

# CHAPTER 4

## Audit Evidence

### SA 500 "Audit Evidence"

#### BASICS

Audit evidence may be defined as information (Info.) used by auditor in forming opinions on conclusions on which audit opinions are based. It **includes**

##### 1. Info contained in accounting records

- records of initial **accounting entries** & supporting records, such as cheques & ETFs
- **invoices** | contracts
- general & subsidiary **ledgers**, journal entries and other adjustments to F.S.
- work sheets & **spreadsheets** supporting cost allocations, computations, reconciliations.

##### 2. Other info. that authenticates accounting records & supports auditor's rationale

- **minutes** of the meetings,
- **written confirmations** from trade receivables and trade payables,
- **manuals** containing details of internal control etc

#### TYPES OF AUDIT EVIDENCE

Depending upon nature	Depending upon source:
<ol style="list-style-type: none"><li>1. <b>Visual:</b> <b>Observing</b> physical verification of inventory conducted by the client's staff.</li><li>2. <b>Oral:</b> For E.g., <b>discussion</b> with the mgt. and various officers of the client.</li><li>3. <b>Documentary:</b> E.g. - fixed deposit certificate, loan agreement, sales bill etc.</li></ol>	<ol style="list-style-type: none"><li>1. <b>Internal Evidence:</b> Evidence which <b>originates within organisation</b> E.g. Sales invoice, Copies of sales challan, goods received note, etc.</li><li>2. <b>External evidence:</b> Evidence that <b>originates outside</b> client's <b>organization</b> E.g. Purchase invoice, quotations, confirmations, etc.</li></ol>

#### RELEVANCE AND RELIABILITY OF AUDIT EVIDENCE

##### ➤ Relevance

- It deals with **Logical connection** with purpose of procedure & assertion under consideration.
- It may be **affected by direction of testing**.
  - If purpose is to **test overstatement** in a/c payable - testing **recorded a/c payable** may be a relevant audit procedure
  - If **testing** for **understatement** of a/c payable - testing recorded a/c payable would not be relevant, but testing subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.
- A given set of **procedures** may **provide evidence** that is **relevant to certain assertions, but not others**. E.g. ~ Inspection of docs related to collection of receivables after period end may provide evidence regarding existence & valuation, but not necessarily cut-off.
- Obtaining evidence regarding a particular assertion, e.g., existence of inventory, is **not a substitute** for obtaining evidence regarding another assertion, E.g., valuation of inventory.

##### ➤ Reliability

- Reliability of info. to be used as evidence, is influenced by its **source** & its **nature** & **circumstances** under which it is obtained, including controls over its preparation & maintenance.
- While recognising that exceptions may exist, following **Generalisations about reliability of evidence** may be useful:

- Reliability of evidence is **increased** when obtained from **independent sources** outside co.
- Reliability of evidence that is **generated internally** is increased when **controls**, over its preparation & maintenance, imposed by entity are **effective**.
- Evidence **obtained directly** by auditor is **more reliable** than obtained indirectly.
- Evidence in **documentary form**, (paper, electronic) is **more reliable** than obtained **orally**
- **Original docs** is **more reliable** than evidence obtained as photocopies or facsimiles, or docs that have been transformed into electronic form.

## SUFFICIENT & APPROPRIATE AUDIT EVIDENCE

### ➤ Sufficiency

- It is measure of **quantity** of evidence. Quantity needed is **affected by**
  - Auditor's **assessment of risks** of misstatement (higher the assessed risks, more evidence is required) and by
  - **Quality** of such audit evidence (higher the quality, less evidence may be required)
- Auditors' judgment as to sufficiency may be affected by factors such as:
  - Materiality - **Less evidence** would be required in case assertions are **less material**, But if assertions are **more material** to users, **more evidence** would be required
  - ROMM (Risk of Material Misstatement) - Risk that F.S are materially misstated prior to audit. This consists of 2 components :
    - ✓ **Inherent risk** - Susceptibility of an assertion to a misstatement before consideration of any related controls.
    - ✓ **Control risk** - A misstatement that could occur in an assertion will not be prevented or detected & corrected on a timely basis by entity's internal control.**Less evidence** in case assertions have a **lower ROMM**. But if assertions have a **higher ROMM**, **more evidence** would be required.
  - Size & characteristics - **Less evidence** in case of **smaller**, more **homogeneous population**  
In case of **larger**, more **heterogeneous populations**, **more evidence** would be required

### ➤ Appropriateness

- Appropriateness is measure of **quality** of evidence; that is, its **relevance & reliability**.
- Reliability is influenced by **its source**, **nature**, and **circumstances** under which it is obtained

