CHAPTER 6
A FRAMEWORK FOR AUDIT EVIDENCE
LEARNING OBJECTIVES

1. Discuss the importance of the evidence concepts of appropriateness and sufficiency
2. Identify factors affecting the appropriateness of audit evidence
3. Make professional judgments about the type and timing of audit procedures to use to obtain audit evidence
4. Discuss the use of, and apply, substantive analytical procedures
LEARNING OBJECTIVES

5. Identify factors affecting the sufficiency of audit evidence
6. Identify issues related to audit evidence needed for accounts involving management estimates
7. Determine situations requiring the auditor to use a specialist/expert and describe the auditor’s responsibilities related to that specialist/expert
8. Describe the evidence needs for related-party transactions
LEARNING OBJECTIVES

9. Describe the characteristics of quality audit documentation

10. Explain the nature, design, and purposes of audit programs

11. Apply the frameworks for professional decision making and ethical decision making to issues involving audit evidence
THE AUDIT OPINION FORMULATION PROCESS

I. Making Client Acceptance and Continuance Decisions
   Chapter 14

II. Performing Risk Assessment
    Chapters 3, 7 and 9–13

III. Obtaining Evidence about Internal Control Operating Effectiveness
     Chapters 8–13 and 16

IV. Obtaining Substantive Evidence about Accounts, Disclosures and Assertions
    Chapters 8–13 and 16

V. Completing the Audit and Making Reporting Decisions
   Chapters 14 and 15

The Auditing Profession, the Risk of Fraud and Mechanisms to Address Fraud: Regulation, Corporate Governance, and Audit Quality
   Chapters 1 and 2

Professional Liability and the Need for Quality Auditor Judgments and Ethical Decisions
   Chapter 4

The Audit Opinion Formulation Process and A Framework for Obtaining Audit Evidence
   Chapters 5 and 6
Some excerpts describe following types of audit deficiencies related to evidence:

- Failure in sufficiently testing inventory
- Failure in sufficiently testing valuation of accounts receivable and net revenue
- Failure in obtaining sufficient audit evidence to support its opinion on effectiveness of internal control over financial reporting (ICFR)
- Failure in sufficiently testing revenue
PROFESSIONAL JUDGMENT IN CONTEXT - EVIDENCE-RELATED FINDINGS IN PCAOB INSPECTION REPORTS

- What is sufficient appropriate evidence, and how does it differ across clients? (LO 1, 2, 5)
- What are substantive analytical procedures, and when is evidence from these procedures appropriate? (LO 4)
- What are the unique evidence challenges for accounts such as allowance for doubtful accounts that are based on management estimates? (LO 6)
• How could the use of a standardized audit program lead to some of the problems identified in the PCAOB Releases introduced earlier? (LO 10)
LEARNING OBJECTIVE 1

DISCUSS THE IMPORTANCE OF THE EVIDENCE CONCEPTS OF APPROPRIATENESS AND SUFFICIENCY
AUDIT EVIDENCE DEFINED BY AS 15

- Information that is used by the auditor in arriving at conclusions on which auditor’s opinion is based
- Consists of information that either supports or contradicts management’s assertions regarding:
  - Financial statements
  - Internal control over financial reporting
EXHIBIT 6.1 - INTERRELATIONSHIP OF RISK AND EVIDENCE APPROPRIATENESS AND SUFFICIENCY

RISK
That Account or Assertion Is Materially Misstated

- Inherent Risk
- Control Risk

APPROPRIATENESS
- Relevance
- Reliability
  
  Quality of Evidence That Auditor Collects

SUFFICIENCY
  
  Quantity of Evidence That Auditor Collects
IDENTIFY FACTORS AFFECTING THE APPROPRIATENESS OF AUDIT EVIDENCE
APPROPRIATENESS OF AUDIT EVIDENCE

- Measure of quality of audit evidence that includes:
  - **Relevance**: Evidence that provides insight on the validity of the assertion being tested
  - **Reliability**: Measure of quality of underlying evidence influenced by:
    - Risk
    - Potential management bias
    - Quality of internal control system
RELEVANCE OF AUDIT EVIDENCE

• Affected by the following factors
  • Purpose of procedure being performed
  • Direction of testing
  • Specific procedure or set of procedures being performed
AUDITING IN PRACTICE - IS THE EVIDENCE RELEVANT TO THE ASSERTION BEING TESTED?

