

Principles of Auditing: An Introduction to International Standards on Auditing

Chapter 10 – Audit Evidence

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Audit procedures for gathering evidence

- Evidence-gathering techniques are techniques employed by an auditor to obtain evidence.
- Evidence-gathering techniques are:
 - **Inquiry**
 - **Observation**
 - **Inspection (physical evidence and examination of documents)**
 - **Recalculation**
 - **Re-performance**
 - **Confirmation**
 - **Analytical procedures.**

Inquiry

Inquiry consists of seeking information of knowledgeable persons inside (client) or outside the entity.

It cannot be regarded as conclusive because it is not from an independent source and might be biased in the client's favour.

The auditor must gather evidence to corroborate inquiry evidence by other alternative procedures.

Inquiry (Continued)

Famous court case of Escott *et al.* vs. BarChris Const. Corp. 1968, wherein the court ruled against the auditor because he did not seek supporting evidence related to inquiries made with management. The court stated he was, 'too easily satisfied with glib answers to his inquiries.'

Observation

- **Observation** consists of looking at a process or procedure being performed by others.
- For example, the observation by the auditor of the counting of inventories by the entity's personnel or by the performance of internal control procedures that leave no audit trail.
- **Observation** should be supported by other types of evidence.

Count of physical inventory

ISA 501 ‘When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting.’

Alternative inventory procedures

If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and, when necessary, perform tests of controls of intervening transactions.

- An example is inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

Inspection

Inspection consists of examining records or documents, or tangible assets.

Examples of evidence gathering by inspection techniques is the review by an auditor of sales orders, sales invoices, shipping documents, bank statements, electronic records (via CAATs), mechanical inspection of assets, etc.

Internal documents and external documents

- Internal documents processed under good internal controls are more reliable than those processed under weak controls.
- External documents may be processed by both internal and external parties representing agreement.
- External documents like title to property, insurance policies and contracts are very reliable evidence.

Vouching and tracing

- **Vouching** is the use of documentation to support recorded transactions or amounts. It is an audit process whereby the auditor selects sample items from an account and goes backward through the accounting system to find the source documentation that supports the item selected.
- **Tracing** is an audit procedure whereby the auditor selects sample items from basic source documents and proceeds forward through the accounting system to find the final recording of the transactions (e.g. in the ledger).

Recalculation and re-performance

Recalculation consists of checking the mathematical accuracy of source documents and accounting records or of performing independent calculations.

Re-performance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or through the use of CAATs.

Recalculation

Examples:

- Extending sales invoices
- Adding journals and subsidiary records
- Checking calculations of depreciation
- Checking mechanical accuracy of records and ledgers.

Confirmation

- An auditor may use a confirmation in response to a significant risk.
- The auditor must ordinarily **confirm accounts receivable**.
- Written confirmations received from third parties are highly persuasive, but very costly and an inconvenience for those who are asked to supply them.

External confirmation

- **Defined:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

Four key characteristics:

1. Information is requested by client auditor.
2. Request and response is in writing, sent to the auditor.
3. Response comes from an independent third party.
4. Positive confirmation involves a receipt of information.

- **Positive confirmation:** A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
 - Reliable evidence
- **Negative confirmation:** A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
 - Use for large number small balances, low control risk, response is expected.

Reliability of procedures

A list of the **most reliable** to the **least reliable** evidence gathering techniques are in general:

1. **Recalculation**
2. Inspection
3. Re-performance
4. Observation
5. Confirmation
6. Analytical procedures
7. **Inquiry**

Cost of procedures

- The auditor considers the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. The evidence-gathering procedures in order of cost from **most costly** to **least costly** are in general:
 1. **Confirmation**
 2. Inspection
 3. Recalculation
 4. Re-performance
 5. Observation
 6. Analytical procedures
 7. **Inquiry**

Audit sampling objective

The objective of the auditor, when using audit sampling, is to provide a reasonable basis for drawing conclusions about the population (e.g. invoices, shipping documents, and other original source material) from which the sample is selected.

Audit sampling

Audit sampling (sampling) is the application of audit procedures to less than 100% of items within a population of relevant items such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. Audit sampling can use either a statistical or a non-statistical approach.

Sampling risk

- Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.
- Sampling risk can lead to two types of erroneous conclusions:
 - For test of controls, controls are more effective than they actually are, or for test of details, that a material misstatement does not exist when in fact it does.
 - For test of controls, controls are less effective than they actually are, or with a test of details, material misstatement exists when in fact it does not.