### ➤ Obtaining SAAE

- Most of auditor's work in forming opinion consists of obtaining & evaluating audit evidence.
- Auditor shall **design & perform procedures** that are **appropriate** for obtaining SAAE.
- Evidence is **necessary** to support auditor's opinion & report. It is **cumulative** in nature.
- It also includes info. obtained from other sources such as previous audits.
- In addition to other sources, entity's accounting records are an important source of evidence.
- Evidence comprises both - info. that supports & **corroborates** mgt.'s assertions, & info. that **contradicts** such assertions.
- In some cases, absence of info. (E.g., mgt.'s refusal to provide a requested representation) is used by auditor, and therefore, also constitutes audit evidence.

## AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

- ✓ **Inspection** - Inspection involves **examining records or docs**, whether internal or external, in paper or electronic form, or physical **examination of asset**.

- Inspection of records & docs provides audit evidence of **varying degrees of reliability**, depending on their **nature & source** and effectiveness of **controls** over their production.
- Example of **inspection used as a TOC** is inspection of records for evidence of authorisation.
- Some docs represent **evidence of existence** of asset, E.g. ~ Financial instrument (stock or bond). It **may not necessarily** provide evidence **about ownership or value**.
- **Inspection of tangible assets** may provide **evidence w.r.t their existence**, but **not necessarily** about entity's rights & **obligations or valuation**.

- ✓ **Observation** - **Looking at process** or procedure **being performed by others**. E.g. observation of inventory counting. It **provides evidence** about performance of a process but is **limited to point in time** & by **fact that being observed** may affect how process is performed.
- ✓ **External Conformation** - It represents **evidence obtained as a direct written response** to auditor **from a 3<sup>rd</sup> party** (confirming party), in paper form, or by electronic or other medium. These are relevant when addressing assertions of certain a/c bal. However, **need not be restricted to a/c balances**. E.g. Auditor may request confirmation of **terms of agreements**, to ask if any **modifications** have been made or to obtain **evidence about absence** of certain conditions.
- ✓ **Recalculation** - It consists of **checking mathematical accuracy** of data or records.
- ✓ **Reperformance** - Involves auditor's **independent execution** of **procedures** or controls that were **originally performed** as part of entity's internal control. E.g. Re-performing BRS, Re-performing aging of a/c receivable.
- ✓ **Analytical procedures** - Evaluations of financial info. made by study of **plausible relationships among both financial & non-financial data**. It also **encompass investigation** of **identified fluctuations, relationships that are inconsistent** with other info. OR **deviate significantly** from predicted amounts.
- ✓ **Inquiry** - Inquiry consists of **seeking info.** from knowledgeable persons about financial & non-financial info., within or outside entity.

- It is **used extensively** throughout audit.
- It may range from **formal written** inquiries to **informal oral** inquiries.
- **Evaluating responses** to inquiries is an **integral part** of inquiry process.
- Responses to inquiries may provide auditor with **info. not previously possessed or corroborative** evidence.
- Responses to inquiries may provide a basis to modify or perform additional procedures
- **Inquiry alone** does **not** provide **SAAE** of - Absence of a MM at assertion level, nor of operating effectiveness of controls

## ASSERTIONS

Assertions refers to **Representations by mgt.**, explicit or otherwise, that are **embodied in F.S**, as used by auditor to consider **different types of potential misstatements** that may occur.

Assertions fall into following 3 categories:

### A. **Assertions about existence of transactions & events** (trxn & events)

- **Occurrence** - All & that have been recorded have **occurred and pertain to entity**
- **Completeness** - All trxn & events that **should be recorded have been recorded**
- **Accuracy** - Amounts & other data relating to recorded trxn & events have been **recorded appropriately**
- **Cut-off** - Trxn & events have been recorded in **correct accounting period**
- **Classification** - Trxn & events have been recorded **in proper accounts**

### B. **Assertions about balances at period end**

- **Existence** - assets, liabilities, and equity interests **exist**.
- **Rights & Obligations** - entity holds **rights to assets**, & **liabilities are obligations** of entity

- **Completeness** - All assets, liabilities and equity that **should be recorded have been recorded**
- **Valuation** - Assets, liabilities and equity are included at **appropriate amounts**

### C. Assertions about presentation and disclosure

- **Occurrence & Rights & Obligations** - Disclosed trxn & events **have occurred & pertain to entity**
- **Completeness** - All disclosures that **should be included** in F.S **have been included**
- **Classification & Understandability** - Financial info. is appropriately presented & disclosures are **clearly expressed**.
- **Accuracy & Valuation** - Financial info is disclosed fairly and **at appropriate amounts**

