chapter

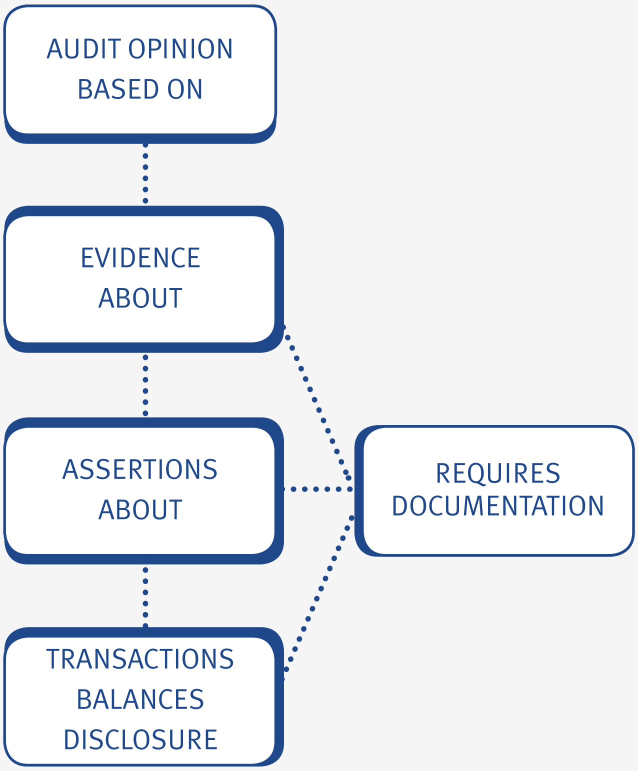
9

Audit evidence

Chapter learning objectives

When you have completed this chapter you will be able to:

- explain the assertions contained in the financial statements
- explain the use of assertions in obtaining audit evidence
- explain the principles and objectives of testing transactions, account balances and disclosures
- discuss the sources and relative merits of the different types of evidence available
- define audit sampling and explain the need for sampling
- identify and discuss the differences between statistical and non-statistical sampling
- discuss and provide relevant examples of, the application of the basic principles of statistical sampling and other selective testing procedures
- discuss the results of statistical sampling, including consideration of whether additional testing is required
- describe why smaller entities may have different control environments
- describe the types of evidence likely to be available in smaller entities
- discuss the quality of evidence obtained
- explain the need for and the importance of audit documentation
- explain the procedures to ensure safe custody and retention of working papers.



1 Why does the auditor need evidence?

If the auditors are to:

- form an opinion which is worth something
- be paid good money for it

they will need to base their opinion on valid evidence.

2 Evidence about what exactly?

FINANCIAL STATEMENTS ARE A SUMMARY OF

MANAGEMENT'S ASSERTIONS

Financial statements are complex documents

They consist of:

- income statement
- balance sheet
- cash flow statement
- notes.

Each of which contains numbers of headings:

- revenue
- expenditure
- non-current assets
- inventories
- receivables
- payables, etc.

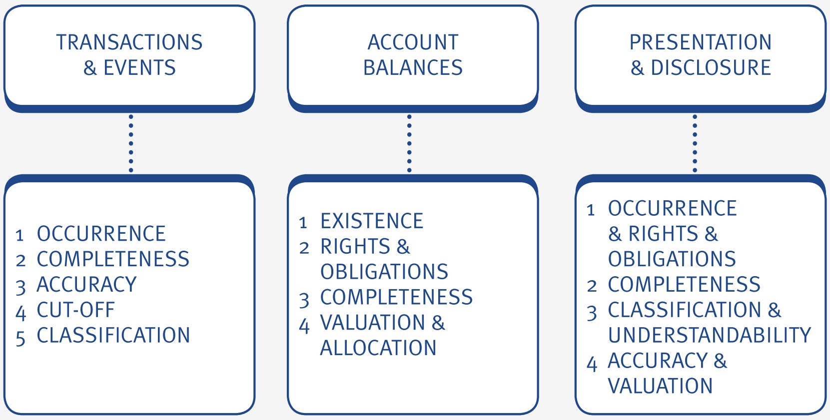
Management is responsible for the preparation of financial statements that give a true and fair view, but what does this really mean?

For each item in the financial statements, management is making **assertions**.

Assertions like:

- This factory is owned by the company.
- The receivables really do owe us this money and will pay fairly soon.
- The payroll expense was for the company's genuine employees working on the company's business.

The auditors therefore need evidence that these assertions are valid.



3 Financial statement assertions

Occurrence – did the transaction actually take place?

