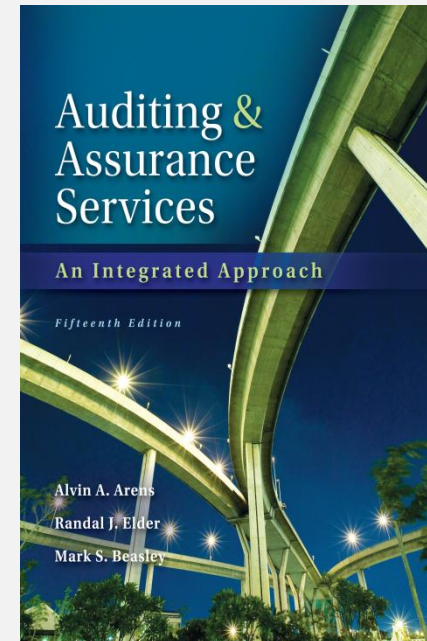


Audit Evidence

Chapter 7



Learning Objectives

- 1 Contrast audit evidence with evidence used by other professions.
- 2 Identify the four audit evidence decisions that are needed to create an audit program.
- 3 Specify the characteristics that determine the persuasiveness of evidence.
- 4 Identify and apply the eight types of evidence used in auditing.

Learning Objectives

- ⑤ Understand the purposes of audit documentation.
- ⑥ Prepare organized audit documentation.
- ⑦ Describe how technology affects audit evidence and audit documentation.



Contrast audit evidence with
evidence used by other
professions.

Nature of Evidence

- Any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria
- The use of evidence is not unique to auditors
- Evidence is also used by scientists, lawyers, and historians

Nature of 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

2

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

Audit Evidence Decisions

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 (timing)



Audit Program

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

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

Many auditors use audit software packages to generate audit programs.



Specify the characteristics that determine the persuasiveness of evidence.

Persuasiveness of Evidence

Two determinants:



Appropriateness

Sufficiency

The persuasiveness of evidence can be evaluated only after considering the combination of appropriateness and sufficiency

Six Characteristics of Reliable Evidence

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

Relationships Among Evidence Decisions and Persuasiveness

Audit Evidence Decisions	Qualities Affecting Persuasiveness of Evidence
Audit procedures and timing	<ul style="list-style-type: none">Appropriateness<ul style="list-style-type: none">RelevanceReliability<ul style="list-style-type: none">Independence of providerEffectiveness of internal controlsAuditor's direct knowledgeQualifications of providerObjectivity of evidenceTimeliness<ul style="list-style-type: none">When procedures are performedPortion of period being audited
Sample size and items to select	<ul style="list-style-type: none">Sufficiency<ul style="list-style-type: none">Adequate sample sizeSelection of proper population items

