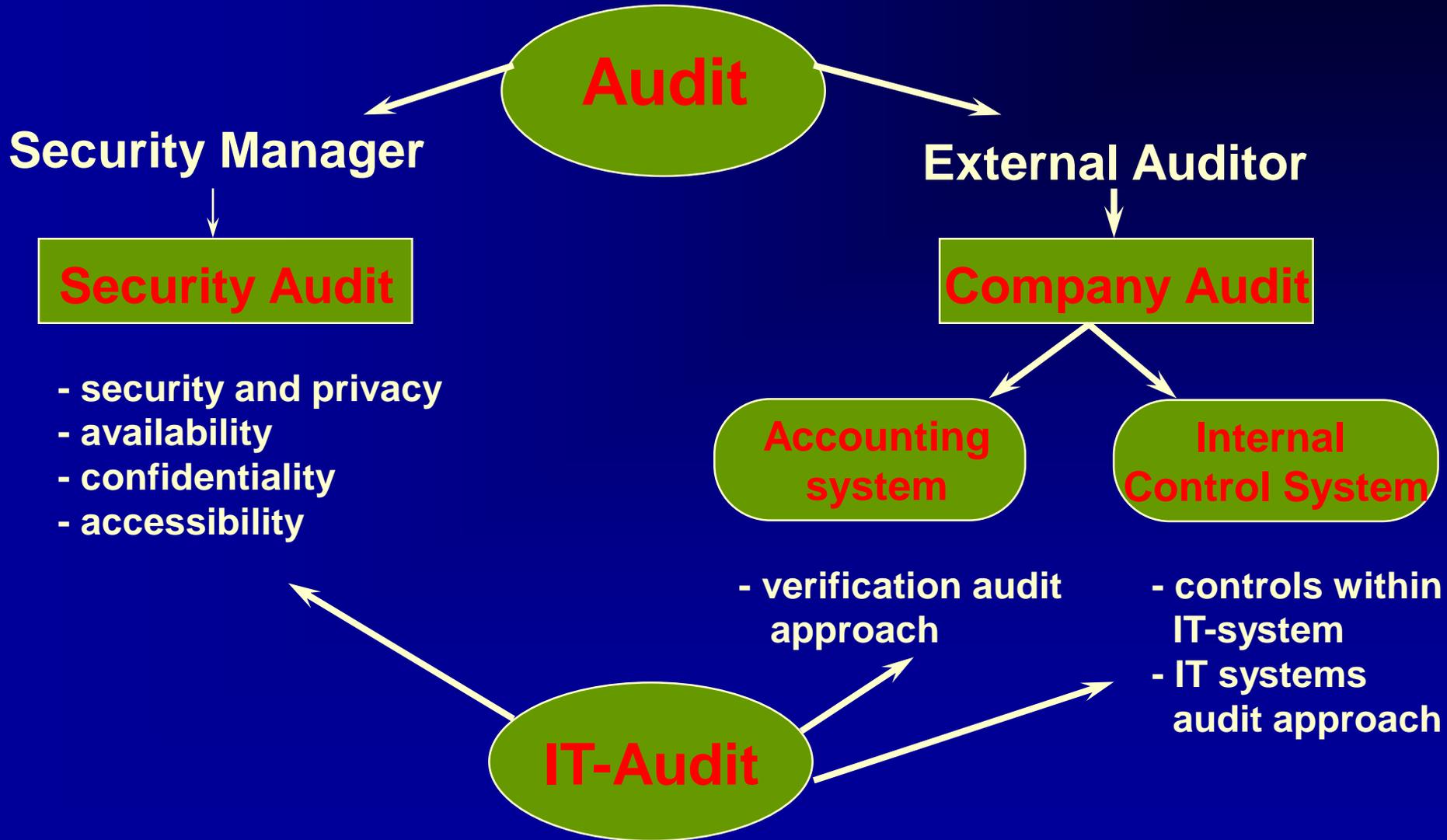
**Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria , and communicating the results to interested users.**

# ***Explanation of the Definition***

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- **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*

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- **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***

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- **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***

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## **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***

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**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*

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- **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***

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**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***

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**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***

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- **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***

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## **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***

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**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**