Completeness – are all transactions or balances that should be included in the financial statements, actually included?

Accuracy – are the amounts correct?

Cut-off – are transactions accounted for in the correct period?

Classification – are transactions recorded in the proper accounts?

Existence – do the assets or liabilities actually exist?

Rights and obligations – does the client own or have other rights over the assets and have a genuine obligation to pay liabilities?

Valuation – are assets or liabilities included at appropriate amounts?

Allocation – are account balances included in appropriate accounts?

Classification and understandability – are items in the financial statements disclosed under appropriate headings and in such a way that they can be readily understood by readers?

Accuracy – are the amounts disclosed in the financial statements appropriate?

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The assertions are **important** because they have an impact on how the auditor gathers evidence.

There are 13 different types of assertion across the three headings although some of them repeat each other and this may seem to be rather daunting to remember.

Remember that the audit evidence required depends on both:

- the nature of the item being tested

AND

- the assertion being tested

and it can all be simplified down to four key questions that the auditor needs to answer.

(1) Should it be in the accounts at all?
   - Occurrence.
   - Existence.
   - Rights and obligations.
   - Cut-off.

(2) Is it included at the right value?
   - Accuracy.
   - Valuation.

(3) Are there any more?
   - Completeness.

(4) Is it disclosed properly?
   - Classification.
   - Allocation.
   - Understandability.

ASSERTION	ACTIVITY
E.G.	
EXISTENCE	INSPECT THE ASSET
VALUATION	INSPECT EVIDENCE OF COST/VALUATION (INVOICES, ETC)
RIGHTS & OBLIGATIONS	INSPECT EVIDENCE OF OWNERSHIP (TITLE DEEDS, INVOICES, ETC)
CUT-OFF	INSPECT DOCUMENTS/ OBSERVE PROCESSES (DATES ON INVOICES, DESPATCH NOTES, ETC)
COMPLETENESS	LOOK FOR EVIDENCE OF UNDISCLOSED ITEMS (PAYMENTS TO SUPPLIERS OMITTED FROM PAYABLES LIST, OMITTED DIVIDENDS FROM SHARES, ETC)

4 Why assertions matter to auditors

Assertions matter to auditors because:

- The auditor chooses suitable procedures based on the nature of the item in the financial statements being audited.
- The procedures will be refined further depending on which assertion about the item the auditor is testing.

Different items – different approach

The audit approach to testing receivables will be different from testing payroll.

e.g.

Item	Audit tests e.g.
Accounts receivable	Carry out third party confirmation. Review correspondence and aged analysis for evidence of delinquent receivables. Test subsequent receipt of cash from customers.
Payroll	Inspect timesheets. Inspect authorised pay rates. Verify employees are genuine through contracts of employment. Check tax and other deductions.

Different assertions – different approaches

For a single item in the financial statements – e.g. freehold property, the auditor may need to use different approaches for different assertions

Assertion	Audit tests e.g.
Existence	Inspect the property concerned.
Valuation	Agree cost to purchase contract or subsequent revaluation to valuer's report. Re-perform depreciation calculation.

Rights and obligations	Inspect title deeds.
Cut-off	Inspect purchase contract to verify date of purchase.
Completeness	Review repairs account, correspondence with lawyers and property consultants for evidence that there are no additional properties.

Note. The completeness assertion tends to be the most difficult assertion to test. It is usually easier to verify items we know about than to think about what should be there, but is not.

