MODULE 13
AUDIT EVIDENCE

HANDOUT

Audit Evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. It includes the information contained in "accounting records underlying the financial statements" and "other information".

Underlying Accounting Data	***Corroborating Information***
Books of original entry (journals)	Documents such as checks, invoices, contracts
2. General and subsidiary ledgers	Confirmations and other written representations
3. Related accounting manuals	ıformation from inquiry, observation, inspection, and physical examination.
Informal and memorandum records, such as worksheets, calculations	)ther information obtained or developed by the auditor

Nature of Audit Evidence

Audit evidence is a fundamental concept in auditing by which the auditor achieves the objective of reasonable assurance that none of management's assertions is materially misstated.

Sufficiency is the measure of the quantity of audit evidence that must be obtained.
It is affected by the risk of material misstatements (the greater the risk, the more audit evidence required) and also by the reliability of audit evidence.

The sufficiency and appropriateness of audit evidence are interrelated.

Factors that may affect the auditor's judgment of sufficiency include
1. Materiality and risk
2. Economic factors
3. Size and characteristics of population

Appropriateness is the measure of the quality of audit evidence – that is both reliable and relevant in providing support for, or detecting misstatements in, financial statement assertions.

Relevance of evidence is the appropriateness (pertinence of evidence to the audit objective being tested).

Reliability is the quality of information when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Generalizations:
1. Obtained from knowledgeable independent sources outside the client company rather than non-independent sources.
2. Generated internally through a system of effective controls rather than ineffective controls.
3. Obtained directly by the auditor rather than indirectly or by inference.
4. Documentary in form (paper, electronic media, or other media) rather than an oral representation.

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5. Provided by original documents rather than photocopies or facsimiles.

	Least Reliable	**Most Reliable**
Source relative to the entity	Internal (from inside entity)	External (from outside entity
Source – person: employee or auditor	Employee of the company	External auditor
Source – person: employee or third party	Employee of the company	Third party
Source: independence of provider	Associated with company	Not associated with company
Source: qualification of provider	Little knowledge of subject	Expert in subject
Source: operation of internal controls	Not in operation	Effective operations.

The sufficiency and appropriateness of audit evidence to support the auditor's conclusions throughout the audit are a matter of professional judgment. The auditor's judgment as to what constitutes sufficient appropriate evidence is influenced by such factors such as the following:

1. Significance of the potential misstatement in the assertion and the likelihood of having a material effect, individually or aggregated with other potential misstatements on the financial statements.
2. Effectiveness of management's responses and controls to address the risks.
3. Experience gained during previous audits with respect to similar potential misstatements.
4. Results of audit procedures performed including whether such audit procedures identified specific instances of fraud or error.
5. Source and reliability of the available information.
6. Persuasiveness of audit evidence.
7. Understanding of the entity and its environment, including internal control.

Persuasiveness

Audit evidence is persuasive when there is consistency between items from different sources or of a different nature. Evidence is usually more persuasive for balance sheet accounts when it is obtained close to balance sheet date. For income statement accounts, evidence is more persuasive if it is a sample from entire period. A random sample from the entire period is more persuasive than a sample for the first six (6) months.

Cost/Benefit

The auditor also needs to think about the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the matter of difficulty and expense involved is not in itself a valid basis for omitting a necessary procedure. If the auditor is unable to obtain sufficient appropriate audit evidence, he should express a **qualified opinion or disclaimer of opinion.**

The Use of Assertions in Obtaining Audit Evidence

Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. In representing that the financial statements (are presented fairly, in all material

respects) in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

The auditor should use assertions for classes of transactions, account balances and presentation and disclosures in sufficient detail to form a basis for the assessment of procedures. The audit uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks.

Assertions used by the auditor fall into the following categories:

1. Assertions about classes of transactions and events for the period under audit:

- **a.** Occurrence – transactions and events that have been recorded have occurred and pertain to the entity
- **b.** Completeness – all transactions and events that should have been recorded have been recorded.
- **c.** Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately.
- **d.** Cutoff – transactions and events have been recorded in the correct accounting period.
- **e.** Classification – transactions and events have been recorded in the proper accounts.