• Guard against unwarranted inferences in gathering audit evidence

• Example of inappropriate inference
  • Testing existence of client’s equipment by inspecting asset and concluding that asset exists and is properly valued
  • Evidence about existence of equipment does not provide relevant evidence that equipment is properly valued
PURPOSE OF AN AUDIT PROCEDURE

- Risk assessment - Identifies risks of material misstatement
- Tests of controls - Evaluates effectiveness of controls in detecting and correcting, material misstatements
- Substantive procedures - Provides direct evidence about presence of material misstatements
DIRECTIONAL TESTING

• Approach to test account balances that considers:
  • Type of misstatement likely to occur
  • Corresponding evidence provided by other accounts that have been tested
• Assets and expenses for overstatement and liabilities and revenues for understatement because:
  • There is major risks of misstatements
  • Tests of other accounts provide evidence of possible misstatements in other direction
EXHIBIT 6.2 - ILLUSTRATION OF TESTING FOR EXISTENCE AND COMPLETENESS

Panel A: Testing for existence - Vouching

- Source Document
- Subsidiary Ledger/General Ledger

Panel B: Testing for completeness - Tracing

- Source Document
- Subsidiary Ledger/General Ledger
TESTING FOR EXISTENCE

- **Vouching**: Taking a sample of recorded transactions and obtaining original source documents supporting recorded transaction
  - Addresses overstatement
  - Provides evidence on the assertion that recorded transactions are valid
TESTING FOR COMPLETENESS

- **Tracing**: Taking a sample of original source documents and ensuring that transactions related to source documents have been recorded in appropriate journal and general ledger
  - Called reprocessing
  - Addresses understatement
TYPE OF PROCEDURE

• Specific audit procedure required to provide audit evidence that is relevant to certain assertions, but not others
  • Example - Walking through client’s warehouse to inspect inventory would result in evidence related to existence of inventory, but not to valuation
DIRECT AND INDIRECT EVIDENCE

• Direct
  • Relevant to a specific assertion
  • Requires only one inference to reach a conclusion about the assertion being tested

• Indirect
  • Not directly relevant to a specific assertion
  • Insufficient, when high risk of material misstatement exists
  • Requires a linkage of inferences to provide assurance
RELIABILITY OF AUDIT EVIDENCE

• Judged by its ability to provide convincing evidence related to the audit objective being evaluated

• According to the text of ISA 500 (A31)
  • The reliability of the audit evidence is influenced by:
    • Its source and its nature
    • Circumstances under which it is obtained
    • Includes the controls for preparation and maintenance
  • Generalizations about reliability of various kinds of audit evidence are subject to important exceptions
## Generalizations Established by IAASB, in ISA 500

<table>
<thead>
<tr>
<th>More Reliable</th>
<th>Less Reliable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Directly obtained evidence (for example, observation of a control)</td>
<td>Indirectly obtained evidence (for example, an inquiry about the working of a control)</td>
</tr>
<tr>
<td>Evidence derived from a well-controlled information system</td>
<td>Evidence derived from a poorly controlled system or easily overridden information system</td>
</tr>
<tr>
<td>Evidence from independent outside sources</td>
<td>Evidence from within the client’s organization</td>
</tr>
<tr>
<td>Evidence that exists in documentary form</td>
<td>Verbal evidence</td>
</tr>
<tr>
<td>Evidence from original documents</td>
<td>Evidence obtained from photocopies or facsimiles, or digitized data (would depend on the quality of controls over their preparation and maintenance)</td>
</tr>
</tbody>
</table>
INTERNAL DOCUMENTATION

- Reliability varies depending on:
  - Effectiveness of internal controls
  - Management motivation to misstate individual accounts
  - Formality of documentation
    - Example - Acknowledgment of its validity by parties independent of the accounting function
  - Independence of those preparing documentation from those recording transactions
EXTERNAL DOCUMENTATION

• Considered highly reliable
• Reliability varies depending on whether the documentation:
  • Was prepared by a knowledgeable and independent outside party
  • Is received directly by auditor
• Is directed to the client
TYPES OF INTERNAL AND EXTERNAL DOCUMENTS

• Internal
  • Legal documents
  • Business documents
  • Accounting documents
  • Other planning and control documents

• External
  • Business documents
  • Third-party documents
  • General business information
EVIDENCE FROM A MANAGEMENT’S SPECIALIST

• Management’s specialist
  • Individual or organization possessing expertise in a field other than accounting or auditing
  • Assists in preparing financial statements

• Consider the following factors
  • Competence, capabilities, and objectivity
  • Work performed
  • Appropriateness of his or her work as audit evidence for relevant assertion
LEARNING OBJECTIVE 3

MAKE PROFESSIONAL JUDGMENTS ABOUT THE TYPE AND TIMING OF AUDIT PROCEDURES TO USE TO OBTAIN AUDIT EVIDENCE
## EXHIBIT 6.5 - TYPE OF AUDIT PROCEDURES