Test your understanding 1

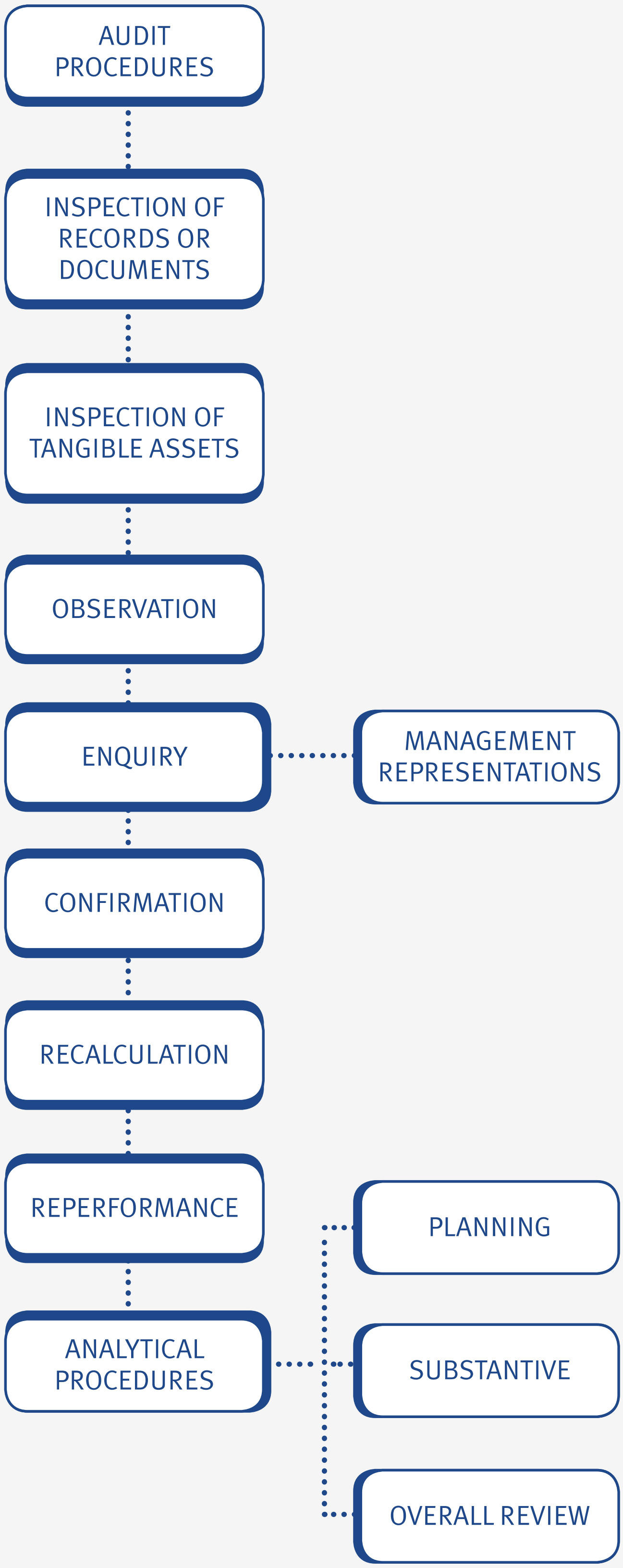
(1) **Name the five assertions associated with transactions.**

(2) **Name the four assertions associated with account balances.**

(3) **Name the four assertions associated with disclosures in financial statements.**

(4) **Why do assertions matter to auditors?**

5 How does the auditor test things?



Audit procedures

We have seen above, that:

- the nature of the transaction or balance being audited and
- the assertion being tested

demand different approaches from the auditor.

ISA 500 identifies eight types of procedures that the auditor can adopt to obtain audit evidence:

In Chapter 10 'Audit procedures' we will look in detail at how these procedures are applied in specific circumstances as well as at some of the more detailed requirements of ISAs.

ISA 500 identifies eight procedures that the auditor can adopt to obtain audit evidence:

6 Inspection of records or documents

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7 Inspection of tangible assets

- Will usually give pretty conclusive evidence of existence!
- May give evidence of valuation, e.g. obvious evidence of impairment of inventory or non-current assets.
- Unlikely to give evidence of rights and obligations, e.g. a vehicle may be leased, inventory held on behalf of a third party, etc.

3. Observation

- Involves looking at a process or procedure.
- May well provide evidence that a control is being operated, e.g. double staffing or a cheque signatory examining supporting documentation.

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4. Enquiry

- Enquiry is a major source of audit evidence, however the results of enquiries will usually need to be corroborated in some way through other audit procedures.
- The answers to enquiries may themselves be corroborative evidence.

Management representations

Management representations are a sub-set of Enquiry.

The auditor obtains written representations from management to confirm oral enquiries where:

- the issue is material or
- where other sources of evidence cannot reasonably be expected to exist or
- where other evidence is of lower quality.

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5. Confirmation

- A specific form of enquiry
- Examples of use:
  - circularisation of receivables
  - confirmation of bank balances
  - confirmation from legal advisers of actual or contingent liabilities arising from legal proceedings
  - confirmation of inventories held by third parties
  - confirmation of investment portfolios by investment managers.

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6. Recalculation

- Checking the arithmetical accuracy of the client's calculations.

7. Reperformance

- May be something relatively simple, e.g. test checking inventory counts.
- May be more sophisticated, e.g. using IT tools to check a receivables ageing.

8 Analytical procedures

- The consideration of the relationships between figures in the financial statements or between financial and non-financial information.