2. Assertions about account balances at the period end:

- **a.** Existence – assets, liabilities and equity interests exist.
- **b.** Rights and obligations – the entity holds or controls the rights to assets, and liabilities are obligations of the entity.
- **c.** Completeness – all assets, liabilities and equity accounts that should have been recorded have been recorded.
- **d.** Valuation and allocation – assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

3. Assertions about presentation and disclosure:

- **a.** Occurrence and rights and obligations – disclosed events, transactions and other matters have occurred and pertain to the entity.
- **b.** Completeness – all disclosures that should have been included in the financial statements have been included.
- **c.** Classification and understandability – financial information is appropriately presented and described, and disclosures are clearly expressed.
- **d.** Accuracy and valuation – financial and other information are disclosed fairly and at appropriate amounts.

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Audit Procedures for Obtaining Audit Evidence

3. The auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:

- **a.** Obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels (audit procedures performed for this purpose are referred to in the PSAs as **"risk assessment procedures"**).
- **b.** When necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the PSAs as **"tests of controls"**).
- **c.** Detect material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the PSAs as **"substantive procedures"** and include tests of details of classes of transactions, account balances and disclosures and substantive analytical procedures).

4. The auditor always performs risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion, however, and are supplemented by further audit procedures in the form of tests of controls, when necessary, and substantive procedures.

5. Tests of controls are necessary in two circumstances. When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor is required to test those controls to support the risk assessment. In addition, when substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor is required to perform tests of controls to obtain audit evidence about their operating effectiveness.

6. The auditor plans and performs substantive procedures to be responsive to the related assessment of the risks of material misstatement, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental however, and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control, including the risk of management override, the possibility of human error and the effect of system changes. Therefore, substantive procedures for material classes of transactions, account balances, and disclosures are always required to obtain sufficient appropriate audit evidence.

Types of Audit Evidence

1. Accounting information system
2. Documentary evidence.
3. Third-party representations
4. Physical evidence
5. Computations
6. Data interrelationships
7. Client representations

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Timing of Substantive Audit Procedures

1. Interim date (before the client's year-end)
2. Subsequent to year-end.

Extent of Substantive Procedures

Holding other factors such as the nature and timing of procedures constant, the greater the risk of material misstatement, the greater the needed extent of substantive procedures. The main way in which the auditors increase the extent of substantive tests of transactions and balances is to examine more items.

Cost of Audit Procedures

The most efficient set of audit procedures is that which achieves the required low level of audit risk at the minimum audit cost.

Substantive Audit Procedures

Substantive tests are performed to obtain audit evidence to detect material misstatements in the financial statements. Substantive tests are responses to the auditor's assessment of the risk of material misstatement. The higher the assessed risk, the more likely the extent of substantive tests will increase and the timing of procedures will be performed close to the period.

"Irrespective of the assessed risk of material misstatement, the auditor should plan and perform substantive tests for each material class of transaction, account balance and disclosure." Furthermore, if the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive tests that are specifically responsive for that risk.

Nature of Substantive Procedures

1. Tests of details (of transactions and of balances) – more appropriate to obtain audit evidence regarding certain financial statement assertion, including existence and valuation.
2. Substantive analytical procedures – more applicable to large volume of transactions that tend to be predictable over time.

Tests of Balances

These are substantive tests that provide either reasonable assurance of the validity of a general ledger balance or identify a misstatement in the account. When testing balances, the auditor is concerned with the overstatement or understatement of the line item in the financial statement. These tests are used to examine actual details making up high turnover accounts such as cash, accounts receivable, accounts payable. Tests of balances are important because the auditor's ultimate objective is to express an opinion on financial statements that are made up of account balances, in audits of small businesses, auditors may rely exclusively on tests of balances.

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Direction of Testing

Testing for overstatement and understatement is called the direction of testing. By coordinating the direction of testing, each account balance is simultaneously tested for both overstatement and understatement. All liability, equity and revenue account balance are tested for understatement, and all asset and expense accounts are tested for overstatement, then all account balances in the statement of financial position and the income statement will be tested, either directly or indirectly, both overstatement and understatement.

