

ISA 500 : AUDIT EVIDENCE

Auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion

SUFFICIENT APPROPRIATE AUDIT EVIDENCE

SUFFICIENCY -- measure of quantity

APPROPRIATENESS -- measure of quality or reliability

- audit evidence usually persuasive not conclusive
- different sources examined
- "reasonable assurance" that FS are free from misstatement
- not all sources examined

Auditor is influenced by :

- degree of risk
- nature of accounting and internal control system
- materiality
- knowledge of business and industry
- experience from previous audits
- findings from audit procedures
- source and reliability of info.

TESTS OF CONTROL

Auditor seeks to obtain evidence in relation to :

- DESIGN : capable of preventing or detecting material misstatements
- OPERATION : operated effectively in relevant period

of the accounting and internal control system

SUBSTANTIVE PROCEDURES

Consider extent to which evidence supports the relevant financial statement assertions

- Existence
- Rights and Obligations
- Occurrence
- Completeness (See Glossary of Terms)
- Valuation
- Measurement
- Presentation and Disclosure

Audit evidence is usually obtained to support each FS assertion

Reliability of evidence is influenced by its source (internal / external) and by its nature (visual , documentary , oral)

Consistency of evidence from different sources increases persuasiveness

PROCEDURES FOR OBTAINING AUDIT EVIDENCE

- ***Inspection*** -- of records / documents (reliability depends on source)
 -- of tangible assets to confirm existence (not necessarily ownership , cost or value)
- ***Observation*** -- of an operation / procedure (only reliable at that time)
- ***Enquiry and Confirmation***
 - of knowledgeable persons inside or outside the business
 - written or oral
 - reliability depends on competence , experience , independence and integrity of respondent
- ***Computation*** -- check of arithmetical accuracy or independent calculation
- ***Analytical Procedures***
 - of ratios , trends , variations , comparisons etc.

AUDIT EVIDENCE AND AUDIT PROCEDURES

AUDIT EVIDENCE (ISA 500)

The objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, with an identified financial reporting framework.

Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Auditors are not expected to look at all the information that might exist. They will tend to select samples to test.

FINANCIAL STATEMENT ASSERTIONS

Audit tests are designed to obtain evidence about the financial statement assertions. Assertions relate to classes of transactions and events, account balances at the period end, and presentation and disclosure.

Financial statement assertions are the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatement that may occur.

ISA 315 states that the auditor must use assertions for classes of transactions (ie profit and loss account), account balances (ie balance sheet) and presentation and disclosures in sufficient detail to form the basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. It gives examples of assertions in these areas which are set out in the table below:

ASSERTIONS USED BY THE AUDITOR

Assertions about classes of transactions and events for the period under audit	Occurrence: transactions and events that have been recorded have occurred and pertain to the entity. Completeness: all transactions and events that should have been recorded have been recorded. Accuracy: amounts and other data relating to recorded transactions and events have been recorded appropriately. Cut-off: transactions and events have been recorded in the correct accounting period. Classification: transactions and events have been recorded in the proper accounts.
Assertions about account balances at the period-end	Existence: assets, liabilities, and equity interests exist. Rights and obligations: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity. Completeness: all assets, liabilities and equity interests that should have been recorded have been recorded. 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.
Assertions about presentation and disclosure	Occurrence and rights and obligations: disclosed events, transactions and other matters have occurred and pertain to the entity. Completeness: all disclosures that should have been included in the financial statements have been included. Classification and understandability: financial information is appropriately presented and described, and disclosures are clearly expressed. Accuracy and valuation: financial and other information are disclosed fairly and at appropriate amounts.

AUDIT PROCEDURES TO OBTAIN AUDIT EVIDENCE

Audit evidence can be obtained by **inspection, observation, inquiry and confirmation, recalculation, reperformance and analytical procedures.**

The auditor obtains audit evidence by undertaking audit procedures to do the following:

- Obtain an understanding of the entity and its environment to assess the risks of material misstatement at the financial statement and assertion levels (**risk assessment procedures**)
- Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (**tests of controls**)
- Detect material misstatements at the assertion level (**substantive procedures**)

The auditor must always perform risk assessment procedures to provide a satisfactory assessment of risks.