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Test your understanding 2

(1) **What are the eight types of audit procedure?**

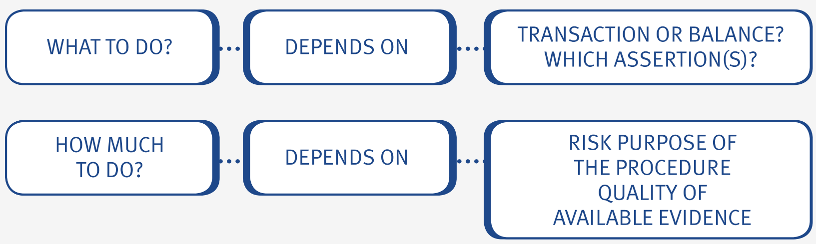
(2) **What are the two purposes for which the auditor must use analytical procedures?**

(3) **What is the third use of analytical procedures available to the auditor?**

(4) **Why does the auditor need to obtain management representations?**

(5) **Give three examples where an auditor might use confirmations.**

9 How much evidence does the auditor need?



We have seen that the types of audit procedure the auditor can carry out:

- are quite limited – inspection, observation, enquiry, etc.
- are driven by the nature of the transaction or balance being audited and the assertion being tested.

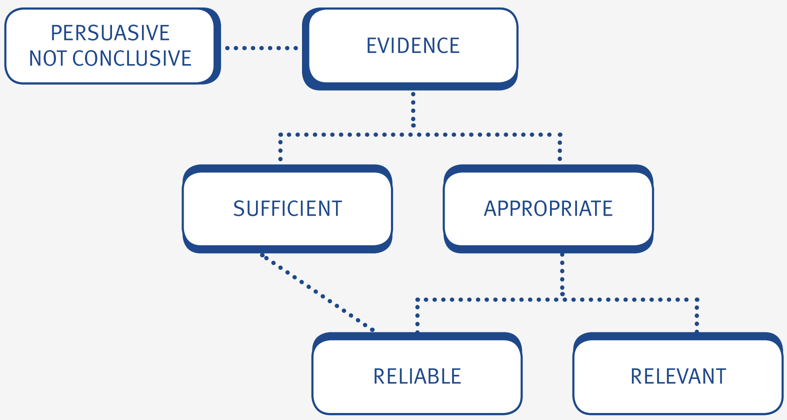
We now need to consider how much evidence the auditor needs.

This is driven by:

- the risk of material misstatement
- the quality of the evidence obtained
- the purpose of the procedure (test of controls or substantive test).

These three factors – risk, purpose and quality – have a complex relationship, as we shall see. Although risk is the most important factor, as everything the auditor does on an audit is in response to the assessed level of risk, we will consider it after we have dealt with the quality and the purpose of audit evidence.

10 The quality of evidence – 'Sufficient appropriate evidence'



'The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.'

ISA 500 para 2

The key questions here are:

What do we mean by:

- sufficient?
- appropriate?

'Appropriate' breaks down into two qualities:

- reliable
- relevant

and 'sufficient', 'reliable' and 'relevant' are all interlinked.

Sufficient

There needs to be 'enough' evidence, and what is 'enough' is a matter of professional judgement.

Example 1

For the client's bank balance, one confirmation letter from the bank (if the client has only one bank account) will be enough, and indeed is all there is available.

The bank letter will not, however, give the auditor all the information required. There will need to be consideration of the bank reconciliation as well.

So, 2 sources of evidence combining to be sufficient.

Example 2

To test purchases for a manufacturing client where there are literally thousands of transactions a year, the auditor may well decided to extract a statistical sample of purchase transactions to test to purchase orders, invoices, delivery notes, etc. But how many items should there be in the sample? Statistical sampling theory will give some help here – see below – but ultimately it is a question for the auditor's professional judgement.

Reliable

This is better	This is worse
Independent external evidence.	Internally generated evidence.
Internal evidence subject to effective controls.	Internal evidence not subject to such controls.
Evidence obtained directly by the auditor.	Evidence obtained indirectly or by inference.
Documentary.	Oral.
Original documents.	Photocopies or facsimiles.

ISA 500 gives the above guidance.

The link between sufficient and reliable

Broadly speaking, the more reliable the evidence the less of it the auditor will need.

However, the relationship is quite subtle:

If the evidence is found to be unreliable, looking at a greater quantity of such evidence will never be sufficient.

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Relevant

As we have seen above the nature of the evidence the auditor wants depends on:

- the nature of the transaction or balance being tested

and

- the assertion being tested.

Persuasive not conclusive

Consider:

- The auditor gives an opinion about the financial statements **not** a certificate that the financial statements are correct.
- The audit report gives reasonable **not** absolute assurance about the financial statements.
- Audit procedures are designed to reduce the risk that the financial statements contain **material** misstatements **not** to eliminate all possibility of error.

