

Audit Evidence

Chapter 7

Learning Objective 1

- Contrast audit evidence with evidence used by other professions.

EVIDENCE : any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria.

Nature of Evidence

- The use of evidence is not unique to auditors
- Evidence is also used by scientists, lawyers, and historians

all use evidence to help them draw conclusions.

Learning Objective 2

- Identify the four audit evidence decisions that are needed to
- create an audit program.

Audit Evidence Decisions

about what evidence to gather and how much of it to accumulate:

1. Which audit procedures to use

detailed instruction that explains the audit evidence to be obtained during the audit

2. What sample size to select for a given procedure

vary the sample size from one to all the items in the population being tested

3. Which items to select from the population

Methods can be used to select the specific items to be examined

4. When to perform the procedures (timing)

vary from early in the accounting period to long after it has ended. In part, the timing decision is affected by when the client needs the audit to be completed.

Audit Program

It includes a list of the audit procedures the auditor considers necessary.

- Sample sizes
- Items to select
- Timing of the tests

Most auditors use computers to facilitate the preparation of audit programs.

Learning Objective 3

- Specify the characteristics that determine the persuasiveness
- of evidence.

Persuasiveness of Evidence

➤ Appropriateness

is a measure of the quality of evidence, meaning its relevance and reliability in meeting audit objectives

selecting audit procedures that Are ***relevant to the audit objective that the auditor is testing***

when the auditor traced from the duplicate sales invoices to related shipping documents, the evidence was relevant for the occurrence transaction objective

tracing from shipping documents to sales invoices, the auditor can determine whether shipments have been billed to customers. Relevant for completeness

➤ Sufficiency

The quantity of evidence obtained determines its sufficiency.

Six Characteristics of Reliable Evidence

refers to the degree to which evidence can be believable or worthy of trust

1. Independence of provider

Evidence obtained from a source outside the entity is more reliable than that obtained from within.

2. Effectiveness of client's internal controls

When a client's internal controls are effective, evidence obtained is more reliable than when they are weak.

3. Auditor's direct knowledge

Evidence obtained directly by the auditor through physical examination, observation, recalculation, and inspection is more reliable than information obtained indirectly

4. Qualification of individuals providing the information

the individual providing evidence must be qualified

5. Degree of objectivity

Objective evidence is more reliable than evidence that requires considerable judgment to determine whether it is correct.

the qualifications of the person providing the evidence in subjective evidence.

6. Timeliness

Evidence is usually more reliable for balance sheet accounts when it is obtained as close to the balance sheet date as possible

For income statement accounts, evidence is more reliable if there is a sample from the entire period under audit, such as a random sample of sales transactions for the entire year

Persuasiveness and Cost

In making decisions about evidence for a given audit, both persuasiveness and cost must be considered.

The auditor's goal is to obtain a sufficient amount of appropriate evidence at the lowest total cost.

Learning Objective 4

- Identify and apply the eight types of evidence used in auditing.

Types of Audit Evidence

1. Physical examination
2. Confirmation
3. Documentation
4. Analytical procedures
5. Inquiries of the client
6. Recalculation
7. Reperformance
8. Observation

Physical Examination

the most reliable and useful types of audit evidence

It is the inspection or count by the auditor of a *tangible asset*.

This type of evidence is most often associated with inventory and cash.

verifying that an asset actually exists (existence objective)

verifying existing assets are recorded (completeness objective).

Confirmation

the receipt of a direct written response from a third party verifying the accuracy of information that was requested by the auditor.

Information

Source

Assets

Cash in bank	Bank
Marketable securities	Customer
Accounts receivable	Maker
Notes receivable	Consignee
Owned inventory out on consignment	Public warehouse
Inventory held in public warehouses	Insurance company
Cash surrender value of life insurance	Investment custodian

they are a highly regarded and often-used type of evidence . most costly

Confirmation

Information

Source

Liabilities

Accounts payable

Creditor

Notes payable

Lender

Advances from customers

Customer

Mortgages payable

Mortgagor

Bonds payable

Bondholder

Confirmation

Information

Source

Owners' Equity

Shares outstanding

Registrar and
transfer agent

Other Information

Insurance coverage
Contingent liabilities

Insurance company
Bank, lender, and
client's legal counsel

Bond indenture agreements
Collateral held by creditors

Bond holder
Creditor

Documentation

It is the auditor's inspection of the *client's documents and records*.

Internal
documents

External
documents

Internal document has been prepared and used within the client's organization and is retained without ever going to an outside party.

