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Audit Evidence

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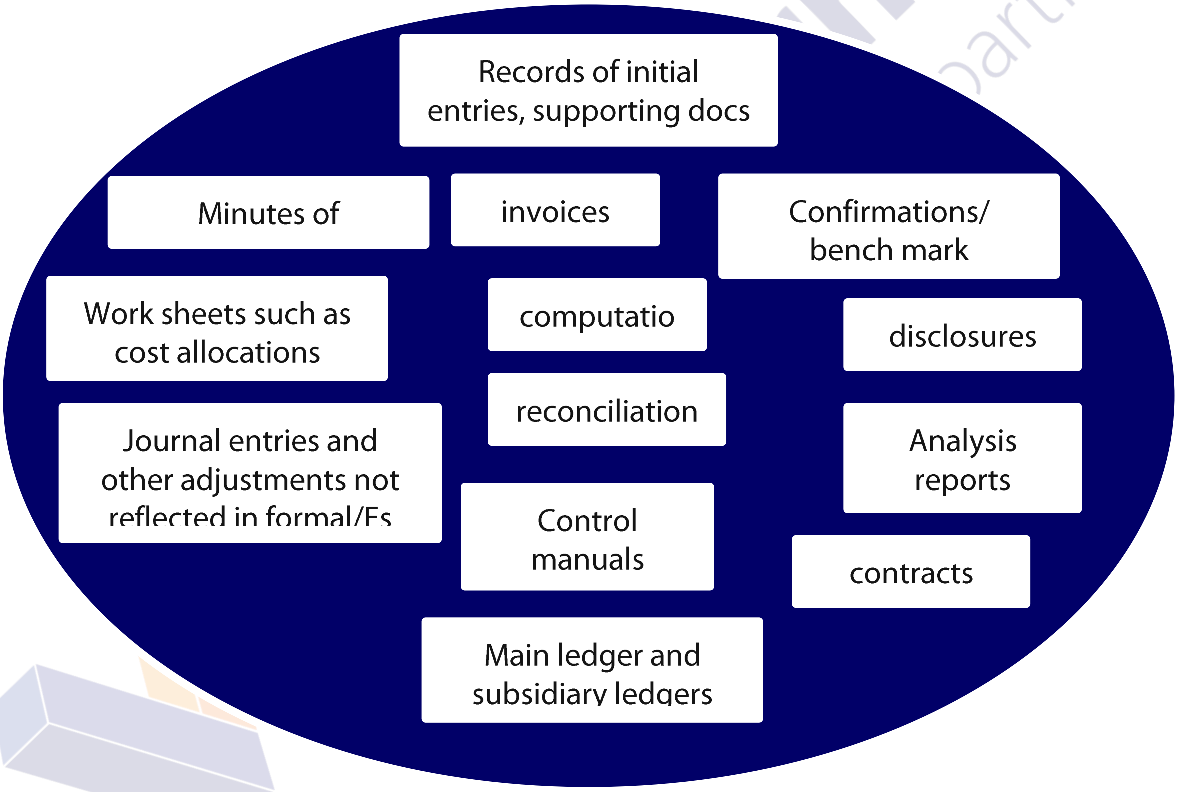
Unit 6 - Audit Evidence (10%)

Think – Remember that sometimes not getting what you want is a wonderful stroke of luck

1. Auditors responsibility with respect to audit evidence
   "Auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion".

2. What is meant by audit evidence?

   - All the information used by auditor in arriving at the conclusions on which the audit opinion is based.
   - Includes the information in the accounting records underlying financial statements and other information.



Audit procedures for obtaining audit evidence

- Inspection of records or documents
- Inspection of tangible assets
- Observation
- Inquiry
- Confirmation
- Re-calculation
- Re-performance
- Analytical procedures

Generalisations about reliability of evidence:

- More reliable when it is obtained from an Independent source outside the entity.
- Internally generated evidence are more reliable, when controls are effective.
- Evidence obtained directly by the auditor rather than indirectly of by inference.
- Written evidence is more reliable than the others.
- Original documents of evidence is more reliable than the photocopies.

Relationship of Financial Statement Assertions and the Audit

Unit 7 - Audit Evidence – Further Considerations (10%)

Think – A certain darkness is needed to see the stars

Using the Work of an Auditor's Expert

1. **Definition**

Auditor's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

Examples

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The estimation of oil and gas reserves.
- The valuation of environmental liabilities, and site clean-up costs
- The analysis of complex or unusual tax compliance issues.

2. **Determining the Need for an Auditor's Expert**

- The nature of the matter to which that expert's work relates;
- The risks of material misstatement in the matter to which that expert's work relates;
- The significance of that expert's work in the context of the audit;
- The auditor's knowledge of and experience with previous work performed by that expert; and
- Whether that expert is subject to the auditor's firm's quality control policies and procedures.

3. **The Competence, Capabilities and Objectivity of the Auditor's Expert**

Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.

- The auditor's firm's quality control policies and procedures.

4. Agreement with the Auditor's Expert

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert

a) The nature, scope and objectives of that expert's work

b) The respective roles and responsibilities of the auditor and that expert

c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert

d) The need for the auditor's expert to observe confidentiality requirements.