The reason for all this lack of absolute, definitive certainty is the nature of audit evidence which is gathered by human beings in real live organisations.

- The auditor gathers evidence on a test basis (the sample may or may not be representative).
- People make mistakes (both client and auditor).
- Documents could be forged (increasingly easy with digital technology).
- The client's personnel may not always tell the truth.

As a result, we have to say that audit evidence is persuasive rather than conclusive in nature.

This also means that the auditor will need to gather evidence from a variety of sources.

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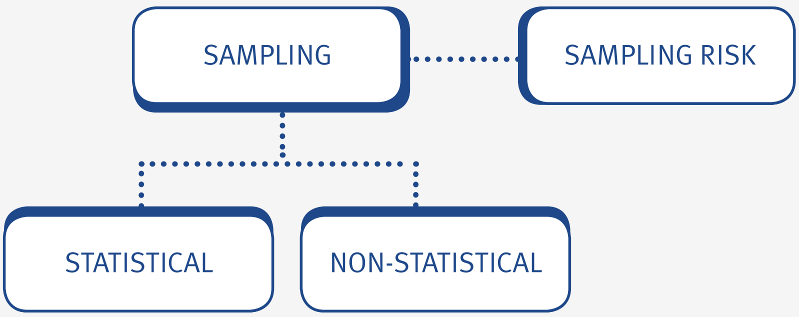
11 Sampling



The need for sampling

It will usually be impossible to test every item in any accounting population because of the costs involved – remember the audit gives reasonable **not** absolute assurance. The audit evidence gathered, therefore, will be on a test basis – hence the need for the auditor to understand the implications and effective use of **sampling**.

However, it is important to understand that:

- there is no **requirement** to use sampling laid down in the ISAs
- 100% testing may be appropriate in certain circumstances – particularly where there is a small population of high-value items
- the use of analytical procedures – see section 7 above and the more detailed coverage in Chapter 10 – and a variation on analytical procedures 'proof in total', may be a more effective and efficient method of gathering audit evidence
- because analytical procedures **are** a requirement of ISA 520 at the planning and overall review stages of the audit, it is sensible to make best use of the work done.

In other circumstances some form of sampling will be used.

Definition

The definition of sampling set out in ISA 530 Audit sampling and other means of testing is:

'Audit sampling' (sampling) involves the application of audit procedures to less than 100% of items within a class of transactions or account balance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.

ISA 530

Statistical or non-statistical sampling

'Statistical sampling' means any approach to sampling that has the following characteristics:

- random selection of a sample, and
- use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have both these characteristics is considered non-statistical sampling.

ISA 530

Statistical sampling requires the following:

- **Random selection**, e.g. generating a random number to determine which item or $ in the population is the first in the sample and using a sampling interval, usually based on tolerable error, to select subsequent items.

  Judgmental or haphazard sampling – picking say two invoices from each month, or focusing on a particular period do not usually count as statistical sampling because of the risk of bias in selecting the sample.

- **Evaluation of results** using probability theory, e.g. if a sample with a total value of $100,000 contains errors of $1,000, it may be possible to extrapolate and say that there may be an error of 1% in the population as a whole, i.e $30,000 in a population of $3m or $100,000 in a population of $10m.

  Clearly this will depend on how representative the sample is and the margin of error according to probability theory.

  To be representative, a sample needs to be of sufficient size

  – usually at least 30 items – and the larger the sample size, the greater the precision it will give.

  If the results of the sample reveal potential errors which might be material, the auditor has to resolve the problem:

  – by considering whether there were special circumstances surrounding the errors, e.g. the absence of a key member of the client's staff and carrying out additional testing on items or the period likely to be affected

  – by deciding whether, because the risk of misstatement has clearly increased, which will lead to an increase in the level of materiality, the new level of materiality is too high. If it is, it will be necessary to increase the level of testing. However, care needs to be taken over this – see the section on risk revisited below.