Persuasiveness and Cost

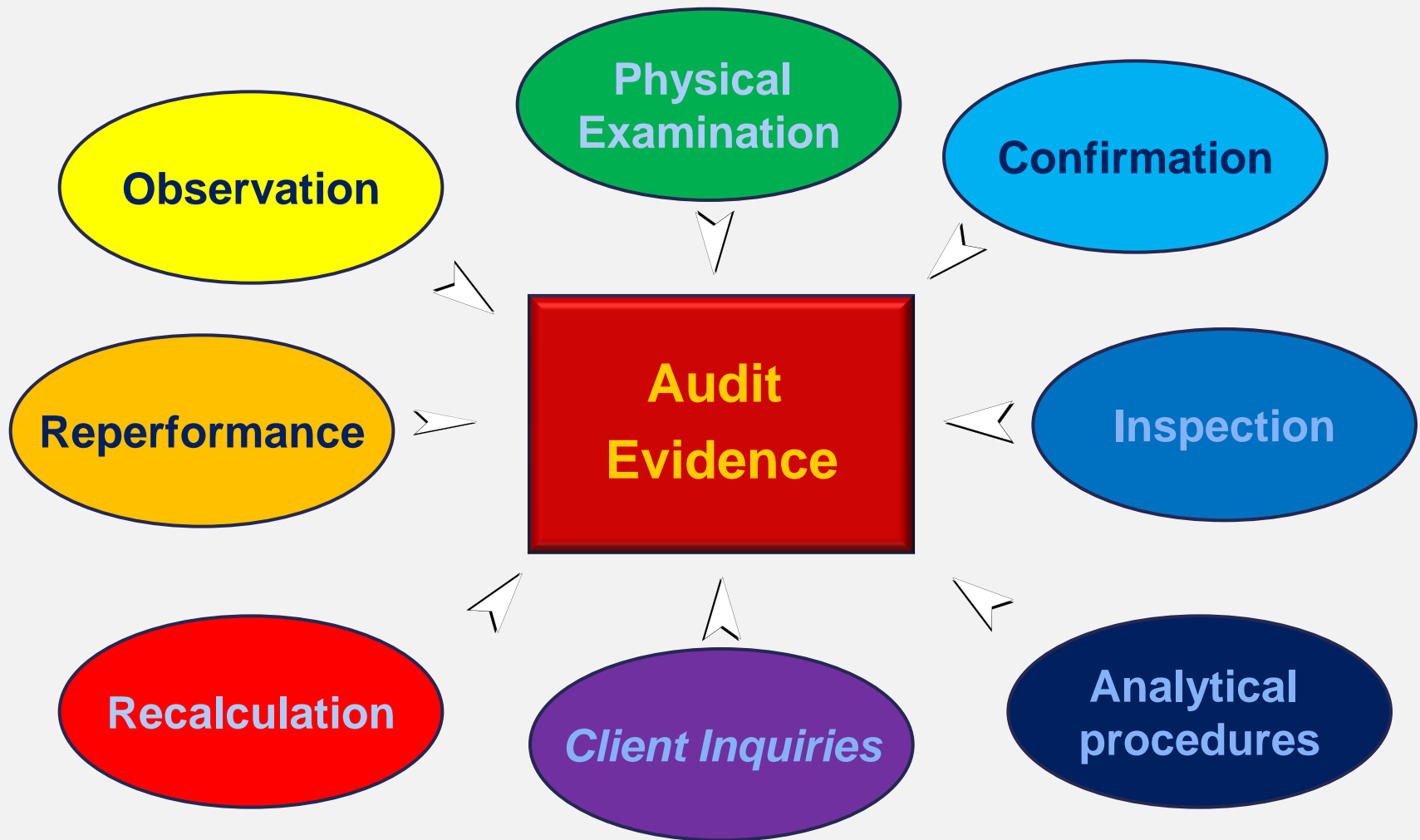
In making decisions about evidence for a given audit, both persuasiveness and cost must be considered.