<table>
<thead>
<tr>
<th>Categories of Audit Procedures</th>
<th>Purpose</th>
<th>Types of Audit Procedures Typically Performed</th>
<th>Examples of Audit Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tests of controls</td>
<td>Evaluate the operating effectiveness of controls</td>
<td>Inspection of documentation</td>
<td>Review client-prepared internal control documentation</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Select purchase transactions and review documentation for required approval</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Observation</td>
<td>Observe whether controls designed to limit access to a secure area (e.g., ID card need to access storage room) are functioning</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Reperformance</td>
<td>Reperform a reconciliation performed by client personnel</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Inquiry</td>
<td>Inquire of management and supervisory personnel about their control-related responsibilities</td>
</tr>
<tr>
<td>Substantive procedures</td>
<td>Determine whether material misstatements exist in the financial statements</td>
<td>Inspection of documentation</td>
<td>Review shipping documents as evidence of a sale having occurred</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Inspection of assets</td>
<td>Tour the manufacturing facility and inspect client’s equipment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>External confirmation</td>
<td>Obtain confirmations from client’s customers regarding amount owed by the customer to the client</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Recalculation</td>
<td>Recalculate the total amount included on a sales invoice</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Analytical procedures</td>
<td>Estimate the expected amount of interest income to be recorded by the client and follow up on significant unexpected differences between expectation and client’s recorded balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Scanning</td>
<td>Scan the sales journal to identify unusual transactions posted to the sales account and follow up on the transactions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Inquiry</td>
<td>Inquire of client management as to its valuation of the allowance for doubtful accounts</td>
</tr>
</tbody>
</table>
ACCOUNTING RECORDS

• Initial accounting entries and supporting records
• Include:
  • Evidence of internal controls over financial reporting, as well as supporting records
  • The general and subsidiary ledgers
  • Journal entries
  • Worksheets supporting cost allocations, computations, reconciliations, and disclosures
CORROBORATING INFORMATION

- Validates underlying accounting records
- Includes the following evidence
  - Minutes of meetings
  - Confirmations from independent parties
  - Industry data
  - Inquiry
  - Observation
  - Inspection of documents
Involved a large family-held Italian company that produced dairy products around the world

Company’s management committed a fraud that involved:

- Taking cash from the business for family purposes, but not recording transactions in the books
- Shifting monetary assets in and out of banks
- Audit senior’s carelessness in mailing the bank confirmation provided a way for management to conceal the fraud
EXHIBIT 6.6 - TYPES OF RECALCULATIONS PERFORMED BY AUDITOR

- **Footing** Adding a column of figures to verify the correctness of the client’s totals.
- **Cross-footing** Checking the agreement of the cross-addition of a number of columns of figures that sum to a grand total. For example, the sum of net sales and sales discounts should equal total sales.
- **Tests of extensions** Recomputing items involving multiplication (for example, multiplying unit cost by quantity on hand to arrive at extended cost).
- **Recalculating estimated amounts** Recomputing an amount that the client has already estimated, such as recomputing the allowance for doubtful accounts based on a formula related to the aging of accounts receivable ending balances.
### EXHIBIT 6.7 - MANAGEMENT ASSERTIONS AND EXAMPLES OF RELATED AUDIT PROCEDURES

<table>
<thead>
<tr>
<th>Assertions</th>
<th>Fixed Assets</th>
<th>Contingencies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Existence</strong></td>
<td>• Inspect the assets.</td>
<td>• Inquire of management.</td>
</tr>
<tr>
<td></td>
<td>• Select new assets that have been added to the subsidiary ledger/general journal and inspect supporting documentation (for example, invoices).</td>
<td>• Send confirmation request to legal counsel.</td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
<td>• Select source documents for repairs/maintenance expense to determine if a fixed asset was inappropriately expensed.</td>
<td>• Inquire of management.</td>
</tr>
<tr>
<td></td>
<td>• Inquire regarding process for determining whether an expenditure is an asset or an expense.</td>
<td>• Select source documents for legal expense and determine that the expenses were appropriately recorded.</td>
</tr>
<tr>
<td><strong>Rights/obligations</strong></td>
<td>• Inspect documentation related to purchase contracts.</td>
<td>• Inquire of management.</td>
</tr>
<tr>
<td><strong>Valuation/ allocation</strong></td>
<td>• Inspect vendor’s invoice to establish purchase price.</td>
<td>• Obtain confirmation from legal counsel.</td>
</tr>
<tr>
<td></td>
<td>• Determine that estimated life and salvage value are consistent with similar purchases, company policies, expected future use, and past experience.</td>
<td>• Inspect documentation of payments related to in-progress litigation.</td>
</tr>
<tr>
<td></td>
<td>• Recalculate depreciation expense.</td>
<td>• Inquire of management.</td>
</tr>
<tr>
<td></td>
<td>• Develop an expectation of total depreciation using analytical procedures.</td>
<td>• Obtain confirmation from legal counsel.</td>
</tr>
<tr>
<td></td>
<td>• Recalculate potential damages sought by plaintiff.</td>
<td>• Review court filings.</td>
</tr>
<tr>
<td><strong>Presentation/ disclosure</strong></td>
<td>• Review presentation within the financial statements to ensure completeness and conformance with the applicable financial reporting financial reporting framework.</td>
<td>• Review presentation within financial statements to ensure completeness and conformance with the applicable financial reporting framework.</td>
</tr>
<tr>
<td></td>
<td>• Review disclosures to ensure that they are adequate and understandable.</td>
<td>• Review disclosures to ensure that they are adequate and understandable.</td>
</tr>
</tbody>
</table>
ASSESSING THE CONSISTENCY OF EVIDENCE