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Test your understanding 3

(1) **What three qualities must audit evidence have?**

(2) **Which type of evidence is more reliable – a faxed copy of a contract or the original contract?**

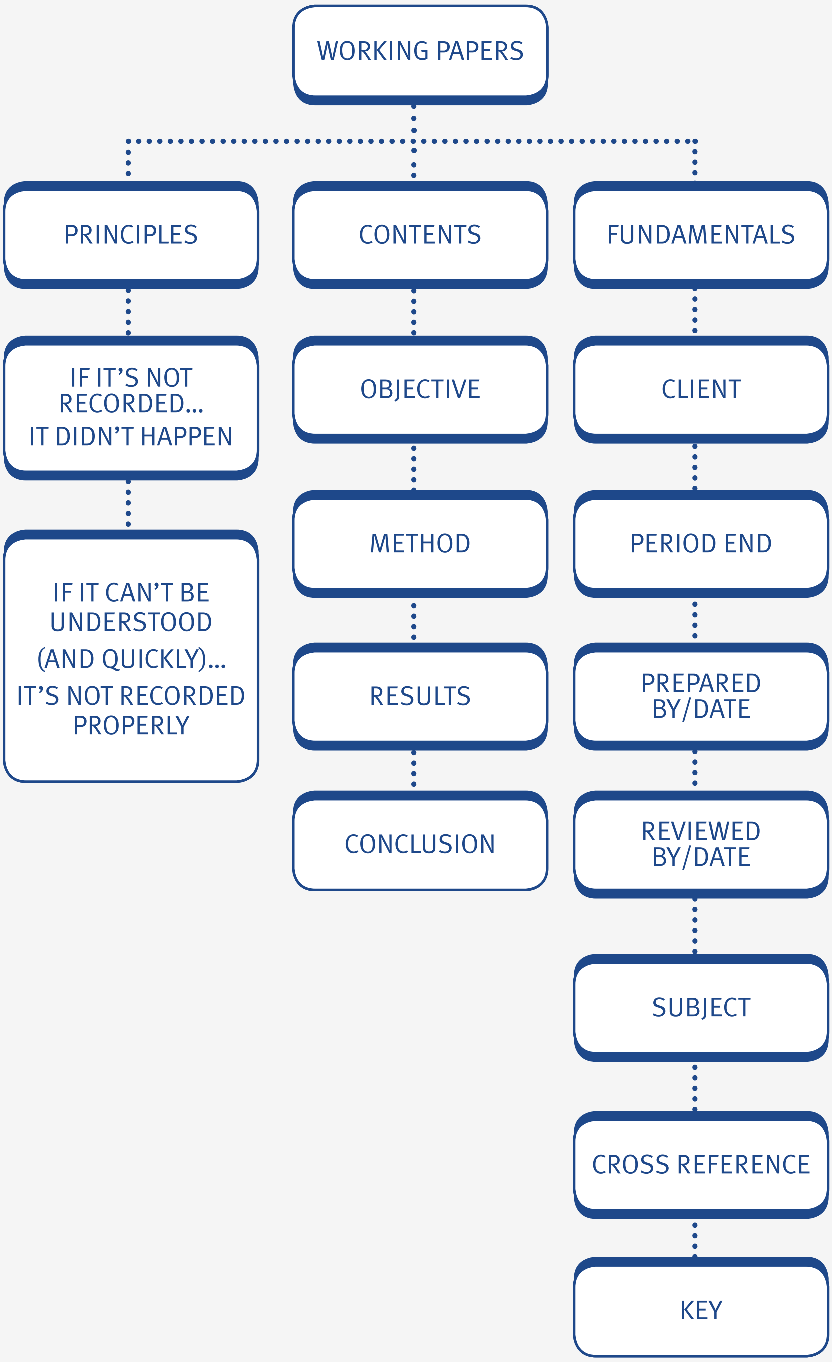
(3) **Which is more reliable – the client's bank statement or a confirmation letter from the bank direct to the auditor?**

(4) **Give two reasons why audit evidence is likely to be persuasive rather than conclusive.**

(5) **Give two examples where it would be appropriate to use statistical sampling.**

12 Audit documentation

Why do we need working papers?



The job of working papers is to:

- provide a record of the basis for the auditor's report
- provide evidence that the audit was conducted in accordance with ISAs and legal and regulatory requirements.

To assist with the planning, performance, supervision and review of the audit.

To aid the auditors' defence if subsequently sued for negligence.

Principles

There are two major principles

- **If it's not recorded, it didn't happen.**

  If there is nothing on file, there is no evidence that the necessary procedures were completed, so there can be no basis for the audit opinion.

- **If it can't be understood, it might as well not have happened.**

  Clarity is important for two reasons

  Completeness – If the working papers are easy to understand it will be more obvious if anything has been omitted.

  Efficiency – Working papers need to be reviewed for quality control purposes and to ensure that the audit opinion is justified. The reviewer may be at a senior level in the firm and therefore time will be charged at an expensive rate. Clear working papers will keep the time spent and therefore the costs to a minimum.

Structure and layout

The file

There are two broad areas to the file.

- The control part consisting of:
  - the planning section
  - the completion and review section.
- The main working papers are divided into the relevant sections of the financial statements, e.g. non-current assets, inventories, receivables, etc.