Audit of estimates

- Some financial statement items cannot be measured precisely, but can only be estimated. These items are accounting estimates.
- An **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

Testing estimates

In order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates, the auditor must obtain an understanding of how management identifies accounting estimates that are needed and how these estimates are made.

The auditor must gain an understanding of the data on which they are based, including:

- the method and model used in making the accounting estimate;
- relevant controls;
- whether management has used an expert;
- the assumptions underlying the accounting estimates;
- whether there has been, or ought to have been, a change from the prior period in the methods for making the accounting estimates, and if so, why;
- whether and, if so, how management has assessed the effect of estimation uncertainty.

Written representations and documentation on audit of estimates

- The auditor must obtain written representations from management and those charged with governance, saying that they believe significant assumptions used in making their accounting estimates are reasonable.
- The auditor must include in the audit documentation the basis for the conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and indicators of possible management bias, if any.

Evaluation of misstatements identified during the audit

- The objective of the auditor is to evaluate the effect of identified misstatements on the audit; and the effect of **uncorrected misstatements** on the financial statements.
 - Uncorrected misstatements are misstatements that the auditor has accumulated during the audit and that have not been corrected.

Generally if misstatements are found, the auditor asks management to correct them.

- If management corrects the misstatements that were detected, the auditor must still perform additional audit procedures to determine whether misstatements remain.
- If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should take into account management's reasons for not making the corrections.

- The auditor must request a written representation from management and those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.
- In their workpaper documentation the auditor must include:
 - the amount below which misstatements would be regarded as clearly trivial;
 - all misstatements accumulated during the audit and whether they have been corrected;
 - the auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate and the basis for that conclusion.

Related parties

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operation decisions.

Related party transactions

A **related party transaction** is a transfer of resources or obligations between related parties, regardless of whether a price is charged.

International Accounting Standards (IAS 24) require disclosure of the nature and volume of transactions with related parties.

Risk-increasing circumstances involving related parties

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions.

Circumstances that may indicate unidentified related parties

During the course of the audit, the auditor needs to be alert for transactions that appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include:

- Transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
- Transactions which lack an apparent logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High-volume or significant transactions with certain customers or suppliers as compared with others.
- Unrecorded transactions such as the receipt or provision of management services at no charge.

Illustration 10.3 Circumstances That May Indicate Unidentified Related Parties

Procedures to identify related parties transactions

During the course of the audit, the auditor carries out procedures that may identify the existence of transactions with related parties. Examples include:

- Performing detailed tests of transactions and balances.
- Reviewing minutes of meetings of shareholders and directors.
- Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognised at or near the end of the reporting period.
- Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
- Reviewing investment transactions, for example purchase or sale of an equity interest in a joint venture to another entity.

Illustration 10.4 Procedures to Identify Related Parties' Transactions

Written representations by management

- A written statement by management is provided to the auditor to confirm certain matters or to support other audit evidence.
- ISA 580: The auditor shall request management to provide written representation it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework.

Written representations by management (Continued) (Management representations letter) Illustration 10.5

Is the written communication from the client's management to the auditor formalising statements that the client has made about matters that are pertinent to the audit and matters that are material to the financial statements.

The following illustrative letter includes written representations that are required by ISA 580 and other ISAs in effect for audits of financial statements. It is assumed in this illustration that the applicable financial reporting framework is International Financial Reporting Standards; the requirement of ISA 570 to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions. Representations by management will vary from one entity to another and from one period to the next.

(Entity's Letterhead)

To Auditor...

... (date)

Subject: Representation in connection with the financial statements 201X

Dear (addressee),

This representation letter is provided in connection with your audit of the financial statements 20XX of Company XYZ for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the financial position of XYZ as at December 31, 20XX and of the result for the year then ended in accordance with Part 9 of Book 2 of the Dutch Civil Code. We have made appropriate inquiries of management and officers of the entity with the relevant knowledge and experience, as we considered necessary and relevant for the purpose of appropriately informing ourselves. Accordingly, we confirm, to the best of our knowledge and belief, the following representations:

Illustration 10.5 Management Representation Letter

Financial Statements

- 1 We acknowledge our responsibility for the preparation and fair presentation of the financial statements and for the preparation of the management board report, both in accordance with Part 9 of Book 2 of the Dutch Civil Code. We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements including its fair presentation.
- 2 All transactions have been recorded in the accounting records and are reflected in the financial statements)
- 3 Significant assumptions used by us in making accounting estimates, including those measured at fair value and...(name of elements with accounting estimates), are reasonable.
- 4 All events subsequent to the date of the financial statements and for which Part 9 of Book 2 of the Dutch Civil Code requires adjustment or disclosure have been adjusted or disclosed.
- 5 The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.
- 6 [The auditor shall obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.] The restatement of the comparative information of 20XX-1 as a result of the adjustment of a material misstatement in the prior period financial statements has been appropriately recorded and disclosed in accordance with the requirements of Part 9 of Book 2 of the Dutch Civil Code.
- 7 [The auditor shall also obtain a specific written representation if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern.]The financial statement discloses all information of which we are aware that is deemed relevant for our assessment with respect to the entity's ability to continue as a going concern. This includes all relevant key events and circumstances, mitigating factors and our plans for future action. We intend to execute these plans and consider these to be feasible. We confirm that the attached schedule contains our plans for future action relevant to the entity's ability as a going concern, which is the base for our assessment that the entity will be able to continue as a going concern [overview of plans].

Illustration 10.5 Management Representation Letter (Continued)

Information Provided

8 We have provided you with:

- Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, supporting documentation and other matters including all minutes of the General Meetings, Supervisory Board/Audit Committee (or similar body) and the Board of Directors, namely those held on [Data], respectively, and when applicable, summaries of actions of meetings held after period end for which minutes have not yet been prepared, namely those held on [Date].
- Additional information that you have requested from us for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence as part of the audit of the financial statements.

Fraud and compliance with law and regulation

- 9 The term fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Fraud also includes misstatements resulting from misappropriation of assets, including pledging of assets without proper authorization. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in the financial statements to deceive financial statement users.
- 10 We acknowledge responsibility for the design and implementation of internal control to prevent and detect fraud.
- 11 We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Illustration 10.5 Management Representation Letter (Continued)

Fraud and compliance with law and regulation

- 12 We have disclosed to you all information in relation to suspected fraud, allegation of fraud or fraud affecting the entity involving:
- Management;
 - Employees who have significant roles in internal control; or
 - Others where the fraud could have a material effect on the financial statements.
- 13 We have disclosed to you all information in relation to any suspected fraud, allegations of fraud, or fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.
- 14 We have disclosed to you all known instances of non-compliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements.

Related parties.

- 15 We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
- 16 Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of Part 9 of Book 2 of the Dutch Civil Code.

Claims and litigations

- 17 We have disclosed to you all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements and have appropriately accounted for and/or disclosed these in the financial statements in accordance with Part 9 of Book 2 of the Dutch Civil Code. [Other representations which considers the auditor necessary.]

Illustration 10.5 Management Representation Letter (Continued)

Additional representation [if deemed relevant]

- 18 Presentation and disclosure of fair value measurements are in accordance with Part 9 of Book 2 of the Dutch Civil Code. The amounts disclosed represent our best estimate of fair value of assets and liabilities required to be disclosed by these standards. The measurement methods and significant assumptions used in determining fair value have been applied in a consistent way, are reasonable and such assumptions appropriately reflect our intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures.
- 19 We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.
- 20 We believe that the carrying amounts of all fixed assets will be recoverable.
- 21 Information regarding financial risks exposure and our financial risk management objectives and policies has been adequately disclosed in the financial statements.
- 22 The entity has economic title to all assets. There are no rights of distraint or mortgage rights on the entity's assets, except for those that are disclosed in [Note X] to the financial statements.
- 23 We have properly recorded or disclosed in the financial statements the capital stock repurchase options and agreements, and capital stock reserved for options, warrants, conversions and other requirements.
- 24 We have requested the legal advisors who perform services for us to provide you with all required information and have requested them to disclose to you any matters you may request in this respect.

Yours Sincerely,

Company XYZ

[Senior Executive Officer]

[Senior Financial Officer]

Optional cc: Audit Committee

Enclosure: Schedule of uncorrected financial statement misstatements

Illustration 10.5 Management Representation Letter (Continued)

Management representations letter contains

- Management's acknowledgement that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework.
- Management has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement.
- All transactions have been recorded and are reflected in the financial statements.
- The selection and application of accounting policies are appropriate.

Management representations letter contains (Continued)

- Matters such as the following, have been recognised, measured, presented or disclosed in accordance with the applicable financial accounting framework:
 - plans or intentions that may affect the carrying value or classification of assets and liabilities;
 - liabilities, both actual and contingent;
 - title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral;
 - aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

Thank you for your attention

Any Questions?