- Consider all sources of information and consistency of information
  - AS 15 requirement
- Consider internal consistency of evidence gathered
- Consider consistency of internal evidence generated with external evidence gathered
- Expand evidence-gathering procedures for areas where results are inconsistent
- Document conclusions based on evidence gathered
COST–BENEFIT CONSIDERATIONS WHEN SELECTING AUDIT PROCEDURES

• Should balance following objectives
  • Profitability
  • Managing risk
• Each audit procedure takes time, effort, and ultimately money to perform
• Rigorous audit procedures providing higher quality evidence are more costly to perform
• Determining appropriate mix of evidence based on auditor’s professional judgment
### EXHIBIT 6.8 - COST OF AUDIT PROCEDURES AND EVIDENCE QUALITY

<table>
<thead>
<tr>
<th>Type of Substantive Procedure</th>
<th>Cost of Procedure</th>
<th>Evidence Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspection of documents (includes vouching and tracing)</td>
<td>Low to medium (depends on sample size)</td>
<td>Medium to high (assuming the documents are valid and unaltered, needs to consider source)</td>
</tr>
<tr>
<td>Inspection of physical assets</td>
<td>Low to high (depends on complexity, location of process, and expertise required)</td>
<td>High (existence) Low to medium (valuation, ownership)</td>
</tr>
<tr>
<td>Observation</td>
<td>Low to high (depends on complexity, location of process, and expertise required)</td>
<td>Medium (because people may change behavior while being observed)</td>
</tr>
<tr>
<td>External confirmations</td>
<td>Low to medium (can be performed manually or electronically; depends on sample size)</td>
<td>Medium to high (assuming that there is no fraud in the confirmation process)</td>
</tr>
<tr>
<td>Recalculation</td>
<td>Low to medium (can be performed manually or electronically; depends on sample size)</td>
<td>Medium to high</td>
</tr>
<tr>
<td>Reperformance</td>
<td>Low to high (depends on sample size and complexity of process)</td>
<td>Medium to high</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>Low to medium (depends on the type of analytical procedure)</td>
<td>Medium to high (if the auditor who is conducting the test is competent, and will generally have to obtain additional corroborating evidence)</td>
</tr>
<tr>
<td>Scanning</td>
<td>Low to medium (can be performed manually or electronically; depends on the length of document)</td>
<td>Low to medium (will need to follow on significant or unusual items using other procedures)</td>
</tr>
<tr>
<td>Inquiry of knowledgeable persons</td>
<td>Low</td>
<td>Low (will also need corroborating evidence)</td>
</tr>
</tbody>
</table>
TIMING OF PROCEDURES

• At the balance sheet date
• **Interim date**: Earlier than balance sheet date
• After the balance sheet date
• Decision based on:
  • Assessment of risk associated with account
  • Effectiveness of internal controls
  • Nature of the account
  • Availability of audit staff
TIMING OF PROCEDURES

• Performing procedures after year end may provide most convincing evidence
• Performing procedures prior to the balance sheet date
  • Allows earlier completion of audit
  • Might require less overtime of the audit staff
  • Might meet management’s desire to distribute financial statements shortly after year end
  • May increase in risk of failing to detect material misstatements that occur between interim date and year end
TIMING OF PROCEDURES

- **Roll-forward period**: Period between the confirmation date and the balance sheet date
- **Cutoff period**: Covers several days before and after client’s balance sheet date
  - Risk- Recording transactions in wrong period
  - **Cutoff tests**: Applied to transactions recorded during cutoff period
    - Provide evidence, as to whether transactions have been recorded in the proper record period
TIMING OF PROCEDURES