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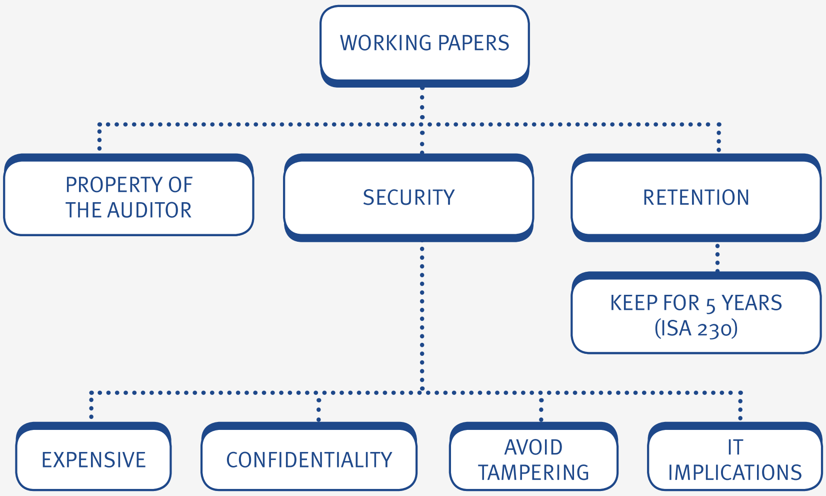
Custody and retention of working papers



Who owns the working papers?

The auditor does. This is important because:

- Access to the working papers is controlled by the auditor, not the client, which is an element in preserving the auditor's independence.
- In some circumstances care may need to be taken when copies of client generated schedules are incorporated into the file.

Security

Working papers must be kept secure.

- Audits are expensive exercises. If the files are lost or stolen, the evidence they contain will need to be recreated, so the work will need to be done again. The auditors may be able to recover the costs from their insurers, but otherwise it will simply represent a loss to the firm. Either way, prevention is better than cure.
- By its nature, audit evidence will comprise much sensitive information that is confidential. If the files are lost or stolen, the auditor's duty of confidentiality will be compromised.
- There have been cases of unscrupulous clients altering auditors' working papers to conceal frauds.

The implications of IT based audit systems are also far reaching.

- By their nature, laptops are susceptible to theft, even though the thief may have no interest in the contents of the audit file. Nevertheless, all the problems associated with re-performing the audit and breaches of confidentiality remain.
- It is more difficult to be certain who created or amended computer based files than manual files – handwriting, signatures and dates have their uses – and this makes it harder to detect whether the files have been tampered with.

This means that the following precautions need to be taken.

- If files are left unattended at clients' premises – overnight or during lunch breaks – they should be securely locked away, or if this is impossible, taken home by the audit team.
- When files are left in a car, the same precautions should be taken as with any valuables.
- IT-based systems should be subject to passwords, encryption and backup procedures.

Retention

ISA 230 states that audit documentation should be retained for five years from completion of the audit. Many firms keep working papers for longer than this because information may still be required for tax purposes.

All of this means that firms need to make arrangements for:

- secure storage of recent files
- archiving older files
- archiving and backup of IT-based files.

13 Smaller entities

Smaller commercial entities will usually have the attributes above most of which are double edged in a good news/bad news kind of way:

- **Lower risk**: Smaller entities may well be engaged in activity that is relatively simple and therefore lower risk. However, this will not be true for small – often one person businesses – where there is a high level of expertise in a particular field, e.g. consultancy businesses, creative businesses, the financial sector.
- **Direct control by owner managers** is a strength because they can know what is going on and have the ability to exercise real control. They are also in a strong position to manipulate the figures or put private transactions 'through the books'.
- **Simpler systems**: Smaller entities are less likely to have sophisticated IT systems, but pure, manual systems are becoming increasingly rare. This is good news in that many of the bookkeeping errors associated with smaller entities may now be less prevalent. However, a system is only as good as the person operating it.

Evidence implications

- The normal rules concerning the relationship between risk and the quality and quantity of evidence apply irrespective of the size of the entity.
- The quantity of evidence may well be less than for a larger organisation.
- It may be more efficient to carry out 100% testing in a smaller organisation.

Small not-for-profit organisations

Small not for profit organisations have all the attributes of other small entities. Arguably, however, the position is more difficult for the auditor because:

- While most small businesses are under the direct management of the owner, small not-for-profit organisations tend to be staffed by volunteers and the culture is more likely to be one of trust rather than accountability.