Internal documents include duplicate sales invoices, employees' time reports, and inventory receiving reports

External document has been handled by someone outside the client's organization who is a party to the transaction being documented, but which are either currently held by the client or readily accessible

vendors' invoices, cancelled notes payable, and insurance policies

- External one is more reliable than Internal documents
- Internal documents created and processed under effective internal control is more reliable than conditions of weak internal control
- Original documents are considered more reliable than photocopies or facsimiles.

When auditors use documentation to support recorded transactions or amounts, the process is often called **vouching**

Analytical Procedures

use comparisons and relationships to assess whether account balances or other data appear reasonable compared to the auditor's expectations.

- Understand the client's industry and business (highlighted any changes)
- Assess the entity's ability to continue as a going concern (assess the likelihood of failure)
- Indicate the presence of possible misstatements in the financial statements

Significant unexpected differences. Unusual fluctuations

- Reduce detailed audit tests

analytical procedure reveals no unusual fluctuations, this implies the possibility of a material misstatement is minimized. perform fewer detailed tests

Inquiries of the Client

It is the obtaining of *written* or *oral* information from the client in response to questions from the auditor.

usually cannot be regarded as conclusive

Recalculation

It involves rechecking a sample of calculations made by the client.

Reperformance

It is the auditor's independent tests of client accounting procedures or controls that were originally done.

Observation

It is the use of the senses to assess client activities.

The auditor may tour the plant to obtain a general impression of the client's facilities.

Appropriateness of Types of Evidence

- Type of evidence
- Independence of provider
- Effectiveness of client's internal controls
- Auditor's direct knowledge
- Qualifications of provider
- Objectivity of evidence

Criteria to Determine Appropriateness

Type of Evidence	Independence of Provider	Effectiveness of Client's Internal Controls	Auditor's Direct Knowledge	Qualifications of Provider	Objectivity of Evidence
Physical examination	High (auditor does)	Varies	High	Normally high (auditor does)	High
Confirmation	High	Not applicable	Low	Varies—usually high	High
Documentation	Varies—external more independent than internal	Varies	Low	Varies	High
Analytical procedures	High/low (auditor does/ client responds)	Varies	Low	Normally high (auditor does/ client responds)	Varies—usually low
Inquiries of client	Low (client provides)	Not applicable	Low	Varies	Varies—low to high
Recalculation	High (auditor does)	Varies	High	High (auditor does)	High
Reperformance	High (auditor does)	Varies	High	High (auditor does)	High
Observation	High (auditor does)	Varies	High	Normally high (auditor does)	Medium

Types of Evidence and Four Evidence Decisions for a Balance-Related Audit Objective for Inventory*

Type of Evidence	Evidence Decisions			
	Audit Procedure	Sample Size	Items to Select	Timing
Observation	Observes client's personnel counting inventory to determine whether they are properly following instructions	All count teams	Not applicable	Balance sheet date
Physical examination	Count a sample of inventory and compare quantity and description to client's counts	120 items	40 items with large dollar value, plus 80 randomly selected	Balance sheet date
Documentation	Compare quantity on client's perpetual records to quantity on client's counts	70 items	30 items with large dollar value, plus 40 randomly selected	Balance sheet date

Terms and Types of Evidence

Terms

Type of Evidence

Examine

Documentation

Scan

Analytical procedures

Read

Documentation

Compute

Analytical procedures

Recompute

Recalculation

Foot

Recalculation

Trace

Documentation/Reperformance

Compare

Documentation

Count

Physical examination

Observe

Observation

Inquire

Inquiries of client

Vouch

Documentation

Term and Definition	Illustrative Audit Procedure	Type of Evidence
<i>Examine</i> —A reasonably detailed study of a document or record to determine specific facts about it.	<i>Examine</i> a sample of vendors' invoices to determine whether the goods or services received are reasonable and of the type normally used by the client's business.	Documentation
<i>Scan</i> —A less-detailed examination of a document or record to determine whether there is something unusual warranting further investigation.	<i>Scan</i> the sales journal, looking for large and unusual transactions.	Analytical procedures
<i>Read</i> —An examination of written information to determine facts pertinent to the audit.	<i>Read</i> the minutes of a board of directors meeting and summarize all information that is pertinent to the financial statements in an audit file.	Documentation
<i>Compute</i> —A calculation done by the auditor independent of the client.	<i>Compute</i> inventory turnover ratios and compare with those of previous years as a test of inventory obsolescence.	Analytical procedures
<i>Recompute</i> —A calculation done to determine whether a client's calculation is correct.	<i>Recompute</i> the unit sales price times the number of units for a sample of duplicate sales invoices and compare the totals with the calculations.	Recalculation