Period Being Audited \[\rightarrow\] Balance Sheet Date \[\rightarrow\] Subsequent Period

Cutoff Period

\[\text{Balance Sheet Date}\]

\[\text{Period Being Audited} \rightarrow \text{Cutoff Period} \rightarrow \text{Subsequent Period}\]
LEARNING OBJECTIVE 4

DISCUSS THE USE OF, AND APPLY, SUBSTANTIVE ANALYTICAL PROCEDURES
EXHIBIT 6.9 - ALTERNATIVE APPROACHES TO SUBSTANTIVE PROCEDURES

**BOX A**
- 25% Tests of Controls
- 75% Substantive Procedures: Only tests of details

**BOX B**
- 25% Tests of Controls
- 75% Substantive Procedures: Both tests of details and analytical procedures
CONSIDERATIONS IN PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

• Does the company have adequate internal controls over the account?
• Is the risk of material misstatement low enough that inferences from indirect evidence are appropriate to make conclusions about an account?
• Are the underlying data used in evaluating an account both relevant and reliable?
• Are the relationships among the data logical and justified by current economic conditions?
THE PROCESS FOR PERFORMING ANALYTICAL PROCEDURES

1. Developing an expectation
2. Defining when the difference between the auditor’s expectation and what the client has recorded would be considered significant
3. Computing the difference between the auditor’s expectation and what the client has recorded
4. Following up on significant differences
Improving the Effectiveness of Substantive Analytical Procedures

- Providing reliable evidence depends on:
  - Nature of assertion being tested
  - Plausibility and predictability of relationships in data
  - Availability and reliability of data used
  - Precision of expectation, which requires the auditor to use disaggregated data
    - **Disaggregation**: Breaking data down into their component parts based on time periods, geographical locations, customer type, or product lines
  - Rigor of analytical procedure employed
TYPES OF LESS RIGOROUS ANALYTICAL PROCEDURES EMPLOYED

• Trend analysis - Analysis of changes over time
  • Rigor improved by:
    • Including more periods in the trend
    • Using disaggregated data
    • Using relevant external benchmarks

• Ratio analysis - Comparison of relationships between accounts and between an account and nonfinancial data
TYPES OF LESS RIGOROUS ANALYTICAL PROCEDURES EMPLOYED

- Rigor improved by:
  - Using disaggregated data
  - Using relevant external benchmarks
- Scanning - Detects unusual or unexpected balances or transactions in account balances, listings of transactions and journals
  - Expectations based on:
    - Knowledge of the client
    - Knowledge of accounting
    - Common sense
MORE RIGOROUS ANALYTICAL PROCEDURES EMPLOYED

• **Reasonableness test**
  • Development of an expected value of an account by using data partly or wholly independent of the client’s accounting information system

• Regression analysis - Expected value is determined using a statistical technique whereby one or more factors are used to predict an account balance
AUDITING IN PRACTICE - PERFORMING AND DOCUMENTING SUBSTANTIVE ANALYTICAL PROCEDURES BY KBA GROUP

- PCAOB noted that an audit team failed to perform and document adequate essential analytical procedures
  - PCAOB might conclude that audit team did not obtain sufficient evidence to support its audit opinion
- U.S. auditing standards (AU-C and AU) require the documentation of process of substantive analytical procedures
- International auditing standard (ISA 520) does not include specific documentation requirements for substantive analytical procedures
APPLICATION OF SUBSTANTIVE ANALYTICAL PROCEDURES

- Difficult decision-making process
- Designed to provide evidence about the correctness of an account balance
- Should be used when procedures are:
  - Reliable
  - More cost-effective than other substantive procedures
QUANTIFICATION AND CORROBORATION

• **Quantification**: Determining whether management’s explanation for observed differences can account for the observed difference

• **Corroboration**: Obtaining sufficient evidence that management’s explanation is accurate
AUDITING IN PRACTICE - ANALYTICAL PROCEDURES ARE NOT CLIENT ESTIMATES

• Auditor can obtain independent evidence about account balances
  • By gathering evidence to support client’s assumptions and re-computing estimate
  • From substantive analytical procedures
• Substantive analytics are designed to provide independent evidence about account balances, not to replace management’s underlying estimation process
LEARNING OBJECTIVE 5