Tests of controls are necessary to test the controls to support the risk assessment, and also when substantive procedures alone do not provide sufficient appropriate audit evidence. Substantive procedures must always be done for material classes of transactions, account balances and disclosures.

The audit procedures described in the table below can be used as risk assessment procedures, tests of controls and substantive procedures.

PROCEDURES	
Inspection of tangible assets	Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation. Confirmation that assets seen are recorded in accounting records gives evidence of completeness.
Inspection of documentation or records	This is the examination of documents and records, both internal and external, in paper, electronic or other forms. This procedure provides evidence of varying reliability, depending on the nature, source and effectiveness of controls over production (if internal). Inspection can provide evidence of existence (eg a document constituting a financial instrument), but not necessarily about ownership or value.
Observation	This involves watching a procedure or process being performed (for example, post opening). It is of limited use, as it only confirms the procedure took place when the auditor was watching, and because the act of being observed could affect how the procedure or process was performed.
Inquiry	This involves seeking information from client staff or external sources. Strength of evidence depends on the knowledge and integrity of source of information. Inquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level nor is it sufficient to test the operating effectiveness of controls.
Confirmation	This is the process of obtaining a representation of information or of an existing condition directly from a third party eg confirmation from the bank of bank balances.
Recalculation	This consists of checking the mathematical accuracy of documents or records. It can be performed through the use of IT.
Reperformance	This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
Analytical procedures	Evaluating and comparing financial and/or non-financial data for plausible relationships. Also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

SUBSTANTIVE PROCEDURES

Auditors need to obtain sufficient appropriate audit evidence to support the financial statement assertions. Substantive procedures can be used to obtain that evidence

These are tests to obtain audit evidence to detect material misstatements in the financial statements. They are generally of two types:

- Analytical procedures
- Tests of detail of transactions, account balances and disclosures

The types of substantive tests carried out to obtain evidence about various financial statement assertions are outlined in the table below:

Audit assertion	Type of assertion	Typical audit tests
Completeness	Classes of transactions Account balances Presentation and disclosure	(a) Review of post balance sheet items (b) Cut-off testing (c) Analytical review (d) Confirmations (e) Reconciliations to control accounts
Rights and obligations	Account balances Presentation and disclosure	(a) Inspecting invoices for proof that item belongs to the company (b) Confirmations with third parties
Valuation and allocation	Account balances Presentation and disclosure	(a) Matching amounts to invoices (b) Recalculation (c) Confirming accounting policy consistent and reasonable (d) Review of post balance sheet payments and invoices (e) Expert valuation
Existence	Account balances	(a) Physical verification (b) Third party confirmations (c) Cut-off testing
Occurrence	Classes of transactions Presentation and disclosure	(a) Inspection of supporting documentation (b) Confirmation from directors that transactions relate to business (c) Inspection of items purchased
Accuracy	Classes of transactions Presentation and disclosure	(a) Recalculation of correct amounts (b) Third party confirmation (c) Analytical review
Classification and understandability	Classes of transaction Presentation and disclosure	(a) Test compliance with law and accounting standards (b) True and fair override invoked
Cut-off	Classes of transactions	(a) Cut-off testing (b) Analytical review

The following model should be used as an audit testing plan:

- Agree opening balances to previous year's working papers
- Review nominal ledger for unusual records
- Match client schedules to/from accounting records to ensure completeness
- Carry out analytical review
- Test transactions in detail
- Test balances in detail
- Review presentation and disclosure in accounts

Audit tests: the difference between tests of control and substantive tests

The purpose of audit tests

The purpose of audit tests, or audit procedures, is to allow the auditor to collect sufficient appropriate audit evidence to be able to conclude with reasonable assurance that the financial statements (FS) are free of material misstatement. If sufficient appropriate audit evidence cannot be obtained, or the evidence points to a material misstatement in the FS, the auditor will have to issue a modified audit opinion.

