

Audit Evidence

What do mean by the Audit Evidence?

Sri Lanka auditing Standard 500 provides the definition of the audit evidence as “ all the information used by auditors in arriving at the conclusions on which the audit opinion is based, and inclusive the information contained in the accounting records underlying the financial statements and other information gather by the auditors such as previous audits (Permanent and previous current audit files) , confirmation from third parties, audit firm quality control procedure for client acceptance and continuation ”

What do mean by sufficient and appropriate audit evidence?

Sufficient and appropriate have two different meaning in terms of gathering audit evidences and such meaning are given below;

a. Sufficiency of Audit Evidence

Sufficiency is mainly related to the quantity and it measures quantity of audit evidence. The quantity of audit evidence needed is affected by the risk of misstatement. Example; the greater the risk, the more audit evidence is likely to be necessary.

b. Appropriateness of Audit Evidence

Appropriateness of audit evidence is the measure of the quality of audit evidence, that is, its relevance and reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, estimates, other account balances, and disclosures, and related assertions. When the quality of such evidence is higher, the less audit evidence may be necessary.

Accordingly, the sufficiency and appropriateness of audit evidence are interrelated and apply to both tests of controls and substantive procedures. However, merely obtaining more audit evidence may not compensate for its poor quality.

What are the factors affecting the reliability of audit evidence?

The following factors affect the reliability of audit evidence;

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

What are the types of methods that the auditor can use to collect audit evidences?

In deciding which audit procedure to use, the auditor may choose from several different types of audit evidences, and those are explained below;

1. Physical Examination/Observation

The observation is that the auditor looks at a procedure or process being performed by others. This method is mostly related to **stock verification, cash counting, and verification of tangible fixed assets, observation of internal control system to decide effective application of such control**. However, there is limitation in this method, as it only confirms the procedure or process take place when the auditor was looking at.

2. Inquiry

Inquiry consists of seeking information of knowledgeable persons both financial and nonfinancial, within the entity or outside the entity. Inquiry is an audit procedure that is used widely throughout the audit and frequently is matching to performing other audit procedures.

Example

- Management Representation on Related Party Transactions
- Inquiry on fraud or theft happened during the year
- New changes in internal control environment
- Gather information to understand the revenue growth, new investments, loans taken etc

3. Inspection of Records/Documents

Inspection consists of examining records or documents, from internal or external, in paper form, electronic form, or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source.

Examples

- Inspection of lease agreement to check the terms and condition of the lease facility
- Inspection of Sales invoice to ensure that the accuracy of amount and the customer
- Inspection of bank statement to ensure the accuracy of the bank balances in the cash book, and bank reconciliation.
- Check the title deed of land, building to ensure the ownership of such assets

4. Recalculation

Recalculation is the checking the arithmetic accuracy of source documents such as sales invoice, bank reconciliation etc, and accounting records. This method is very reliable source of obtaining audit evidences, as the auditor himself performs the required calculation to check the accuracy.

Examples

- Calculate the inventory value based on its cost or Net realizable value whichever is lower
- Calculate the loan interest based on the bank's offer letter
- Calculate the applicable depreciation based on the accounting policy for calculation of depreciation.
- Recalculation Fixed Deposit Interest receivable based on the interest rate given in the Fixed Deposit certificate.

5. Re-performance

This is the method that the auditor independently tests client's accounting procedure or controls that were originally done as part of the entity's accounting and internal control systems. The audit evidence collected from this method is highly reliable as the auditor himself perform the procedure.

Examples

- Re-performance of the ageing of accounts receivable or payables
- Preparing bank reconciliation
- Re-performing the reconciliation between the individual creditors accounts with creditor statements.
- Reconciliation of debtors control account with debtor sub-ledger

6. External Confirmation

Under this method, the audit evidence is obtained by way of direct written response directly addressed to the auditor from third party. These are highly believable as these come from independent third party.

Examples

- Debtor/Creditor Confirmation
- Bank confirmation for Current account, Fixed Deposits, Saving Accounts, Loan, lease etc.
- Confirmation of inventory held by third parties.
- Confirmation from Legal adviser

7. Analytical Procedures

This procedure is the comparison of account balances and relationships and this is used to analysis both financial and nonfinancial data. Analytical procedure is required during the planning and completion phases of the audit. Analytical procedure may be used for the following purposes;

- Better understanding of the client's industry and business
- Assess the client's ability to continue as going concern (Example, abnormal losses in past year is an indication that it will have an impact on the business continuation)
- To understand, if any, abnormal fluctuation in figures in Financial statements
- To reduce the need for detailed audit

Example

- Check the actual verses Budgeted and identify any abnormal variances
- Check the ratios in both financial years such GP, NP, debtor's collection/creditor payment period, stock turn over ratio, stock resident period, gearing ratio etc.
- Check the current year Financial Statements with Prior Year Financial Statements and calculate the variance to identify the abnormal variances or trend.

