

Audit Evidence and Documentation



CHAPTER 5



UCSB

Bob Anderson, UCSB

CHAPTER 5-1

AN AUDIT: SUMMARY

- Plan the engagement: Identify risks and areas where internal controls may be relied upon
 - "NET": Nature, extent and timing of audit procedures is planned.
- Where internal controls may be relied upon, test those controls to justify reliance
- Apply substantive procedures for everything else.

ROUTINE
VS.
NON-ROUTINE TRANSACTIONS

UCSB

Bob Anderson, UCSB

Chapter 5-2

MANAGEMENT'S ASSERTIONS

"Coverd" (i.e covered but misspelled):

Completeness

Most difficult to test

CutOff

High Risk due to subjectivity, therefore generally focus in audit

Valuation, allocation & accuracy

Existence & occurrence

Rights & Obligations

Presentation and Disclosure

UCSB

Chapter 5-3

PCAOB ONE-UP'S THE AICPA

I WILL teach using AICPA management assertions, but know that it can be broken into more confusing detail, which the PCAOB did which is not "CEO APPROVED"

- Completeness
- Existence
- Occurrence
- Allocation
- Presentation
- Rights
- Obligations
- Valuation
- Disclosure

UCSB

Chapter 5-4

THIRD STANDARD OF FIELDWORK

So management makes the COVERD assertions. It is then the auditors responsibility to validate those assertions, as required by the third standard:

“Sufficient Appropriate Audit Evidence” is to be obtained to afford a reasonable basis for an opinion regarding the financial statements under audit”

REQUIRES JUDGMENT

RELEVANT & RELIABLE (or VALID)- see next slide

UCSB Bob Anderson, UCSB Chapter 5-5

Competence of Evidential Matter

To be **appropriate** evidence must be:

- **Relevant**- does it apply to the objective we are testing?
- **Reliable/ Valid**- Is the evidence any good?
 - Independent sources have greater reliability than those within the client organization.
 - Strong internal control increases reliability of evidence created within the client organization.
 - Directly obtained evidence is more reliable than evidence obtained second hand.

UCSB Bob Anderson, UCSB Chapter 5-6

SUBSTANTIVE PROCEDURES

Recall that we generally utilize a “balance sheet” approach- we are testing sales by testing accounts receivable.

Can be:

- Transactional
- OR
- Ending balance

By testing the ending balance, then you are inherently testing ALL of the transactions. If you wanted to audit the ending cash balance, do you think we would need to look at every single entry that impacted cash during the year?

BALANCE SHEET APPROACH- MORE:
Does NOT imply ignoring the income statement! At a MINIMUM you must perform analytics of the income statement.

- In many instances, can perform easy substantive procedures on the income statement lines, or in connection with testing a balance sheet account.


UCSB Bob Anderson, UCSB Chapter 5-7

SUBSTANTIVE Audit Procedures

- Accounting information system
- Documentary evidence
 - Tracing
 - Vouching
 - Inspection
 - Reconciliations
- Third-party representations--Confirmation
- Physical examination
- Computations—Reperformance
- Data interrelationships—Analytical procedures
- Client representations
 - Inquiries
 - Letters of representations

STRONGEST

WEAKEST



UCSB Bob Anderson, UCSB Chapter 5-8

Vouching vs. Tracing

When we examine audit evidence we often look for one thing to match another. We could be vouching or tracing... we "vouch" **FROM** the financials and we "trace" **TO** them:

When testing existence (of something recorded in the financial statements) we ...

VOUCH

When testing completeness (to see if something is recorded in the financial statements) we ...

TRACE

UCSB

Chapter 5-9

INTERNAL CONTROLS

MUST obtain an understanding of the internal controls (that's the 2nd standard of fieldwork... the "I" in PIE from Chapter 2)

Many "classes of transactions" are very "routine" to a client. Accordingly the client may establish strong internal controls over those transactions to ensure that misstatements are Prevented or Detected in a timely fashion. If the internal controls over a class of transactions is strong the auditor **MAY** rely upon those controls. However, in order to rely, the auditor must perform:

- Tests of Design (TOD's): Would the controls prevent/ detect errors?
- Tests of Operational Effectiveness (TOE's): Are the controls functioning as designed?

IF NOT PERFORMING TOD'S AND TOE'S TO RELY UPON INTERNAL CONTROLS, THEN THE AUDITOR MUST PERFORM "SUBSTANTIVE TESTS". WHY WOULD AN AUDITOR GENERALLY SEEK TO RELY UPON CONTROLS FOR ROUTINE TRANSACTIONS?

EFFICIENCY IN THE AUDIT!!