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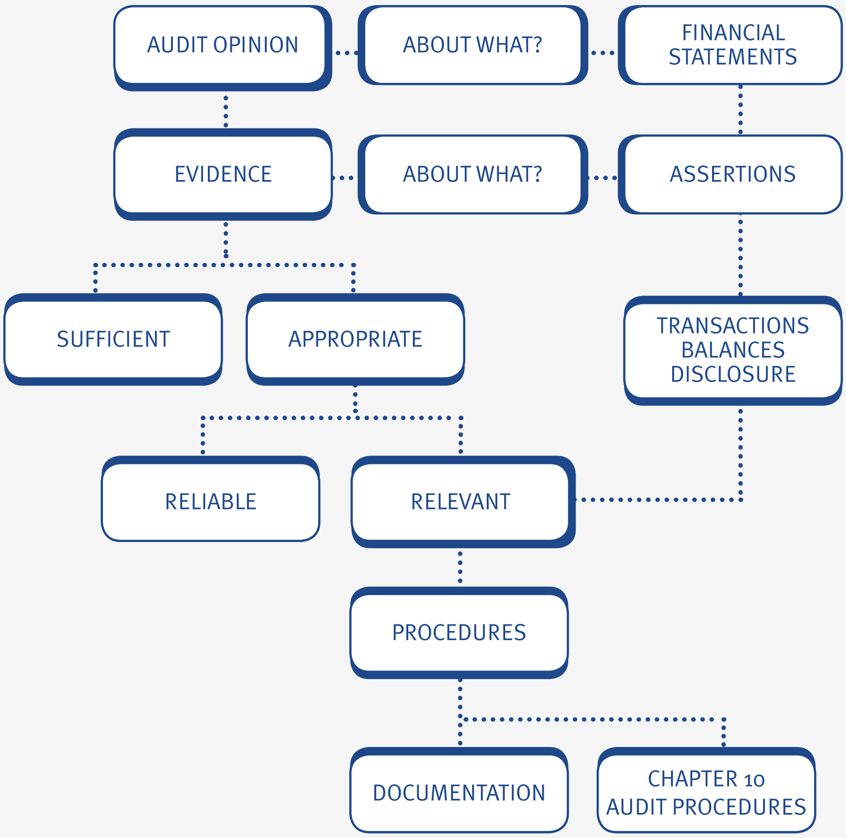
14 Chapter summary



Test your understanding answers

Test your understanding 1

1. Name the five assertions associated with transactions.	Occurrence Completeness Cut-off Accuracy Classification
2. Name the four assertions associated with account balances.	Existence Rights and obligations Completeness Valuation and allocation
3. Name the four assertions associated with disclosures in financial statements.	Occurrence and rights and obligations Completeness Classification and understandability. Accuracy and valuation
4. Why do assertions matter to auditors?	The assertion being tested will have an influence over the nature of the audit procedure used

Test your understanding 2

1. What are the eight types of audit procedure?	Inspection of records or documents. Inspection of assets. Observation. Enquiry. Confirmation. Recalculation. Reperformance. Analytical procedures.
2. What are the two purposes for which the auditor must use analytical procedures?	To assist with planning the audit. At the review stage to make sure that the financial statements make sense.
3. What is the third use of analytical procedures available to the auditor?	As substantive procedures.
4. Why does the auditor need to obtain management representations?	Where the issue is material. Where other sources of evidence cannot reasonably be expected to exist. Where other evidence is of lower quality. Where it is specifically required by an ISA.
5. Give three examples where an auditor might use confirmations.	Circularisation of debtors. Confirmation of bank balances. Confirmation from legal advisers of actual or contingent liabilities arising from legal proceedings. Confirmation of stock held by third parties. Confirmation of investment portfolios by investment managers.

Test your understanding 3

1. What three qualities must audit evidence have?	It must be: • Sufficient. • Relevant. • Reliable.
2. Which type of evidence is more reliable – a faxed copy of a contract or the original contract?	The original contract – (but consider – how do you know it is original).
3. Which is more reliable – the client's bank statement or a confirmation letter from the bank direct to the auditor.	The bank confirmation letter because it is independent third-party evidence. (But beware, it has been known for fraudsters to type letters on paper stolen from a bank).
4. Give two reasons why audit evidence is likely to be persuasive rather than conclusive.	The auditor gathers evidence on a test basis (the sample may or may not be representative). • People make mistakes (both client and auditor). • Documents could be forged (increasingly easy with digital technology). • The client's personnel may not always tell the truth.
5. Give two examples where it would be appropriate to use statistical sampling.	Purchases transaction testing Revenue transactions testing Payroll transactions testing, etc.