<i>Foot</i> —Addition of a column of numbers to determine whether the total is the same as the client's.	<i>Foot</i> the sales journal for a 1-month period and compare all totals with the general ledger.	Recalculation
<i>Trace</i> —An instruction normally associated with documentation or reperformance. The instruction should state what the auditor is tracing and where it is being traced from and to. Often, an audit procedure that includes the term <i>trace</i> will also include a second instruction, such as <i>compare</i> or <i>recalculate</i> .	<i>Trace</i> a sample of sales transactions from sales invoices to the sales journal, and <i>compare</i> customer name, date, and the total dollar value of the sale.	Documentation
	<i>Trace</i> postings from the sales journal to the general ledger accounts.	Reperformance
<i>Compare</i> —A comparison of information in two different locations. The instruction should state which information is being compared in as much detail as practical.	Select a sample of sales invoices and <i>compare</i> the unit selling price as stated on the invoice to the list of unit selling prices authorized by management.	Documentation

<i>Count</i> —A determination of assets on hand at a given time. This term should be associated only with the type of evidence defined as physical examination.	<i>Count</i> a sample of 100 inventory items and compare quantity and description to client's counts.	Physical examination
<i>Observe</i> —The act of observation should be associated with the type of evidence defined as observation.	<i>Observe</i> whether the two inventory count teams independently count and record inventory counts.	Observation
<i>Inquire</i> —The act of inquiry should be associated with the type of evidence defined as inquiry.	<i>Inquire</i> of management whether there is any obsolete inventory on hand at the balance sheet date.	Inquiries of client
<i>Vouch</i> —The use of documents to verify recorded transactions or amounts.	<i>Vouch</i> a sample of recorded acquisition transactions to vendors' invoices and receiving reports.	Documentation

Learning Objective 5

- Understand the purposes of audit documentation. **worki ng papers**

Audit Documentation

Audit documentation is the ***principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement.***

Audit Documentation

➤ Purposes of audit documentation

A Basis for Planning the Audit

A Record of the Evidence Accumulated and the Results of the Tests

Data for Determining the Proper Type of Audit Report

A Basis for Review by Supervisors and Partners

➤ Ownership of audit files

is the property of the auditor.

➤ Confidentiality of audit files

care must be taken to safeguard the audit files at all times.

