

AUDIT EVIDENCE

CHAPTER 7





CHAPTER 7 LEARNING OBJECTIVES

- 7-1 Contrast audit evidence with evidence used by other professions.
- 7-2 Identify the four audit evidence decisions that are needed to create an audit program.
- 7-3 Specify the characteristics that determine the persuasiveness of evidence.
- 7-4 Identify and apply the eight types of evidence used in auditing.
- 7-5 Know the types of analytical procedures and their purposes.
- 7-6 Compute common financial ratios.
- 7-7 Understand the purposes of audit documentation.
- 7-8 Prepare organized audit documentation.

OBJECTIVE 7-1
**Contrast audit evidence with evidence
used by other professions.**

NATURE OF EVIDENCE

Table 7-1 contrasts audit evidence with legal and scientific evidence.

TABLE 7-1 Characteristics of Evidence for a Scientific Experiment, Legal Case, and Audit of Financial Statements			
Basis of Comparison	Scientific Experiment Involving Testing a Medicine	Legal Case Involving an Accused Thief	Audit of Financial Statements
Use of the evidence	Determine effects of using the medicine	Decide guilt or innocence of accused	Determine whether statements are fairly presented
Nature of evidence used	Results of repeated experiments	Direct evidence and testimony by witnesses and parties involved	Various types of audit evidence generated by the auditor, third parties, and the client
Party or parties evaluating evidence	Scientist	Jury and judge	Auditor
Certainty of conclusions from evidence	Vary from uncertain to near certainty	Requires guilt beyond a reasonable doubt	High level of assurance
Nature of conclusions	Recommend or not recommend use of medicine	Innocence or guilt of party	Issue one of several alternative types of audit reports
Typical consequences of incorrect conclusions from evidence	Society uses ineffective or harmful medicine	Guilty party is not penalized or innocent party is found guilty	Statement users make incorrect decisions and auditor may be sued

OBJECTIVE 7-2

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



AUDIT EVIDENCE DECISIONS

The auditor must make **four major decisions** regarding what evidence to gather and how much to accumulate:

1. Which audit procedures to use?
2. What sample size to select for a given procedure?
3. Which items to select from the population?
4. When to perform the procedures?

An **audit program** includes all of the above information for a given audit.

OBJECTIVE 7-3

Specify the characteristics that determine the persuasiveness of evidence.



PERSUASIVENESS OF EVIDENCE

Audit standards require that the auditor accumulate sufficient appropriate evidence to support the opinion issued.

The two determinants of the persuasiveness of evidence are appropriateness and sufficiency.

Appropriateness of evidence depends on:

- **Relevance of evidence**
- **Reliability of evidence**

PERSUASIVENESS OF EVIDENCE (CONT.)

Relevance of evidence means that the evidence must pertain to or be relevant to the audit objective that is being tested.

Reliability of evidence refers to the degree to which evidence is believable or worthy of trust. Reliability depends on the following characteristics:

1. Independence of provider
2. Effectiveness of client's internal controls
3. Auditor's direct knowledge
4. Qualifications of individuals providing the information
5. Degree of objectivity
6. Timeliness

PERSUASIVENESS OF EVIDENCE (CONT.)

Sufficiency of evidence refers to the **quantity** of evidence obtained. The sample size that is considered sufficient is affected by two factors:

- The auditor's expectation of misstatements
- The effectiveness of the client's internal controls

Combined Effect—The **persuasiveness** of the evidence can be evaluated only after considering the combination of **appropriateness and sufficiency**.

In making decisions about audit evidence, both persuasiveness and cost must be considered. The relationships among **evidence decisions and persuasiveness** are illustrated in Table 7-2.

TABLE 7-2**Relationships Among Evidence Decisions and Persuasiveness**

Audit Evidence Decisions	Qualities Affecting Persuasiveness of Evidence
Audit procedures and timing	Appropriateness Relevance Reliability Independence of provider Effectiveness of internal controls Auditor's direct knowledge Qualifications of provider Objectivity of evidence Timeliness When procedures are performed Portion of period being audited
Sample size and items to select	Sufficiency Adequate sample size Selection of proper population items

OBJECTIVE 7-4
**Identify and apply the eight types of
evidence used in auditing.**