IDENTIFY FACTORS AFFECTING THE SUFFICIENCY OF AUDIT EVIDENCE
SUFFICIENCY OF EVIDENCE

• Measure of the quantity of audit evidence
• Quantity of audit evidence needed is affected by:
  • Assessment of risks of material misstatement
  • Quality of such audit evidence
• Amount of evidence must:
  • Be sufficient to convince audit team of effectiveness of internal control or accuracy of an account
  • Stand on its own such that another unbiased professional would reach same conclusion
AUDITING IN PRACTICE - WHEN AN AUDITOR FAILS TO COLLECT SUFFICIENT EVIDENCE

• Ligand Pharmaceuticals case
  • Example of personal ramifications to auditor of knowingly and recklessly not collecting sufficient evidence
  • Audit partner was aware of factors that called into question the adequacy of Ligand’s reserves for returns
  • Did not adequately analyze those factors
  • PCAOB concluded that auditor did not have sufficient basis to support the audit opinion
  • There are no bright line requirements regarding the sufficiency of evidence, but this case illustrates the severe ramifications when regulators subsequently decide that an auditor has not collected sufficient evidence
DETERMINING SAMPLE SIZES

- Requires applying a statistically based formula
- Requires auditor’s professional judgment
- Factors considered
  - Risk of material misstatement
  - Assurance obtained from other procedures
ADDITIONAL SAMPLE SIZE CONSIDERATIONS FOR TESTS OF CONTROLS

- Type of control being tested
- Frequency with which control is performed
- Controls over adjusting entries require additional consideration due to high risk of material misstatement
  - The better the control environment, the smaller the sample size
IDENTIFY ISSUES RELATED TO AUDIT EVIDENCE NEEDED FOR ACCOUNTS INVOLVING MANAGEMENT ESTIMATES
• Exercising professional skepticism in evaluating reasonableness of management estimates

• Cookie jar reserves techniques
  • Management over-accruing expenses in current period to set up a reserve that is reversed back into income in a future period

• Big bath techniques
  • Charging as many potential future costs to expenses in current bad year, so that those costs will not have to be recognized in future
AUDITING IN PRACTICE - A DESCRIPTION OF COMMON TYPES OF EARNINGS MANAGEMENT TECHNIQUES

- Amortization, depreciation, and depletion techniques
  - Companies having long-lived assets are expensed through amortization, depreciation, or depletion
- Auditor should watch for management to exercise judgment in making selective decisions about:
  - Type of write-off method used
  - Write-off period
  - Estimation of salvage value
EVIDENCE NEEDED FOR AUDITING MANAGEMENT ESTIMATES

- Management judgments must be established by independent, objective, and verifiable data that support estimates.
- Understand processes used by management in developing estimates:
  - Controls over the process
  - Reliability of underlying data in developing estimate
  - Use of outside experts by management
  - Reviewing procedure for results of estimates for reasonableness
OPTIONS FOR OBTAINING EVIDENCE NEEDED FOR AUDITING MANAGEMENT ESTIMATES

- Determining whether events occurring up to the date of auditor’s report provide audit evidence
- Testing how management made the accounting estimate and data on which it is based
- Testing the operating effectiveness of controls over process management
- Developing a point estimate or range to evaluate management’s point estimate
LEARNING OBJECTIVE 7

DETERMINE SITUATIONS REQUIRING THE AUDITOR TO USE A SPECIALIST/EXPERT AND DESCRIBE THE AUDITOR’S RESPONSIBILITIES RELATED TO THAT SPECIALIST/EXPERT
USING A SPECIALIST/EXPERT TO ASSIST WITH OBTAINING EVIDENCE

- Certain accounts require expertise in another field to obtain appropriate audit evidence
- Examples
  - Valuation of land and buildings, plant and machinery, works of art, antiques, and intangible assets
  - Estimation of oil and gas reserves
- Responsibility for audit opinion lies with the auditor
EVALUATING PROFESSIONAL QUALIFICATIONS OF A SPECIALIST

• Professional certification, license, or other recognition of competence in his or her field
• Reputation and standing of the specialist in the views of peers familiar with the specialist’s capability
• Specialist’s experience in the type of work under consideration
UNDERSTANDING NATURE OF WORK PERFORMED BY A SPECIALIST

• Obtaining an understanding of methods and assumptions used
• Making appropriate tests of data provided to specialist, taking into account auditor’s assessment of control risk
• Evaluating whether specialist’s findings support the related assertions in financial statements
LEARNING OBJECTIVE 8

DESCRIBE THE EVIDENCE NEEDS FOR RELATED-PARTY TRANSACTIONS
RELATED-PARTY TRANSACTIONS

- Client transactions with other organizations or people related to either the client or client’s senior management
  - Parents and subsidiaries
  - An entity and its owners
  - An entity and other organizations in which it has part ownership, such as joint ventures
  - An entity and an assortment of special-purpose entities (SPEs)
RELATED-PARTY TRANSACTIONS

• Higher risks of material misstatement of financial statements
• May not be conducted under normal market terms and conditions
• Auditors need to identify all related parties and account for all related-party transactions
EXHIBIT 6.10 – A Sample of Relevant Audit Procedures for Related-Party Transactions

AUDIT OBJECTIVE: Determine if related-entity transactions occurred during the year and whether they are properly (a) authorized and (b) disclosed in the financial statements.