UCSB

Bob Anderson, UCSB

Chapter 5-10

Audit Risk

An audit can **NOT** provide absolute assurance. The risk that there is a material error in the financial statements undetected by the audit is the **DETECTION RISK**. All of the risks combined are the "audit risk"

There are several risk factors which can be categorized into three groups:

- | | |
|--|--|
| 1. Inherent Risk --Risk of a material misstatement occurring in an assertion assuming no related internal controls. Impacted by factors such as: <ul style="list-style-type: none"> Complexity of transactions and/ or accounting issues; Number of transactions; Degree of judgment involved Volatility of valuations | SPECIFIC TO THE CLIENT AND ITS |
| 2. Control Risk --Risk that a material misstatement in an assertion will not be prevented or detected on a timely basis by the company's internal control. <ul style="list-style-type: none"> Controls are designed and implemented by management to mitigate the inherent risks Controls can be designed to PREVENT and/ or DETECT an error Control risk is the residual risk that an error was neither PREVENTIVE nor DETECTED | OPERATIONS-combined= Risk of Material Misstatement (RMM) |
| 3. Detection Risk --Risk that the auditors' procedures will lead them to conclude that a material misstatement does not exist in an assertion when in fact such misstatement does exist. | SPECIFIC TO THE AUDITORS |

UCSB

Bob Anderson, UCSB

Chapter 5-11

Audit Risk Formula

$$AR = IR \sim CR \sim DR$$

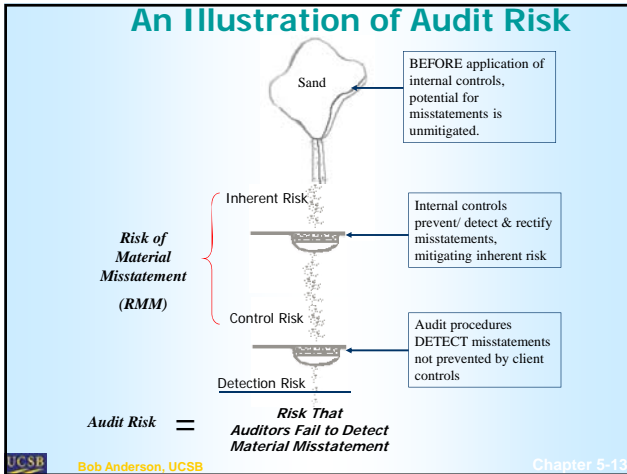
AR = Audit risk
 IR = Inherent risk
 CR = Control risk
 DR = Detection risk

Inherent risk = Inherent risk of statement risks, depending on the strength of the control or audit procedure.

UCSB

Bob Anderson, UCSB

Chapter 5-12



- ### Basic Approaches to Auditing Accounting Estimates
- Review and test management's process for developing the estimate.
 - Independently develop an estimate to compare to management's estimate.
 - Review subsequent events or transactions bearing on the estimate.
- VALUABLE TOOL IN AUDITORS' ARSENAL: **HINDSIGHT!!**
-
- UCSB Bob Anderson, UCSB Chapter 5-14

- ### Auditing Fair Values
-
- If the item is traded on an organized market, fair value may be obtained from market prices
 - If the item does not trade on an organized market determine fair value by:
 - Analyzing to a similar market is possible
 - Using a valuation model
 - Use of specialists
 - Using subsequent information
- UCSB Bob Anderson, UCSB Chapter 5-15

- ### USE OF SPECIALISTS
- The auditor is responsible for the adequacy of the procedures applied. Maybe they need a specialist to supplement where they lack specific expertise. If they do, they are responsible for the work of the specialist, and at a minimum must (DON'T FORGET TO DOCUMENT)
- Satisfy themselves with the professional qualifications of the specialist
 - Obtain an understanding of the methods and assumptions used by the specialist
 - Test any data furnished to the specialist (client could give them bad data- a specialist just works with what they get, they do not "audit" it)
- UCSB Bob Anderson, UCSB Chapter 5-16

Sufficiency of Audit Documentation

- Audit documentation should be sufficient to enable members of the audit team AND future reviewers of the workpapers to:
 - To understand who performed and reviewed the work
 - To understand what work was performed
 - To show that the accounting agree or reconcile to the financial statements

SHOULD ALLOW FOR REPERFORMANCE!!

Functions of Working Papers

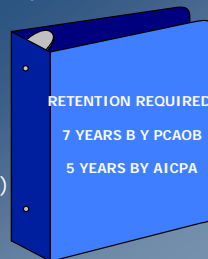
- Provide a means of assigning and coordinating audit work
- Aid in supervising and reviewing the audit work
- Provide support for the auditors' opinion
- Document the auditors' compliance with generally accepted auditing standards, especially the standards of field work
- Aid in planning and conducting future audits