Analytical Procedures

These involve evaluations of financial statement information by a study of relationships among financial and non-financial data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. The auditors can use the relationships to obtain evidence about the reasonableness of financial statement amounts.

The process of performing analytical procedures consists of four (4) steps:

1. Develop an expectation of an account (or ratio) balance.
2. Determine the amount of difference from the expectation that can be accepted without investigation.
3. Compare the company's account (ratio) balance with the expectation.
4. Investigate and evaluate significant differences from the expectation.

Types of analytical procedures:

1. **Trend analysis** – Analysis of changes in the account balance over time.
2. **Ratio analysis** – Comparison of relationship between financial statement accounts, the comparison of an account with non-financial data, or the comparison of relationships between firms in an industry.

   Types or Ratio Analysis:

   a. Ratios that compare client and industry data.
   b. Ratios that compare client data with similar prior period data.
   c. Ratios that compare client data with client-determined expected results.
   d. Ratios that compare client data with auditor-determined expected results.
   e. Ratios that compare client data with expected results using non-financial data.

3. **Reasonableness testing** – Analysis of account balances or changes in account balances within an accounting period in terms of their "reasonableness" in light of expected relationships between accounts.

Timing of analytical procedures

PSA 520 Redrafted "Analytical Procedures" *require* the application of analytical procedures at the **PLANNING** and **OVERALL FINAL REVIEW** stages of audit. The auditors *may decide* to use them during the audit as **SUBSTANTIVE PROCEDURES** to provide evidence as to reasonableness of the specific account balances.

Analytical procedures performed in planning the audit are risk assessment procedures used to assist the auditors in determining the nature, timing and extent of audit procedures that will be used to obtain evidence about specific accounts. This will also help the auditors identify unusual transactions, events or amounts that may affect the fairness of the financial statements. Finally, these will be used to increase the auditor's understanding of the client's business.

Evidence Gathering Techniques

1. Inquiry
2. Inspection (of records or documents, or tangible assets)
3. Observation
4. Confirmation
5. Recalculation
6. Reperformance
7. Analytical Procedures

Reliability of Substantive Audit Procedures

1. Recalculation (most reliable)
2. Inspection
3. Reperformance
4. Observation
5. Confirmation
6. Analytical procedures
7. Inquiry (least reliable)

Cost of Substantive Audit Procedures

1. Confirmation (most costly)
2. Inspection
3. Recalculation
4. Reperformance
5. Observation
6. Analytical procedures
7. Inquiry (least costly)

Inspection of Records or Documents

Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature including quantity of information contained, the difficulty of access to them and source may be from inside or outside the firm, may be competent or incompetent and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of control is inspection of records or documents for evidence of authorization.

Examples:
Reviewing sales orders, sales invoices, shipping documents, bank statements, customer return documents, customer complaint letters.

Inspection of Tangible Assets

Inspection of tangible assets consists of physical examination of the assets. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not for necessarily about the entity's rights and obligations of the valuation of the assets. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.

Observation

Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place and by the fact of being observed may affect how the process or procedure is performed.

Examples:
Observation of the auditor of the counting of inventories by entity's personnel, site visit of the client's facilities.

Inquiry

Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Example:
Obtaining written or oral confirmation from the client in response to specific questions during the audit.

Confirmation

Confirmation, which is a specific type of inquiry, is the process of obtaining representation of information or of an existing condition directly from a third party. For example, the auditor may seek direct confirmation of receivable by communication with debtors. Confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items.

Examples:
Confirm the existence of accounts receivable and accounts payable, verify bank balances with banks, cash surrender value of the insurance, notes payable with lenders or bondholders.

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Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed through the use of information technology, for example, by obtaining an electronic file from the entity and using CAATs to check the accuracy of the summarization of the file.

Examples:
Extending sales invoices and inventory, adding journals and subsidiary records, checking the calculation of depreciation expense and prepaid expense.