1. Inquire of the client about processes used to identify related-party transactions and the client’s approach to accounting for related-party transactions.
2. Ask the client to prepare a list of all related parties. Supplement that list with disclosures that have been made to the Securities and Exchange Commission (SEC) of top officers and directors in the company. For smaller businesses, supplement the list with a listing of known relatives who may be active in the business or related businesses.
3. Ask the client for a list of all related-party transactions, including those with SPEs or variable interest entities, that occurred during the year.
4. Discuss the appropriate accounting for all identified related-party transactions with the client and develop an understanding of the appropriate disclosure for the financial statements.
5. Inquire of the client and its lawyers as to whether the client is under any investigation by regulatory agencies or law officials regarding related-party transactions.
6. Review the news media and SEC filings for any investigations of related-party transactions of the client.
LEARNING OBJECTIVE 9

DESCRIBE THE CHARACTERISTICS OF QUALITY AUDIT DOCUMENTATION
DOCUMENTING AUDIT EVIDENCE

- It forms the basis for an auditor’s representations and conclusions
- Helps plan, perform, and supervise audit process
- Forms basis for reviewing work quality
- Includes:
  - Records of planning and performance of work
  - Procedures performed
  - Evidence obtained
  - Conclusions reached by the auditor
DOCUMENTING AUDIT EVIDENCE

AS 3 requires audit documentation be:

- Prepared in detail to provide a clear understanding of its purpose, source, and the conclusions reached
- Appropriately organized to provide a clear link to the significant findings or issues
An auditor should document:

- Overall audit strategy and audit plan
- Overall planned responses to address assessed risks of material misstatement
- Nature, timing, and extent of further audit procedures
- Linkage of those procedures with assessed risks at relevant assertion level
EXHIBIT 6.11 - EXAMPLES OF INFORMATION DOCUMENTED FROM RISK ASSESSMENT PROCEDURES

AUDIT OBJECTIVE: Determine if related-entity transactions occurred during the year and whether they are properly (a) authorized and (b) disclosed in the financial statements.

1. Inquire of the client about processes used to identify related-party transactions and the client’s approach to accounting for related-party transactions.
2. Ask the client to prepare a list of all related parties. Supplement that list with disclosures that have been made to the Securities and Exchange Commission (SEC) of top officers and directors in the company. For smaller businesses, supplement the list with a listing of known relatives who may be active in the business or related businesses.
3. Ask the client for a list of all related-party transactions, including those with SPEs or variable interest entities, that occurred during the year.
4. Discuss the appropriate accounting for all identified related-party transactions with the client and develop an understanding of the appropriate disclosure for the financial statements.
5. Inquire of the client and its lawyers as to whether the client is under any investigation by regulatory agencies or law officials regarding related-party transactions.
6. Review the news media and SEC filings for any investigations of related-party transactions of the client.
DOCUMENTATION USED TO DEMONSTRATE AUDIT WORK PERFORMED

• Client’s trial balance and any auditor-proposed adjustments to it
• Copies of selected internal and external documents
• Memos describing auditor’s approach to gathering evidence and reasoning process in support of account balances
• Results of analytical procedures and tests of client records, and individuals responsible for performance, and subsequently the review, of procedures
DOCUMENTATION USED TO DEMONSTRATE AUDIT WORK PERFORMED

• Correspondence with specialists who provided:
  • Evidence significant to the evaluation or accounting evaluation or accounting for assets/liabilities
  • Related revenue expense effects
• Auditor-generated analysis of account balances
SIGNIFICANT ISSUES

• Substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached on an audit
  • Called audit findings

• Examples provided by AS 3
  • Selection, application, and consistency of accounting principles, including related disclosures
  • Results indicating a need for modification of:
    • Planned auditing procedures
SIGNIFICANT ISSUES

- Material misstatements
- Omissions in financial statements
- Significant deficiencies
- Material weaknesses in internal control
- **Audit adjustment**: Correction of a misstatement of financial statements proposed by the auditor
- Disagreements of engagement team about conclusions on accounting or auditing matters
TYPES OF DOCUMENTATION FOR IDENTIFICATION OF SIGNIFICANT ISSUES AND THEIR RESOLUTION