TYPES OF AUDIT EVIDENCE

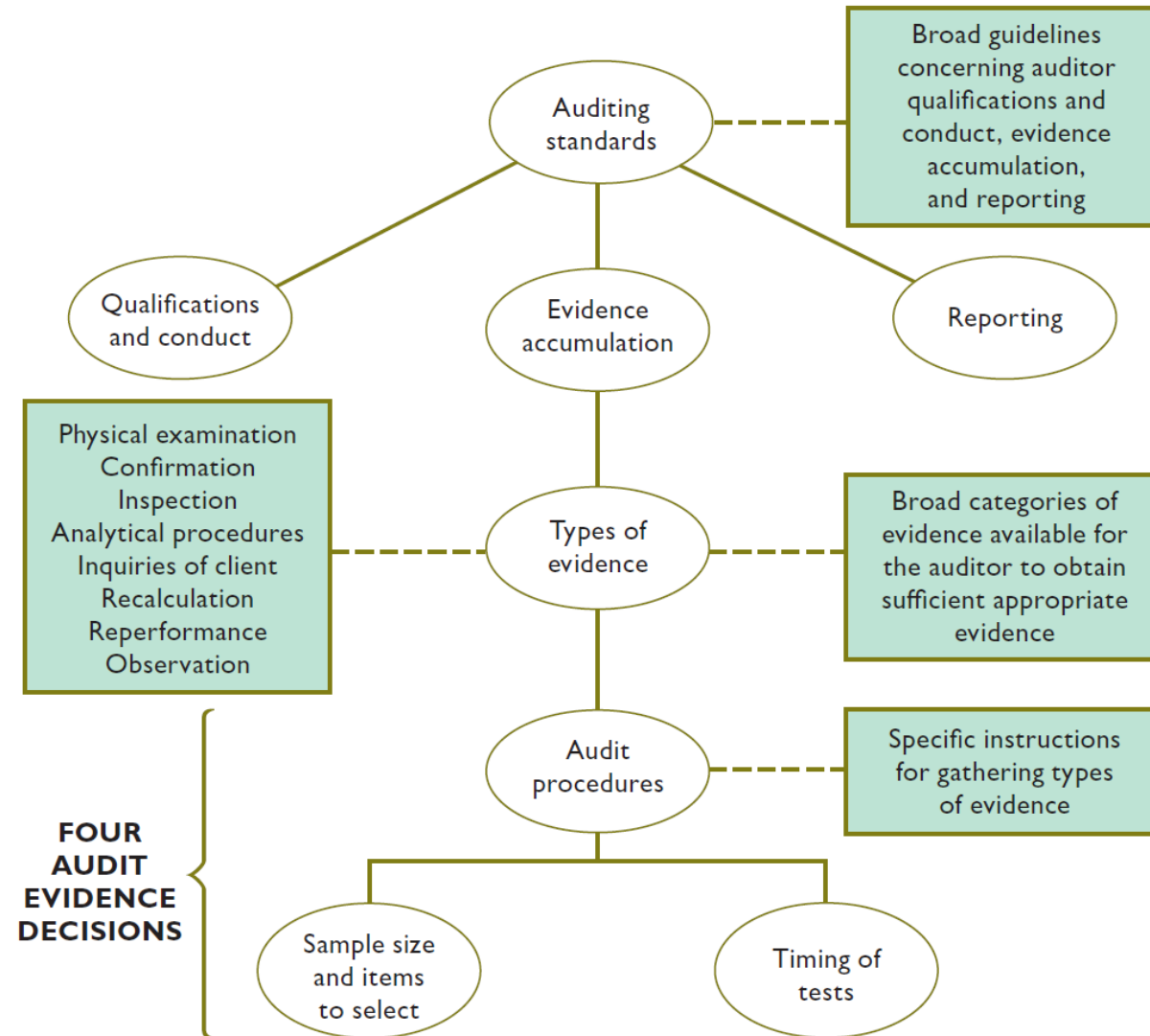
Every audit procedure obtains one or more of the following types of evidence:

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

Relationships among auditing standards, types of evidence, and the four audit evidence decisions are shown in Figure 7-1.

FIGURE 7-1

Relationships Among Auditing Standards, Types of Evidence, and the Four Audit Evidence Decisions



TYPES OF AUDIT EVIDENCE (CONT.)

1. **Physical Examination**—The inspection or count of a tangible asset by the auditor.
2. **Confirmation**—The receipt of a direct written response from a third party verifying the accuracy of information that was requested by the auditor. Information often confirmed is detailed in Table 7-3.
3. **Inspection**—The auditor's examination of the client's documents and records to substantiate the information in the financial statements.
 - Documents can be **internal** (prepared by the client's organization) or **external** (prepared or handled by someone outside the organization who is a party to the transaction).
 - Using documents to support recorded transactions (occurrence) is called **vouching**.
 - Testing from source documents to recorded amounts (completeness objective) is called **tracing**.

