

Chapter 6—Audit Evidence, Audit Objectives, Audit Programs, and Working Papers

SAS 31 says there are 5 types of management assertions:

1—existence or occurrence

The auditor should determine:

Cutoff—all recorded transactions actually occurred during the accounting period

Validity—all recorded assets, liabilities, and equities are valid and are appropriately recorded on the balance sheet

2. completeness

The auditor will usually ascertain:

Completeness/cutoff—all transactions that occurred during the period have been recorded

Completeness—balances included in the balance sheet all appropriate assets, liabilities and equities

3. rights and obligations

Here the auditor usually tests ownership, the appropriateness of an entity's title to assets, and claims against clear title

4. valuation or allocation

The auditor will want to determine application of GAAP—balances are appropriately valued to reflect the appropriate application of GAAP with respect to gross valuation and interperiod allocation of amounts.

Posting and summarization—transactions are properly posted and summarized in the journals and ledgers

5. presentation and disclosure

The auditor will determine the following:

Classification—transactions and balances are properly classified in the financial statements.

Disclosure—all required GAAP disclosures are in the financial statements

Types of Corroborating Evidence

1. physical examination

--inspection or count by the auditor of a tangible asset

--physical examination is not sufficient to verify that assets are owned by the client

--there is a distinction between examination of assets such as marketable securities and cash and the examination of documents (no inherent value)

2. confirmations

--The receipt of a written response from an independent third party verifying the accuracy of information that was requested by the auditor. It may be costly. It is used for A/R (required by the AICPA). To be

reliable, confirmations must be controlled by the auditor.

3. documentation

External documents are usually more reliable than internal ones. Examples are B of D minutes, bank statements, contracts, cancelled checks and sales invoices.

4. analytical evidence

This involves comparisons with expectations developed based on prior experience, budgets, industry data. It involves comparison of client financial statement line items or ratios with prior year results, budgets, and industry statistics. Inferences are drawn about the fairness of financial statement assertions.

5. written representations

These are signed statements that bear on one or more of management's assertions.

They are different from confirmations in 2 ways:

- 1. they may originate inside or outside the entity**
- 2. they may contain subjective information or a person's opinion rather than facts**

A management representation letter is obtained by auditors as part of complying with the third standard of field work. An auditor may also request written representations from outside experts.

6. mathematical evidence

This involves computations by the auditor which are compared with those of the client. The auditor may recalculate journal totals, ledgers, supporting schedules, minimum lease payments, and pension fund obligations.

7. oral evidence

These are verbal responses to inquiries directed at senior management and other employees. It is not regarded as highly reliable. However, a skilled interviewer can learn many important facts or clues from those who work for the client. These facts may be indispensable in complying with SAS 99.

8. electronic evidence

The reliability of such evidence depends on the reliability of controls over the creation, alteration, and completeness of data and the competence of audit tools used to assess electronic evidence.

Types of Audit Procedures

- 1. analytical procedures—involves the use of financial ratios, common size statements, comparison of actual with budgeted amounts and the use of statistical sampling**
- 2. inspecting—involves careful scrutiny of documents and records and physical examination of tangible resources.**
- 3. confirming—a form of inquiry that enables the auditor to obtain information directly from an independent source outside the client entity**

- 4. inquiring—involves either oral or written inquiry directed at management or employees or outside sources such as attorneys. The results of inquiry usually require corroborating evidence.**
- 5. counting—two common applications are physical counting of tangible resources such as cash or inventory and accounting for prenumbered documents.**
- 6. Tracing—here the auditor selects documents involving transactions and makes sure that information from the documents is recorded properly in the accounting records. It is especially useful for detecting understatements in the accounting records. An important procedure in collecting evidence pertinent to the completeness assertion.**
- 7. Vouching—involves selecting entries in the accounting records**

and obtaining and inspecting the documentation that supports the entries. It is especially useful for detecting overstatements in the accounting records. Important evidence for the E or O assertions.

- 8. Observing—pertains to watching or witnessing the performance of some activity. It is important for obtaining an understanding of IC. The subject matter that is relevant is personnel, procedures, and processes.**
- 9. Reperforming—involves redoing calculations and reconciliations made by the client.**

Computer software can do:

- computations in analytical procedures**

- select a sample of A/R for confirmation**

- scan a file to determine that all documents in a series have been accounted for**

- compare date elements in different files**

Analytical procedures—are used to study plausible relationships among both financial and nonfinancial data to develop an expectation for financial statement balances

Initial procedures—done to obtain an understanding of the client's products and services, markets, competition, customers, industry, and regulatory factors.

Permanent files—are intended to contain data of a historical or continuing nature pertinent to the current examination. The permanent files typically include the following:

--extracts or copies of the articles of incorporation, bylaws, loan agreements, and contracts

--analyses from previous years of accounts that have continuing importance such as long-term debt, owners equity, goodwill and fixed assets

--information related to the evaluation of IC such as organizational charts, flowcharts, and questionnaires

--the results of analytical testing from prior years' audits

analysis—is designed to show the activity in a balance sheet account during the entire period under examination tying together the beginning and ending balances. This type of schedule is normally used for marketable securities, notes receivable, allowance for doubtful accounts, P,P & E, long-term debt, and equity accounts.

Trial balance—this type of schedule consists of the details making up a year-end balance of a balance sheet or income statement account. Examples include trial balances or lists in support of A/R, A/P, repair and maintenance expense, legal expense.

Tests of reasonableness—such a schedule contains information that enables the auditor to evaluate whether the client's balance appears to include a misstatement considering the circumstances of the engagement. Auditors often test depreciation expense, allowance for doubtful accounts, and the provision of federal income taxes.