• Correspondence with national office experts
• Clear articulation of auditor’s judgment and reasoning process that led to the judgment on fairness of financial statements
COPIES OF DOCUMENTS

- Important client documents
  - Documents having legal significance
- Documents from outside parties
- Documents of management representations that acknowledge accuracy of its verbal or written assertions
CHARACTERISTICS OF QUALITY AUDIT DOCUMENTATION

• Serves as primary evidence of audit
• Should include:
  • Heading including name of audit client, an explanatory title, and balance sheet date
  • Initials or electronic signature of the:
    • Auditor and the date the test was completed
    • Manager or partner who reviewed the documentation and the date the review was completed
  • Workpaper page number
  • Description of tests performed
CHARACTERISTICS OF QUALITY AUDIT DOCUMENTATION

• Tick marks and a tick mark legend indicating nature of work performed by auditor
• Assessment of whether the tests indicate possibility of material misstatement in an account
• Cross-reference to related documentation
• Section identifying all significant issues that arose during the audit and how they were resolved
• Comprehensive and clear memorandum outlining auditor’s analysis regarding financial presentation
### EXHIBIT 6.12 - WORKING PAPER FOR INVENTORY PRICE TEST

#### CMI Manufacturing Company

**Inventory Price Test**  
**Year Ended December 31, 2013**

<table>
<thead>
<tr>
<th>Item No.</th>
<th>Item Name</th>
<th>Quantity</th>
<th>Cost Per Unit</th>
<th>Extended Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>4287</td>
<td>Advanced Microstamping machine</td>
<td>22*</td>
<td>$5,128†</td>
<td>112,816.00‡</td>
</tr>
<tr>
<td>5203</td>
<td>1/4 HP electric motor</td>
<td>10*</td>
<td>$39†</td>
<td>390.00‡</td>
</tr>
<tr>
<td>2208</td>
<td>Assembly kit for motor housing</td>
<td>25*</td>
<td>$12†</td>
<td>300.00‡</td>
</tr>
<tr>
<td>1513</td>
<td>Micro stamping machine, Model 25</td>
<td>200*</td>
<td>$2,100†</td>
<td>420,000.00‡</td>
</tr>
<tr>
<td>0068</td>
<td>Rack &amp; Pinion component</td>
<td>300*</td>
<td>$42†</td>
<td>12,600.00‡</td>
</tr>
<tr>
<td>8890</td>
<td>Repair kits for stamping machines</td>
<td>1,000*</td>
<td>$48†</td>
<td>48,000.00‡</td>
</tr>
</tbody>
</table>

**Total value of items tested**  
1,802,000.00

**Items not tested**

**Balance per general ledger**  
2,396,106.00§

---

Sampled items were selected utilizing a dollar unit sampling technique with materiality of $50,000, and internal control assessed as effective (B-1).  
*Quantities agree with client physical inventory tested earlier.  
†Traced to client’s standard cost system that was independently tested (B-2). Amount agrees with client’s standard cost.  
‡Tested extension, no exceptions.  
§Footed, no exceptions; agrees with trial balance.  

Conclusion: No significant issues were noted. In my opinion, the pricing and clerical accuracy of inventory is proper.
LEARNING OBJECTIVE 10

EXPLAIN THE NATURE, DESIGN, AND PURPOSES OF AUDIT PROGRAMS
AUDIT PROGRAM

• Documents the procedures to be performed in gathering audit evidence
• Records successful completion of each audit step
• Provides an effective means for:
  • Organizing and distributing audit work
  • Monitoring the audit process and progress
  • Recording audit work performed and those responsible
  • Reviewing completeness and persuasiveness of procedures performed
EXHIBIT 6.13 - PARTIAL AUDIT PROGRAM FOR ACCOUNTS RECEIVABLE

Audit Procedures

1. Test the accuracy and completeness of the underlying accounting records by footing the accounts receivable file and agreeing it to the general ledger (valuation).
2. Take a sample of recorded accounts receivable balances and confirm the balances with the customers (existence, valuation, rights).
3. Vouch aging details to supporting documents, discuss collectibility of receivables with responsible officials, and review correspondence with customers (valuation).
4. Analyze allowance for doubtful accounts; compare to past history and industry trends to determine adequacy (valuation).
5. Take a sample of recorded receivables and prepare a list of subsequent cash receipts to determine if they are fully paid before the end of the audit (existence, valuation, rights).
6. Verify cutoff for sales, cash receipts, and returns by examining transactions near the end of the year (completeness, existence).
7. Determine adequacy of disclosure of related-party, pledged, discounted, or assigned receivables (presentation).