TABLE 7-3**Information Often Confirmed**

Information	Source
Assets	
Cash in bank	Bank
Marketable securities	Investment custodian
Accounts receivable	Customer
Notes receivable	Maker
Owned inventory out on consignment	Consignee
Inventory held in public warehouses	Public warehouse
Cash surrender value of life insurance	Insurance company
Liabilities	
Accounts payable	Creditor
Notes payable	Lender
Advances from customers	Customer
Mortgages payable	Mortgagor
Bonds payable	Bondholder
Owners' Equity	
Shares outstanding	Registrar and transfer agent
Other Information	
Insurance coverage	Insurance company
Contingent liabilities	Bank, lender, and client's legal counsel
Bond indenture agreements	Bondholder
Collateral held by creditors	Creditor

TYPES OF AUDIT EVIDENCE (CONT.)

4. **Analytical Procedures**—The evaluation of financial information through analysis of plausible relationships among financial and nonfinancial data and are required during planning and completion phases of all audits. Purposes of analytical procedures include:
- **Understand the Client's Industry and Business**—Used in planning to gain knowledge about the client.
 - **Assess the Entity's Ability to Continue as a Going Concern**—Many ratios can be an indicator of potential financial problems.
 - **Indicate the Presence of Possible Misstatements in the Financial Statements**—The presence of unusual fluctuations noted in comparing current and prior years could signal misstatements.
 - **Provide Evidence Supporting an Account Balance**—If reliable relationships exist, substantive analytical procedures can be used to support account balances.

TYPES OF AUDIT EVIDENCE (CONT.)

- 5. **Inquiry**—Obtaining written or oral information from the client in response to auditor questions. Usually not considered conclusive unless it is corroborated.
- 6. **Recalculation**—Rechecking a sample of calculations made by the client.
- 7. **Reperformance**—The auditor's test of client accounting procedures or controls.
- 8. **Observation**—Watching a process or procedure being performed by others.

TYPES OF AUDIT EVIDENCE (CONT.)

Appropriateness of Types of Evidence—Table 7-4 details the criteria to determine appropriateness. Conclusions from the criteria:

- **The effectiveness of a client's internal controls has significant influence on the reliability of most types of audit evidence, especially internal documentation and analytical procedures.**
- **Physical examination and recalculation involve the auditor's direct knowledge and are likely to be highly reliable.**
- **Inquiry alone is usually not sufficient to provide appropriate evidence to satisfy any audit objective.**

TABLE 7-4

Appropriateness of Types of Evidence

Type of Evidence	Criteria to Determine Appropriateness				
	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
Inspection	Varies—external documents more independent than internal documents	Varies	Low	Varies	High
Analytical procedures	High/low (auditor does/client responds)	Varies	Low	Normally high (auditor does/client responds)	Varies—depends on reliability of data
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 AUDIT EVIDENCE (CONT.)

Cost of Types of Evidence:

- **Most expensive:**
 - Physical examination
 - Confirmation
- **Moderately costly:**
 - Inspection
 - Analytical procedures
 - Reperformance
- **Least expensive:**
 - Observation
 - Inquiries of the client
 - Recalculation

Terms used in audit procedures are defined in Table 7-5.

TABLE 7-5

Terms, Audit Procedures, and Types of Evidence

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.	Inspection
<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.	Inspection
<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 one-month period and compare all totals with the general ledger.	Recalculation

Trace—An instruction normally associated with inspection 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 *trace* will also include a second instruction, such as *compare* or *recalculate*.

Trace a sample of sales transactions from sales invoices to the sales journal, and *compare* customer name, date, and the total dollar value of the sale.

Trace postings from the sales journal to the general ledger accounts.

Inspection
Reperformance

Compare—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 *compare* the unit selling price as stated on the invoice to the list of unit selling prices authorized by management.

Inspection

Count—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.

Count a sample of 100 inventory items and compare quantity and description to client's counts.

Physical examination

Observe—The act of observation should be associated with the type of evidence defined as observation.

Observe whether the two inventory count teams independently count and record inventory counts.

Observation

Inquire—The act of inquiry should be associated with the type of evidence defined as inquiry.

Inquire of management whether there is any obsolete inventory on hand at the balance sheet date.

Inquiries of client

Vouch—The use of documents to verify recorded transactions or amounts.

Vouch a sample of recorded acquisition transactions to vendors' invoices and receiving reports.

Inspection

OBJECTIVE 7-5
**Know the types of analytical procedures
and their purposes.**



ANALYTICAL PROCEDURES

Purposes of Analytical Procedures During the Audit Engagement:

1. Analytical procedures are required in the planning phase as part of risk assessment to understand the client's business and industry.
2. Analytical procedures are often done during the testing phase of the audit as substantive tests in support of an account balance.
3. Analytical procedures are required during the completion phase of the audit, serving as a final review for material misstatements.

ANALYTICAL PROCEDURES (CONT.)