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



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

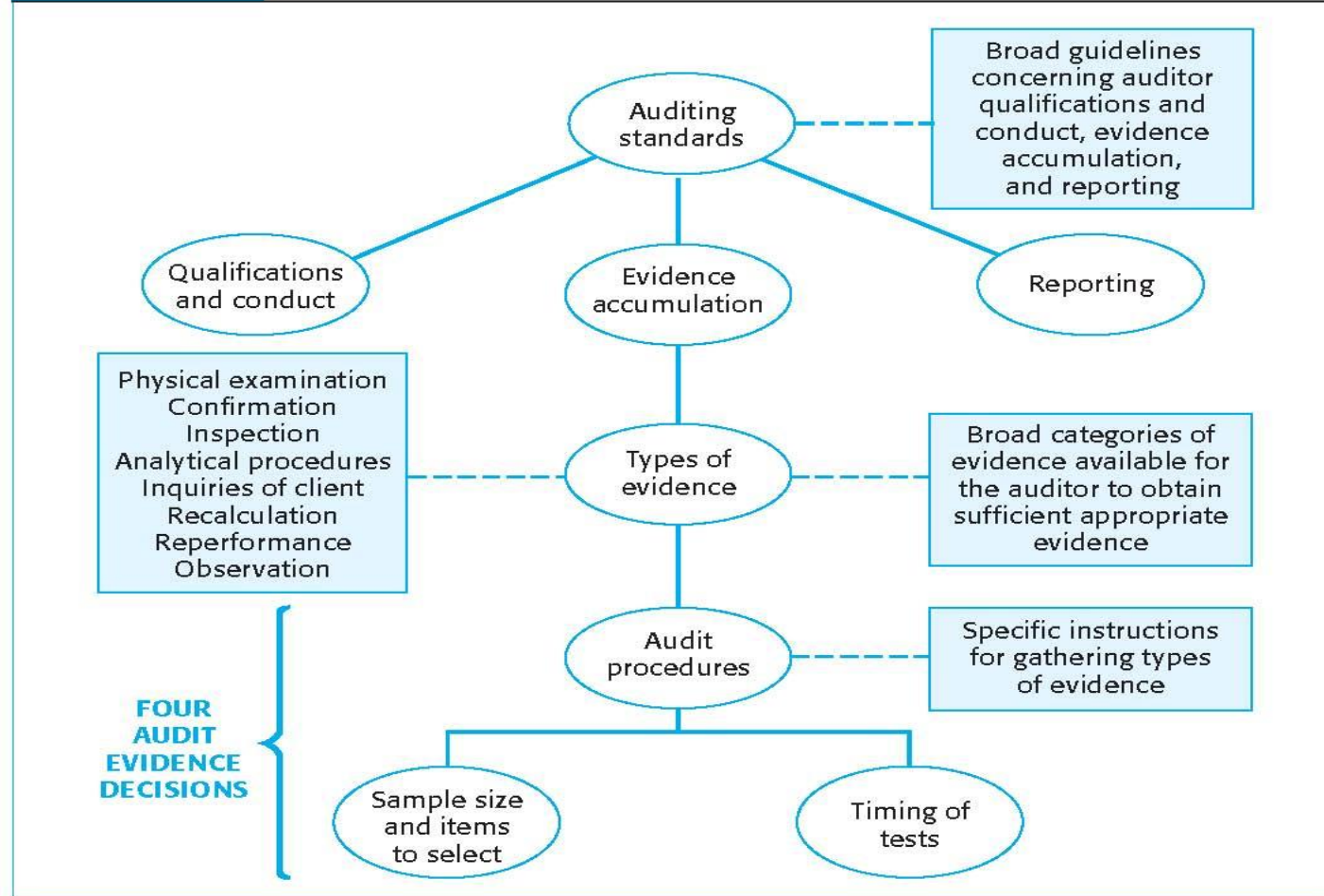
Types of Audit Evidence



Relationships

FIGURE 7-1

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



Physical Examination

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.

Confirmations

Auditing Standards

Requirements

United States

- Auditor must confirm accounts receivable
- Auditors control the mailing and receipt of replies
- Electronic confirmations are permitted

International

- Confirmations are not required

Information often Confirmed

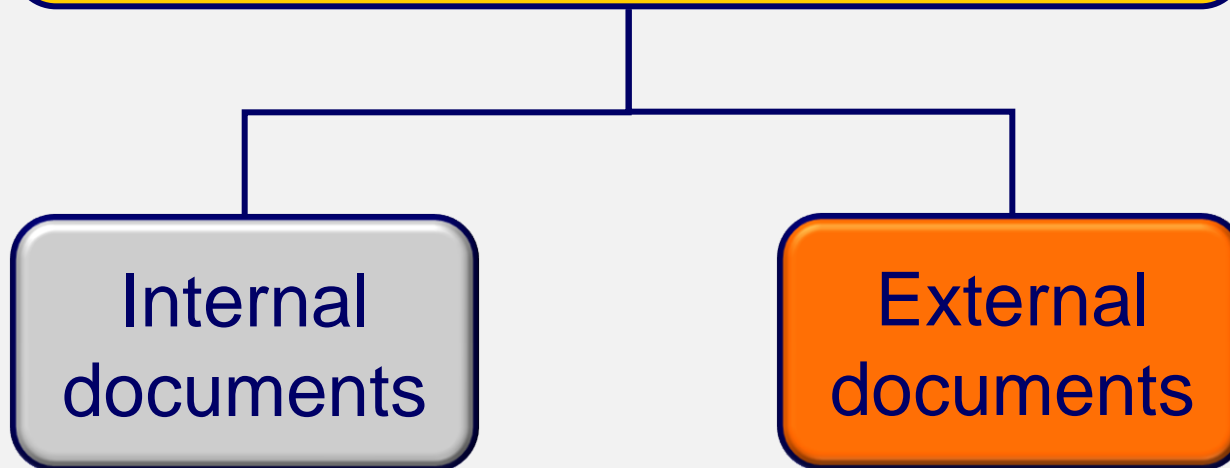
TABLE 7-3

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

Inspection

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



Analytical Procedures

- Understand the client's industry and business
- Assess the entity's ability to continue as a going concern
- Indicate the presence of possible misstatements in the financial statements
- Reduce detailed audit tests

Inquiries of the Client

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

Recalculation

Involves rechecking a sample of calculations made by the client.