Reperformance

Reperformance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or through the use of CAATs, for example reperforming the aging of accounts receivable.

Analytical Procedures

Analytical Procedures consist of evaluation of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Examples:
Calculating trends in sales over the past few years, comparing net profit as a percentage of sales in current year with the percentage of the preceding year, comparing client current ratio to the industry current ratio, and comparing budgets to actual results.

Specific Audit Considerations – PSA 501

Observation of Physical Inventory Procedures

PSA 501 states that 'when inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition by attendance at physical inventory counting". The attendance by the auditor will enable him to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count, and to provide evidence as to the reliability of management's procedures.

If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some inventory counts on an alternative date, and when necessary, perform tests of controls of intervening transactions. Where attendance is impractical, due to factors such as the nature and location of inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that he need not make reference to scope limitation. For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient evidence.

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In planning attendance at the physical inventory count or the alternative procedure, the auditor would consider:

1. The nature of the accounting and internal control systems used regarding inventory.
2. Inherent, control and detection risks, and materiality related to inventory.
3. Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
4. The timing of the count.
5. The location at which inventory is held. (When inventory is located at several locations, the auditor should determine at which locations attendance is appropriate, taking into account the materiality of the inventory and the assessment of inherent and control risk at different locations.
6. Whether an expert's assistance is needed.

The auditor would review management's instructions regarding:

1. The application of control procedures (e.g., collection of used stock sheets, accounting for unissued stock sheets and count and re-count procedures).
2. Accurate identification of the stage of completion of work in progress, of slow-moving, obsolete, or damaged items and items on consignment.
3. Whether appropriate arrangements are made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

When inventory is under the custody or control of a third party, or consignee, the auditor would ordinarily obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. Depending on how material the inventory is the entity's operations, the auditor may also consider:

1. Integrity and independence of the third party.
2. Observing, or arranging for another auditor to observe the physical inventory count.
3. Obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that inventory is correctly counted and adequately safeguarded.
4. Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

Confirmation of Accounts Receivable and Accounts Payable

Confirmation is the auditor's receipt of a written or oral response from an independent third party verifying the accuracy of information requested.

Advantage: Highly persuasive evidence.
Disadvantage: Costly and time-consuming and inconvenience to those asked to supply them.

Four Key Characteristics of Confirmation

1. Information requested is by the client auditor.
2. Request and response are in writing, sent to the auditor.

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3. Response comes from an independent third party.
4. Positive confirmation involves a receipt of information.

PSA 505 identifies **two forms of confirmations: positive and negative confirmation.**
The request for **positive confirmation** asks the recipient (debtor, creditor, or other third party) to confirm agreement or by asking the respondent to fill in information. A response to a positive confirmation request is expected to provide reliable audit evidence. The auditor may reduce the risk that a respondent replies to the request without verifying the information by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but asks the respondent to fill in the amount. However, using this type of "blank" confirmation request may result to a lower response rates because additional effort is required of the respondent. The positive form is preferred when inherent or control risk is assessed as high because with the negative form, no reply may be due to causes other than agreement with the recorded balance.

Two types of positive confirmation
1. Positive confirmation with the request for information to be supplied by the recipient.
2. Positive confirmation with the information to be confirmed included on the form.

A **negative confirmation** asks the respondent to reply only in the event of disagreement with the information provided in the request. However, if there is no response to a negative confirmation request, the auditor cannot be sure that intended third parties have received the confirmation requests and verified the information contained therein is correct.

Negative confirmation requests may be used to reduce audit risk to an acceptably low level when:
1. The assessed level of inherent and control risk is low.
2. A large number of small balances is involved.
3. A substantial number of errors is not expected.
4. The auditor has no reason to believe that the respondents will disregard these requests.

In case the auditor does not receive a reply to a confirmation request, he sends out a second confirmation letter. Regarding those customers who did not reply to the two positive external confirmation requests, the auditor should perform alternative procedures. The alternative procedures should be such as to provide evidence about the financial statement assertions that the confirmation requests were intended to provide.

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