Types of Working Files

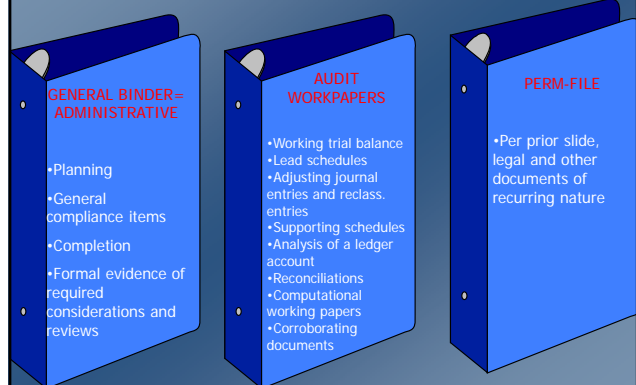
Current files- AKA **Workpapers** Specific to the period being audited (see next slide)

Permanent files- Documents which have an impact to current/ Prior/ Future periods, examples:

- Debt agreement
- Articles of incorporation
- Important resolutions of the BOD
- Stock subscription agreements
- Deferred compensation plans
- Employment contracts (if material)



TYPES OF WORKPAPERS



CLIENT REPRESENTATIONS

Client representation is a weak form of "evidential matter"- but more prevalent than it probably ought to be. Client makes specific written representations in a letter called the "Management representation letter" at the conclusion of the audit (dated same date as the audit). They formally represent:

- Their responsibility for the financial statements, internal controls & fraud programs;
- That they have made available all records, data and minutes of the meetings of the BOD
- Financial statements are GAAP and all disclosures have been made
- That "uncorrected misstatements" are not material
- Specific representations as required by the auditors (auditors have a standard form & MAY ADD SPECIFIC ITEMS when considered necessary)

UCSB

Bob Anderson, UCSB

Chapter 5-21

FIRST THING FIRST

It is beneficial to complete internal control testwork before the other procedures as it provides an indication of how much reliance can be placed on the client. The greater the reliance, the lesser the other procedures.

Remember that IR & CR combined =RMM.

Auditor is required to PLAN (means look at IR's) and to assess internal controls (CR). So right out of the gate, the auditor must have a sense of the RMM for planning their "substantive procedures" and internal controls testwork.

We call those other procedures "substantive" procedures.

UCSB

Bob Anderson, UCSB

Chapter 5-22

ANALYTICS

ANALYTICS are a valuable audit tool and can help you test a lot of balances/ activity

If applying analytics, there are rules:

- Must develop an expectation
- Determine the amount of variation acceptable (Precision)
- Compare financial statement amount to your expectation
- Conclude/ evaluate any variation

ANALYTICS are REQUIRED during PLANNING and at OVERALL FINAL REVIEW

UCSB

Bob Anderson, UCSB

Chapter 5-23

EXAMPLE OF SUBSTANTIVE TEST

Client owed \$1,000,000 on debt at the beginning of the year. Interest rate is 8% and is paid with a \$10,000 principal payment on the 10th of each month for the month prior.

What can we substantively test all at once here?

- Ending debt balance
- Accrued interest payable
- Interest expense

HOW?

Computation/ analytic

UCSB

Bob Anderson, UCSB

Chapter 5-24

EXAMPLE FROM PRIOR SLIDE

Beginning debt balance	1,000,000	
Expected reduction	(120,000)	
ENDING BALANCE SHOULD BE	<u>880,000</u>	
AVERAGE BALANCE	940,000	
Rate	8%	
EXPECTED INTEREST EXPENSE	<u>75,200</u>	Fairly precise
Months accrued	1	
Months in year	12	
Balance for that month	880,000	
Rate/ annual	8%	
EXPECTED ACCR INT.	<u>5,867</u>	Highly precise

INTERIM PROCEDURES

When the client year end comes, you've got a LOT to do and a short time to do it:

- 45 days now if public company
- 90 days general bank requirement

INTERNAL CONTROLS HELP YOU

- Do a lot of your internal control work during the year
 - Must update through year-end
 - Reliance helps you reduce amount of substantive testing at year end (if determine that reliance is justified)
- Substantive testing can be done during the year
 - If a public company, you have to do quarterly reviews, why not apply some audit procedures to significant activities at that time
 - Must update through year end

PUTTING IT TOGETHER

Client closes their books and book "Adjusting Journal Entries", as they deem necessary to properly present.

Audit= IMA CSA:

I nternal controls

M ateriality (assess ROMM)

A ssign risk assessments

C ontrol testing (if appropriate/ required)

S ubstantive testing

A ppropriateness & sufficiency of evidence gathered.

Auditor performs their work on adjusted financial statements. Auditor keeps track of differences noted in a "summary of audit differences"

Auditor and client agree on what audit differences will be "booked" and "passed".

"Passed" audit differences are presented in a summary of "Uncorrected misstatements" which client represents as immaterial in the management representation letter. Auditor must concur, or will have to qualify their opinion. If a public company, audit committee of the BOD must approve the "uncorrected misstatements"

NOTE: PASSED DIFFERENCES must be immaterial both individually and in the aggregate.