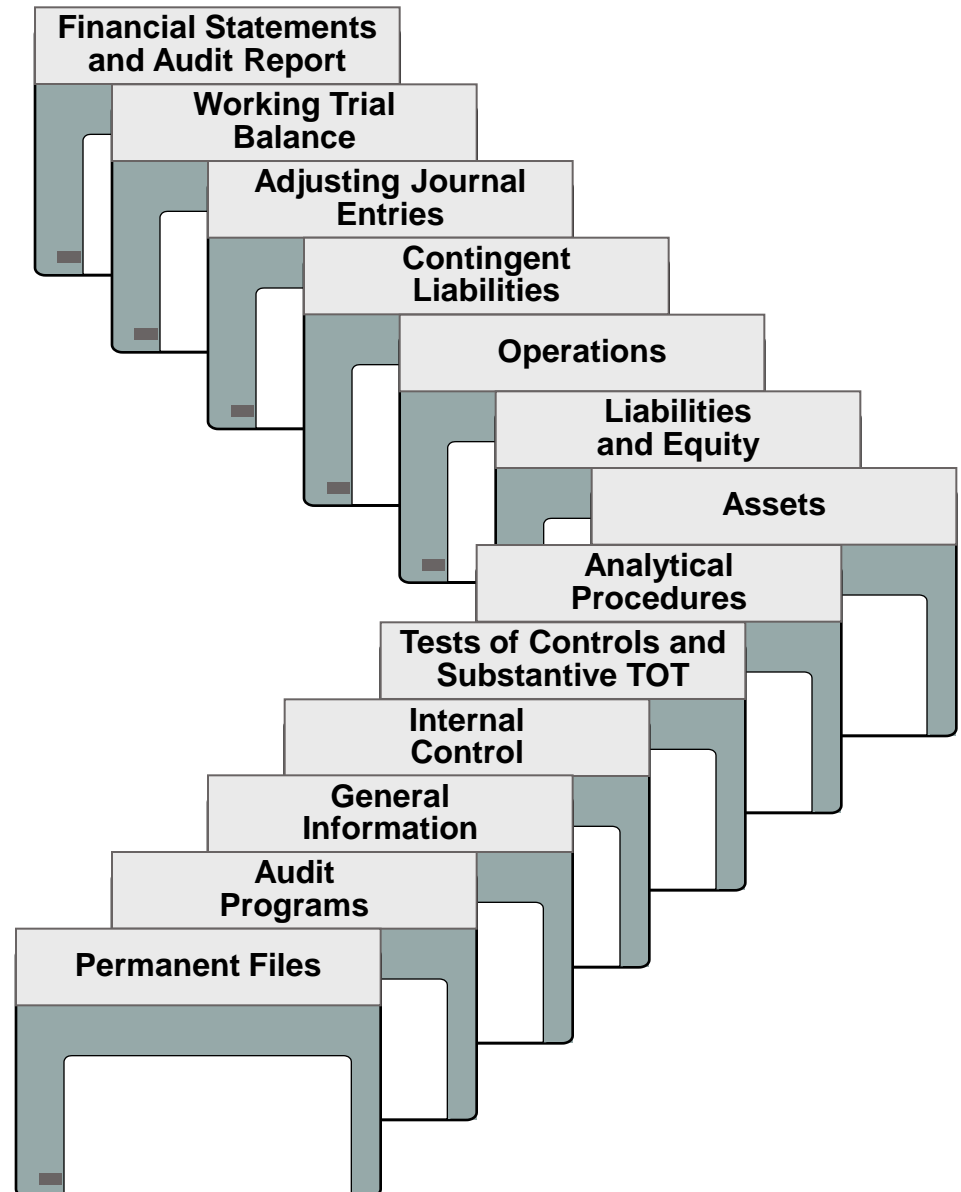
Sarbanes-Oxley Act

The Sarbanes-Oxley Act requires auditors of public companies to prepare and maintain audit working papers for a period of no less than seven years.

Learning Objective 6

- Prepare organized audit documentation.

Audit File Contents and Organization



Robinson Associates Trial Balance 12/31/09

Cash	\$165,237
Accounts Receivable	275,050
Prepaid Insurance	37,795
Interest Receivable	20,493

Permanent Files

These files are intended to contain data of a ***historical or continuing nature*** pertinent to the current audit.

Permanent files contain data of a *historical or continuing nature* pertinent to the current audit. These files provide a convenient source of information about the audit that is of continuing interest from year to year. The permanent files typically include the following:

- *Extracts or copies of such company documents of continuing importance as the articles of incorporation, bylaws, bond indentures, and contracts.* The contracts may include pension plans, leases, stock options, and so on. Each of these documents is significant to the auditor for as many years as it is in effect.
- *Analyses from previous years of accounts that have continuing importance to the auditor.* These include accounts such as long-term debt, stockholders' equity accounts, goodwill, and fixed assets. Having this information in the permanent files enables the auditor to concentrate on analyzing only the changes in the current year's balance while retaining the results of previous years' audits in a form accessible for review.
- *Information related to understanding internal control and assessing control risk.* This includes organization charts, flowcharts, questionnaires, and other internal control information, including identification of controls and weaknesses in the system. These records are used as a starting point for documenting the auditor's understanding of the control system, since aspects of the systems are often unchanged from year to year.
- *The results of analytical procedures from previous years' audits.* Among these data are ratios and percentages computed by the auditor and the total balance or the balance by month for selected accounts. This information is useful in helping the auditor decide whether there are unusual changes in the current year's account balances that should be investigated more extensively.

Documenting analytical procedures, understanding of internal control, and assessing control risk are included in the current period audit files rather than in the permanent file by many CPA firms.

Current Files

include all audit documentation applicable to the year under audit.

- Audit program

- General information

current period information
of a general nature

- Working trial balance

listing of the general ledger accounts and their year-end balances.

- Adjusting and reclassification entries

summarize all entries that have not been recorded in a separate audit schedule as a means of assessing their cumulative effect.

- Supporting schedules

schedules prepared by the client or the auditors in support of specific amounts on the financial statements

Types of Supporting Schedules

- Analysis
- Trial balance or list
- Reconciliation of amounts
- Tests of reasonableness

Types of Supporting Schedules

- Summary of procedures
- Examination of supporting documents
- Informational
- Outside documentation

Preparation of Audit Documentation

- Each audit file should be properly identified
- Documentation should be indexed and cross-referenced
- Completed documentation must clearly indicate the audit work performed
- It should include sufficient information
- It should plainly state the conclusions reached

Learning Objective 7

Describe how technology affects audit evidence and audit documentation. •

Effect of Technology

- Audit evidence is increasingly in electronic form
- Auditors must evaluate how electronic information affects their ability to gather evidence
- Auditors use computers to read and examine evidence
- Software programs are typically Windows-based