What are the evidence created by the auditor?

The evidence created by auditor is more reliable as the auditor himself calculates or performs to gather audit evidence. Further, there is little risk that the evidence can be manipulated by the management

Examples of such audit evidences are given below;

- Analytical procedure such as calculation of trend or variances, ratios to enable the auditor to check the reasons for abnormal fluctuations.
- Physical observations or inspections, such as observing physical stock counting, cash counting, process and procedure in the Internal control, production process, documents flow etc.
- Re-performance of calculation of the figures given in the financial statements such as depreciation, provision for doubtful debts, income tax liability, differed tax, Interest income, interest payments, closing stock value etc.

What are the audit evidence created by third parties?

Third party evidence is more reliable when compared to the evidence created or produced by management as it will be taken from independent sources. However, the reliability will be reduced, if the evidence is collected from source that is not independent, and there is possibility that the client may be possibility to manipulate the evidences collected from such sources.

The examples of the evidences created by the third party are given below;

- Confirmation received from debtors, creditor.
- Confirmation received from bank for loans, lease, fixed deposit, saving accounts, current account balances

- Report produced by expert such as property valuers, legal advisors. In evaluating these evidences, the auditor should check the expert's qualifications, independence, and terms of the reference for the work with the client.
- Documents held by the client which were issued by third parties, such as invoices, price list, credit statements, bank statements, loan/lease agreement prepared by the bank etc.

What the audit evidence created by the Management?

The auditors cannot trace for same degree of reliance on evidence produced by client management as on that produced outside the company. However, it will often be necessary to place some reliance on such evidence. The auditor will need to obtain audit evidence that the information supplied is complete and accurate, and apply judgment in doing so, taking into account previous experience of the client's reliability and extent to which the client's representations appear compatibles with other audit findings, as well as the materiality of the items under discussions.

Example

- The company's accounting records such as ledgers, subsidiary ledgers, journals, supporting schedules etc., supporting documents such as invoices, Good received notes, copy of dispatch Note, gate pass, payment vouchers, petty cash vouchers, deposit slips, stores requisition, stores issue note, debit/credit notes, etc., all journals such as sales, purchase. Although these are prepared by the management, the auditors have a statutory right to examine such records in full, and this right enhances the quality of the information.
- Board minutes, senior manager's meeting minutes, audit committee & related party meeting minutes, agreements etc.
- Budgets, monthly accounts, variances reports prepared in comparison with budget and the actuals, bank reconciliations, debtors age analysis, stock age analysis, income tax & other taxes computation with respective returns.
- Information provided to the auditor about the internal control systems. The auditors need to check whether this information is accurate and up-to-date.

Theoretical and Practical Questions from Audit Evidences

- 1. XYZ has revalued its land and buildings by a professional valuer appointed by the company, and however, it was noted that the current valuation is significantly higher than the book value appearing in last year.**

List matters that the auditor should consider in assessing the appropriateness of the professional value's valuation as audit evidence

- The relevant and reasonableness of conclusion of the valuation
 - Check the reasonableness and appropriateness of assumption used in arriving the valuation.
 - If valuer has used any data or information, it relevant, completeness, and accuracy of such data or information used for the valuation
 - Profession qualification and experience of valuer
- 2. Sarath is senior in charge of the auditing the financial statement of ABC Company (Pvt) Limited for the year ended 31/03/2017, and the manager instructed him to audit the addition of the Property, Plant & Equipment during the financial year, as such addition was material to the financial statements.**

Explain the audit procedure that Sarath should perform to verify the existence of Property, Plant, & Equipment

The audit evidence should be related to the existence of PPE addition during the year, and the following should be performed to verify the existence.

- Physically verification of the additions
 - Check the addition to the fixed assets register
 - Check the board approval, purchase order, and related documents for purchases such as invoice etc.
 - Check the depreciation for PPE
 - Check maintenance agreement signed with third parties
 - Check the supporting documents for the payment for repairs and maintenance
- 3. "Third party confirmation is one of external evidences obtained by external audit on account balances and transaction"**
 - a) State Four (04) instances that the auditor uses external confirmation**

The following are the instances where auditor uses external confirmation as audit evidence;

 - Bank Confirmation for current account, savings balances, loans & lease outstanding normally at year end

- Debtors' Confirmation for trade receivables
- Creditors' Confirmation for trade payables
- Confirmation for deeds or any assets mortgage with the banks
- Confirmation for the bank guarantees given by the bank.
- Confirmation for the Stocks held by third parties or in bonded warehouse outside the premises
- Confirmation for the Deeds or any other valuable documents held by lawyers as custodian
- Confirmation from the company's lawyers for the status of legal cases against the company

b) Identify the factors that might indicate doubts about the reliability of the response to an external confirmation request sent by the auditor.