Types of Analytical Procedures—Auditors compare client data with:

- 1. Industry data**
- 2. Similar prior-period data**
- 3. Client-determined expected results**
- 4. Auditor-determined expected results**

Internal comparisons and relationships are detailed in Table 7-6.

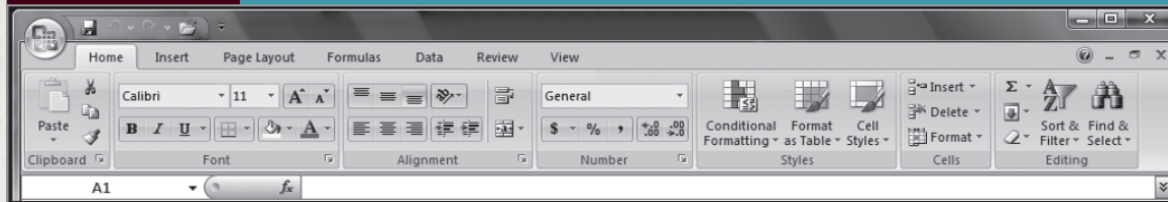
An example of a substantive analytical procedure is included in Figure 7-2.

TABLE 7-6**Internal Comparisons and Relationships**

Ratio or Comparison	Possible Misstatement
Raw material turnover for a manufacturing company	Misstatement of inventory or cost of goods sold or obsolescence of raw material inventory
Sales commissions divided by net sales	Misstatement of sales commissions
Sales returns and allowances divided by gross sales	Misclassified sales returns and allowances or unrecorded returns or allowances subsequent to year-end
Bad debt expense divided by net sales	Misstatement in the allowance for bad debts
Each of the individual manufacturing expenses as a percent of total manufacturing expense	Significant misstatement of individual expenses within a total

FIGURE 7-2

Hillsburg Hardware Overall Test of Interest Expense December 31, 2016



Hillsburg Hardware Co. Overall Test of Interest Expense 12/31/16

Schedule N-3 Date
Prepared by TM 3/06/17
Approved by JW 3/12/17

Expectation of recorded interest expense:

Short-term loans:

Month	Month end Balance ^①	Rate ^②
Jan.	\$ 5,900,000	5.50%
Feb.	6,368,000	5.50%
Mar.	6,824,000	5.75%
Apr.	7,536,000	5.75%
May	5,208,000	5.25%
June	3,748,000	5.50%
July	2,800,000	5.25%
Aug.	2,490,000	5.50%
Sept.	2,092,000	5.25%
Oct.	1,708,000	5.50%
Nov.	5,062,000	5.75%
Dec.	4,180,000	5.50%
Total	\$53,916,000	66.00%

Average Monthly Balance and Interest Rate (total ÷ 12)

\$ 4,493,000 5.50% \$ 247,115

Long-term loans:

Beginning balance	\$26,520,000 ^③		
Ending balance	24,120,000 ^④		
	\$50,640,000	8.50% ^⑤	
Average	\$25,320,000	8.50%	2,152,200
Auditor expectation of interest expense			2,399,315
Recorded interest expense per general ledger			2,408,642 ^④
Difference – over (under) expectation			\$ 9,327

Conclusion: Interest expense appears fairly stated as recorded amount is within 9,327 (.4%) of expected amount.

Tickmark Legend

- ① Monthly balances obtained from general ledger for each month.
- ② Estimated based on examination of several notes outstanding each month.
- ③ Agreed to prior year audit workpapers.
- ④ Agrees with December 31, 2016, general ledger and working trial balance.
- ⑤ Agrees with permanent file schedule of long-term debt.

OBJECTIVE 7-6
Compute common financial ratios.



COMMON FINANCIAL RATIOS

Financial ratios fall into several categories:

- **Short-Term Debt-Paying Ability:**
 - Cash ratio
 - Quick ratio
 - Current ratio
- **Liquidity Activity Ratios:**
 - Accounts receivable turnover
 - Days to collect receivables
 - Inventory turnover
 - Days to sell inventory

COMMON FINANCIAL RATIOS (CONT.)

- **Ability to Meet Long-Term Debt Obligations:**

- Debt to equity
- Times interest earned

- **Profitability Ratios:**

- Earnings per share
- Gross profit percentage
- Profit margin
- Return on assets
- Return on common equity

OBJECTIVE 7-8
Prepare organized audit documentation.



AUDIT DOCUMENTATION

Audit documentation is the record of the audit procedures performed, relevant audit evidence, and conclusions the auditor reached.

Purposes of Audit Documentation:

- Basis for planning the audit
- Record of the evidence accumulated and the results of the tests
- Data for determining the proper type of audit report
- Basis for review by supervisors and partners