Reperformance

The auditor's independent tests of client accounting procedures or controls that were originally done as part of the entity's accounting and internal control system.

Observation

- Use one's senses to assess client activities.
- Tour plant to obtain a general impression of client's facilities.
- Observation is rarely sufficient by itself.
- Often need to corroborate with another kind of evidence.



Appropriateness of Types of Evidence

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—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

Application of Types of evidence to the three Evidence Decisions

TABLE 7-5

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	Observe 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
Inspection	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

*Balance-related audit objective: Inventory quantities on the client's perpetual records agree with items physically on hand.

Terms and Types of Evidence

Terms

Examine
Scan
Read
Compute
Recompute
Foot
Trace
Compare
Count
Observe
Inquire
Vouch

Type of Evidence

Inspection
Analytical procedures
Inspection
Analytical procedures
Recalculation
Recalculation
Inspection/Reperformance
Inspection
Physical examination
Observation
Inquiries of client
Inspection



Understand the purposes of audit documentation.

Audit Documentation

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

Audit Documentation

- Purposes of audit documentation
- Ownership of audit files
- Confidentiality of audit files
- Requirements for Retention of audit Documentation

Sarbanes-Oxley Act

The Sarbanes-Oxley Act requires auditors of public companies to prepare and maintain audit working papers for a period of not less than seven years.



Prepare organized audit documentation.

Audit File Contents and Organization

FIGURE 7-2

Audit File Contents and Organization



- Financial Statements and Audit Report
- Working Trial Balance
- Adjusting Journal Entries
- Contingent Liabilities
- Operations
- Liabilities and Equity
- Assets
- Analytical Procedures
- Tests of Controls & Substantive TOT
- Internal Control
- General Information
- Audit Programs
- Permanent Files