### Negative assertions:

- **Expressed negative assertions** - If FS stated that there is no contingent liability
- **Implied negative assertions** - If in balance sheet (B/S) there is no item as "building"

## AUDIT TRAIL

- It is a **documented flow of a transaction**. It is used to **investigate** how a source document was translated into an a/c entry and from there it was inserted into F.S of an entity.
- It is **used as audit evidence** to establish **authentication & integrity** of a transaction.
- It is a step-by-step record by which accounting, or other financial data can be **traced to their source**.
- Their **purpose is to reduce fraud**, material errors, and **unauthorized use**.
- Audit trails **help to enhance internal controls & data security**.
- It **helps in fixing responsibility**, rebuilding events and in thorough analysis of problem areas.
- However, audit trails **involve costs**. Cost is not only **in terms of system expenditure** but **also** in terms of time involved in **analysing data** made available by audit trails.
- Systems which have a feature of audit trail **inspires confidence in auditors**.
- It helps auditors in **verifying whether** controls devised by the mgt. **were operating effectively** or not. (whether a trxn was indeed performed by authorised person).

## MGT EXPERT

- Individual or organisation possessing expertise in field other than a/c or auditing, whose work is used by entity in preparing FS.
- If entity has employed or engaged experts, auditor may rely on works of experts,
- When info. to be used as evidence has been prepared using work of a mgt.'s expert, auditor shall

- Evaluate the **competence, capabilities & objectivity** of that expert;
- Obtain an **understanding** of work of that expert; and
- Evaluate **appropriateness** of that **expert's work** as audit evidence for relevant assertion.

- When info. to be used as evidence has been prepared using work of mgt's expert, NTE of audit procedures may be affected by:

- The **nature, scope and objectives** of mgt's expert's work
- Whether mgt's expert is subject to **technical performance standards** / industry requirements
- Whether mgt's expert is **employed** by entity, or is a **party engaged** by it
- The extent to which **Mgt. can exercise control** over work of mgt's expert
- The nature and extent of **controls** within entity **over mgt's expert's work**
- The **auditor's knowledge & experience** of mgt's expert's field of expertise
- The **auditor's previous experience** of work of that expert
- The **nature and complexity** of matter
- The **ROMM** in matter

- The **availability of alternative sources** of audit evidence

➤ When using **information produced by the entity (IPE)**, auditor shall evaluate whether info. is sufficiently reliable for the auditor's purposes, including as necessary in circumstances:

- a) Obtaining audit evidence about the **accuracy and completeness** of the information &
- b) Evaluating whether info. is **sufficiently precise and detailed** for the auditor's purposes.

## SELECTING ITEMS FOR TESTING TO OBTAIN AUDIT EVIDENCE

When designing tests of controls & tests of details, auditor shall determine means of selecting items for testing. Means available are:

➤ **Selecting All Items (100% examination)**

- 100% examination is unlikely in **TOC**; however, it is more common for **TOD**
- 100% examination may be appropriate when -
  - ✓ The population has small number of large value items
  - ✓ There is a **significant risk** and other procedures do not provide **SAAE**
  - ✓ The repetitive nature of calculation performed automatically by an information system makes a 100% examination cost effective

➤ **Selecting Specific Items**

- Auditor may decide to select specific items from population. In making this decision, factors that may be relevant include
  - Auditor's **understanding** of entity
  - Assessed **ROMM**, and
  - **Characteristics of population** being tested.
- The **judgmental selection** of specific items is subject to **non-sampling risk**. It may include:
  - ✓ **High value or key items** - Auditor may decide to select specific items because they are of **high value**, or exhibit some **characteristic**. (suspicious, risk-prone or history of error)
  - ✓ **All items over a certain amount** - Items whose recorded **values exceed a certain amount** so as to **verify a large proportion** of total amount.
  - ✓ **Items to obtain information** - Items to obtain info. about matters such as **nature of entity or nature of transactions**.

➤ **Audit Sampling** - Discussed in SA 530

## INCONSISTENCY IN OR DOUBTS OVER RELIABILITY OF AUDIT EVIDENCE

Evidence obtained from

- 1 source is **inconsistent** with that obtained from another; or
  - Auditor has **doubts over reliability** of info. to be used as audit evidence,
- Auditor shall determine what **modifications or additions to procedures are necessary to resolve the matter**, and consider effect of matter, on other aspects of the audit.

E.g. SA 230 includes a specific documentation requirement if auditor identified info. that is inconsistent with auditor's final conclusion regarding a significant matter.