The factors that might indicate the doubt of reliability of the external confirmation are as follows,

- ✓ If confirmation was received indirectly via client
- ✓ If confirmations was received from the place where the address is not match with the address with the client
- ✓ If Confirmation was received from third party on behalf intended party
- ✓ If Confirmation was received via email as an attachment
- ✓ Any confirmation was received with alterations

4. Prasanna is the senior in charge for the audit of Aralia Limited for the year ended 31/03/2017, and identified that the company has given 60 days credit for their debtors. He further noted that the board of directors has approved the annual budget including the Capital expenditure. The followings are the audit findings;

- a) Prasanna selected 20% of debtors out of 100 debtors to call for confirmation on the balances outstanding as at 31/03/2017, and however, there were 5 debtors confirmed the balances which were not tallied with the balances appearing in the accounts.
- b) Though additions of Property, Plant, and Equipment were approved by the board of directors, the approval of machinery purchase value of Rs.100 Million was not available for the auditor's perusal.
- c) Physical verification of PPE has not been carried out the company during the financial year

Identified additional audit procedures to obtain adequate audit evidences in respect of the above findings

Answer

a) Debtor Balance

- Check the subsequent settlements made by the debtors
- Check the dispatch notes accepted by the debtor
- Check the gate pass

- Check the age analysis
 - Check the copy of the invoices related to the balances
- b) Machinery Purchase during year
- Check the board approval
 - Check the supporting documents for the addition such as invoice received from the supplier to ensure the ownership of the machinery
 - Physical verification of machinery
- c) Physical verification of PPE
- Select a sample of fixed asset and physically verify and check with fixed asset register.
 - Check the supporting documents such as deeds, supplier invoices, insurance policies, registration & licenses for vehicles etc. for ownership.
 - Check the payment vouchers and its approval for repairs and maintenance for PPE
 - Vouching of addition of PPE with supporting documents such as board approval, payment vouchers, supplier invoices etc.
 - Check the depreciation of PPE
 - Check the revaluation of PPE, if any.

5. How to check the accuracy of valuation of raw materials at the year end?

- Select a sample of purchase order/Suppliers' invoices and check with the system and ensure that the price and quantities are correctly updated in the system.
- Check the physical verification of raw material and ensure that those stocks have been updated in the systems and taken for the valuation
- Auditor should recalculate the weighted average and cross check with value given in the valuation sheet.
- Check and make sure that damage and obsolete raw material were excluded in valuing the raw material stocks at the year end.

6. State analytical procedures that can be followed to obtain audit evidences on inventories

- Calculate the stock turn over ratio between the current year and the prior year and see any significant variances and look for reasons for such variances
- Calculate the stock resident period between the current year and prior year and check for the reasons for any significant differences observed
- Calculate the inventory values between the current year and the prior year and check the reasons for significant variance between the two values

7. Explain the audit procedure to check the valuation assertion of closing inventories?

- Check the physical verification sheet with the system and ensure that the system stocks were updated with the physically verified quantities and adjusted stock quantities were used for valuation.
- Check and ensure that the closing stocks have been valued at cost or net realisable value whichever is lower
- Obtain age analysis of stocks and ensure that adequate provisions are made for slow moving and obsolete stocks.
- Obtain the list of damaged and obsolete stock list and ensure that those stocks have been excluded from the valuation of stocks.

8. The senior in charge of the auditor has identified the following balances are unusual, and the manager in charge of the audit, has advised the senior to obtain audit evidences under the assertions identified in the table given below;

Transaction/Balance	Assertion
Sales	Cut-off
Accounts Receivable	Right and Obligation
Accounts Payables	Existence
Marketing Expense	Occurrence
Lands and Buildings	Existence

You are required to identify the audit evidences under each of the assertions given above

Answer

Transaction/Balance	Assertion	Audit Evidence/Procedure
Sales	Cut-off	Check last 3 invoices in current year and first 3 invoices in subsequent year. Purpose is to make sure that the sales have been recorded in the correct financial period.
Accounts Receivable	Right and Obligation	Check the evidence that sold items were owned by the company. Need to ensure that invoices, dispatch notes etc. properly addressed to the debtors included in the account receivables.

Accounts Payables	Existence	Check and ensure that the supplier invoice is in the name of the company and GRN was raised for that supply.
Marketing Expense	Occurrence	Checking the supporting documents such as payment vouchers, its approval, invoices received for such marketing expenses, bank statements for the payments etc.
Lands and Buildings	Existence	Check the deeds, physical verification, provision for depreciation, vouching of expenditure incurred in respect of maintaining the building etc.