Misstatements will find their way into published financial statements only if three events all happen:

1. An error is made in the first place. The risk of that happening is known as 'inherent risk', and assessing that is a very big part of audit planning (not the subject of this article).
2. The client's internal control system does not prevent, identify or correct the error. This is known as 'control risk'.
3. The auditor does not detect the error during the audit. This is known as 'detection risk'.

There are therefore two lines of defence preventing an error that has occurred from ending up in the published FS: the internal control system and the work auditor carries out.

If the client's internal control system is good, there is a reduced likelihood that there will be an error in the FS and the auditor will reduce the amount of audit work to be carried out. If the internal control system is poor, the auditor will have to perform much more work as the audit is the only defence left against a material misstatement appearing in the published FS.

Therefore, the auditor must:

1. Assess the effectiveness of the internal control system. This means investigating both its design and its operation. The operation of the internal controls is assessed by carrying out tests of control.
2. Obtain additional, direct evidence about the amounts shown in the FS. This evidence is obtained using substantive testing.

Consider the debtors amount in the balance sheet. One way in which this could be misstated would be if it were incorrectly valued, perhaps because a large balance was owed by a customer who was unlikely to pay.

The controls that would help to prevent that include:

- Take up credit references on new customers.
- Establish a credit limit.
- Producing aged debtors analyses.
- The follow up amounts that are not paid on time.

The operation of these controls needs to be tested. For example:

- Look at the client's files where credit references are kept to ensure that every customer was investigated. The auditor would *inspect* the references.
- Look for evidence of new orders being rejected if they would breach the credit limit. This could be tested by *inspecting* copies of notifications sent to customers. The auditor might also consider using test data to *observe* if an order exceeding the credit limit is actually rejected.
- *Inspecting* notes made by the credit controller of conversations held with slow payers and perhaps *enquiring* about the follow-up procedures that are carried out.

Each of these audit tests are testing a control or control procedure. They are therefore **tests of control**. These tests are *not* investigating the receivables balance in the balance sheet. I repeat, a test of control tests controls, not amounts in the FS.

Tests of control can be grouped into:

Enquiry and confirmation. For example, ask the credit controller about the way in which customers are encouraged to pay and ask how these customers are identified and how often they are followed up. This is a relatively weak source of evidence because the credit controller might exaggerate his or her efforts.

Inspection. For example, the credit references or notes made by the credit controller of conversations.

Observation. For example, observing the credit controller at work.

Recalculation and reperformance. For example, ensuring that the aged receivables analysis seems to be accurate.

Even when internal control systems are very good, the auditor will always carry out tests on the *figures* in the FS. The work has to address all the assertions made by each material figure. For example, valuation, completeness, existence etc. These tests are substantive tests and consist of:

- Analytical procedures and
- Tests of detail.

So, staying with debtors, the auditor would calculate the debtors collection period. If this were not too large and broadly in line with previous periods, the auditor would have gained some evidence about valuation (ie most debts not very old).

Tests of detail would include:

- Writing to customers asking them to *confirm* the amount owed (existence and ownership).
- Tracing, by *inspection*, some sales invoices to the Dr side of customers' accounts (existence and ownership).
- *Observation/inspection* of amounts received after year end. This gives evidence about valuation because if a payment is received subsequently the debt was obviously not bad.
- *Recalculation* of bad debt provisions.

Substantive tests therefore include analytical procedures in addition to the four classes of audit procedures available for testing controls, so giving the well-known mnemonic AEIOU:

Analytical procedures

Enquiry and confirmation

Inspection

Observation

Recalculation and reperformance

Remember if the tests of control show that controls are now operating correctly, the auditor will have to increase the substantive tests. For example, if the client does little to assess customers' credit worthiness to ensure, as far as possible, that debts are recoverable, the auditor will have to do much more work on the receivables figure in the balance sheet to be satisfied that the amount is valued at a true and fair amount.