Permanent Files

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

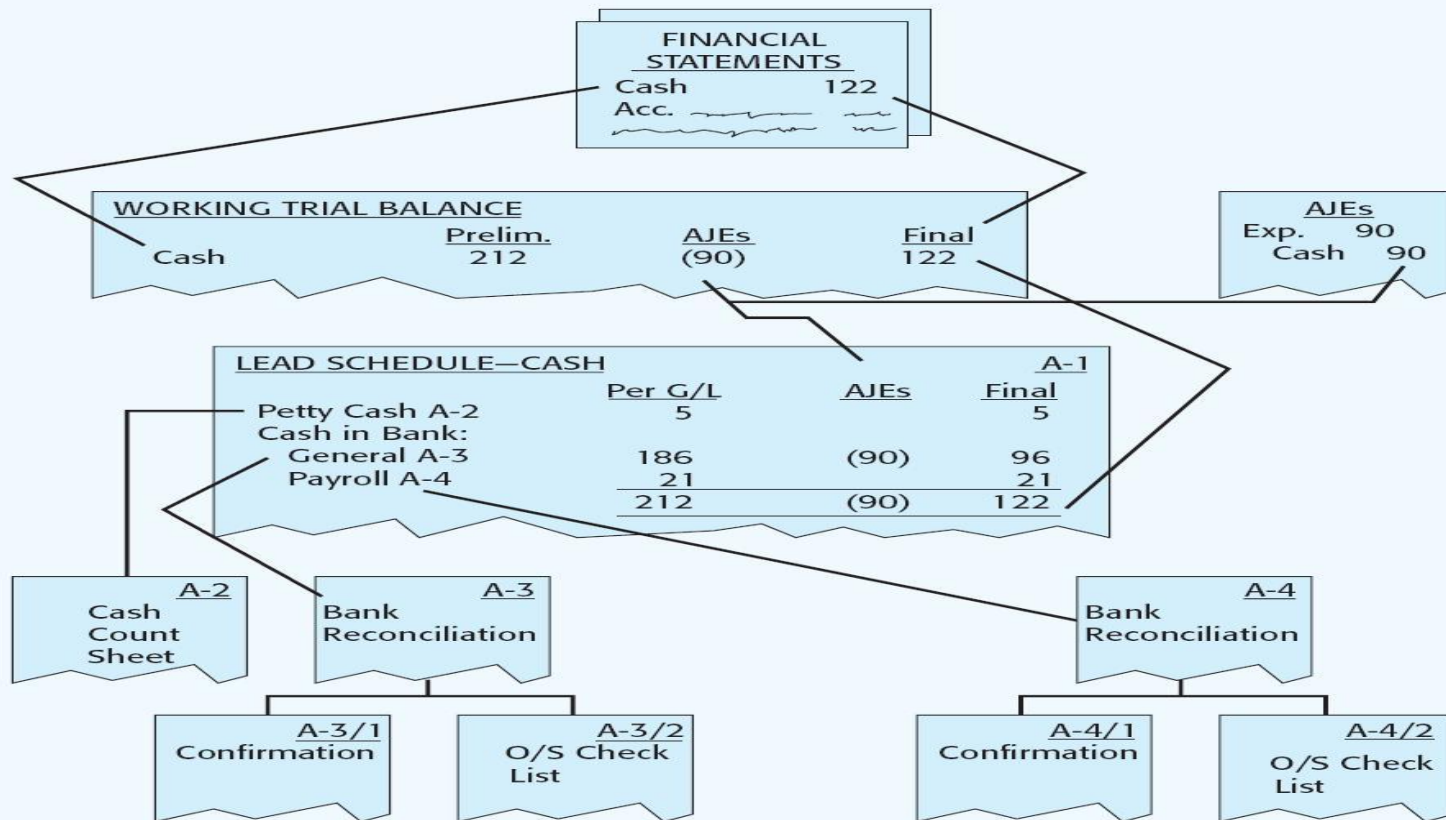
Current Files

- Audit program
- General information
- Working trial balance
- Adjusting and reclassification entries
- Supporting schedules

Relationship of Audit Documentation to Financial Statements

FIGURE 7-3

Relationship of Audit Documentation to 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

- Proper identification of each file
- Files indexed and cross-referenced
- Clear indication of work performed
- Include sufficient information
- State conclusions reached

Preparation of Audit Documentation

FIGURE 7-4

Common Characteristics of Proper Audit Documentation

Client name → Renaldo Machine Co. **Schedule:** C-1 ← **Audit file reference**

Audit area → Notes Receivable—Customers **Preparer:** J.B. ← **Initials of preparer**

Balance sheet date → 11/30/13 **Date:** 12/23/13 ← **Date prepared**

Customer's Name	Interest Rate (percent)	Issue Date	Maturity Date		Face Amount 11-30-13		Accrued Interest 11-30-13	
Graham Metal Works	6.0	10/04/13	12/03/13	x	300,000	p	2,850.00	@
Lopez Hardware Co.	7.0	11/15/13	01/07/14	x	178,000	p	519.17	@
Boise Hinge	5.5	10/09/13	12/08/13	x	400,000	p	3,177.78	@
Eastam Mfg. Co.	7.5	11/10/13	01/02/14	x	144,000	p	600.00	@
Toledo Fabricators	7.0	11/20/13	01/12/14	x	250,000	p	486.11	@
Manor Appliance Co.	6.5	10/21/13	12/20/13	x	112,000	p	808.89	@
Commercial Copper	6.0	10/30/13	12/29/13	x	340,000	p	1,756.67	@
					1,724,000		10,198.62	

Tick mark symbols

- x** Agreed face amount, interest rate, issue and maturity dates to note receivable document.
- P** Positive confirmation received. No exceptions noted in face amount, issue and maturity dates, interest rate, and accrued interest (w/p C-2).
- @** Recalculated accrued interest. No exceptions noted.
- f** Footed.
- t/b** Traced and agreed to trial balance.

Cross-reference to general ledger trial balance → **f, t/b** → **f, t/b**

Explanation of audit procedures performed

Conclusion: Notes receivable balance at 11/30/13 appears fairly stated. The collectibility of all notes was discussed with the controller. Per our conversation, all appear to be collectible. In my opinion, no loss provision is necessary. J.B. ← **Auditor's conclusion**



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