5. Evaluating the Adequacy of the Auditor's Expert's Work

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including

a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence

b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances

c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall

a) Agree with that expert on the nature and extent of further work to be performed by that expert; or

b) Perform additional audit procedures appropriate to the circumstances.

6. The Findings and Conclusions of the Auditor's Expert

Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
  - Observing the auditor's expert's work;
  - Examining published data, such as statistical reports from reputable, authoritative sources;
  - Confirming relevant matters with third parties;
  - Performing detailed analytical procedures;

    - Performing calculations.
- Discussing the auditor's expert's report with management.

1. **Reference to the Auditor's Expert in the Auditor's Report**

   In some cases, law or regulation may require a reference to the work of an auditor's expert, for example, for the purposes of transparency in the public sector.

   It may be appropriate in some circumstances to refer to the auditor's expert in an auditor's report containing a modified opinion, to explain the nature of the modification. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

Sri Lanka Auditing Standard 550 - Related Parties

1. **In summary RP definition includes:**
   - Persons
   - Entities
     - That controls, influences or joint controls a Reporting Entity
     - That is controlled, influenced or joint controlled by a Reporting Entity
   - Entities connected with persons

2. **Auditors responsibility**
   - Auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the:
     - Identification of related parties
     - Disclosure by management of related parties and
     - The effect of related party transactions that are material to the financial statements.

   - However, an audit cannot be expected to detect all related party transactions.
   - Degree of uncertainly is inherent in RPT: affects completeness assertion
   - SLAuS 550 provides audit procedures that will provide sufficient appropriate audit evidence over completeness assertion, unless the auditor identified circumstance that:
     - Increases the risk of material misstatement beyond that which would ordinarily be expected; or
     - Indicates that a material misstatement regarding related parties has occurred.
   - If so perform modified, extended or additional audit procedures as are appropriate in the circumstances.

3. Management's responsibility

- Responsible for the identification and disclosure of related parties and transactions with such parties.
- This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements.

4. Audit procedures

A. Existence and disclosure of RP

- Review prior year working papers for names of known related parties;
- Review the entity's procedures for identification of related parties;
- Inquire as to the affiliation of those charged with governance and officers with other entities;
- Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;
- Review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests;
- Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and
- Review the entity's income tax returns and other information supplied to regulatory agencies.

B. Transactions with Related Parties.

- The auditor should review information provided by those charged with governance and management identifying related party transactions and should be alert for other material related party transactions
- When obtaining an understanding of the entity's internal control, the auditor should consider the adequacy of control activities over the authorization and recording of related party transactions.
- Focus on the
  - Process
  - Internal controls over completeness of recording

C. Examining Identified Related Party Transactions.

- Considers performing audit procedures such as :
  - Confirming the terms and amount of the transaction with the related party.
  - Inspecting information in possession of the related party
  - Confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents.

D. Management Representations

- The auditor should obtain a written representation from management concerning:
  - The completeness of information provided regarding the identification of related parties; and
  - The adequacy of related party disclosures in the financial statements.

5. Audit Conclusions and Reporting

If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should modify the auditor's report appropriately.

SLAuS 570 – Going Concern

1. What is Going Concern Assumption

An entity is viewed as continuing in business operations for the foreseeable future.

Examples

- An oil and gas firm operating in Nigeria is stopped by a Nigerian court from carrying out operations in Nigeria.
  - The firm is not a going concern in Nigeria, because it has to shut down.
- A bank is in serious financial troubles and the government is not willing to bail it out.

  The Board of Directors has passed a resolution to liquidate the business.
  - The bank is not a going concern.
- A merchandising company has a current ratio below 0.5. A creditor $1,000,000 demanded payment which the company could not make. The creditor requested the court to liquidate the business and recover his debts and the court grants the order.
  - The company is no longer a going concern.

2. Accounting Standards perspective

LKAS 1 – Presentation of Financial Statements

- When preparing financial Statements, management shall make an assessment of the entity's ability to continue as going concern (section 25 – LKAS 1)
- An entity shall prepare Financial Statements on going concern basis unless management either intend to liquidate the entity or to cease the trading or has no realistic alternative but to do so
- If the going concern basis is not appropriate, the financial statements are prepared on a break-up basis.

3. Objectives of SLAuS 570

- To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements
- To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
- To determine the implications for the auditor's report.

4. Responsibilities of the Auditor

- To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements
- To conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. However, if this assessment covers less than 12 months from the date of the financial statements, the auditor shall ask management to extend its assessment period to at least 12 months from that date. The auditor shall also enquire of management its knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

Events or conditions identified

If events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by:

- Requesting management to make its assessment, where this has not been done
- Evaluating management's plans for future action
- Evaluating the reliability of underlying data used to prepare a cash flow forecast and considering the assumptions used to make the forecast
- Considering whether any additional facts or information have become available since the date that management made its assessment
- Requesting written representations from management and those charged with governance about plans for future action and the feasibility of these plans.

5. Events and Conditions that may cast doubt about Going Concern Assumption

<u>Financial</u>

- Net liability or net current liability position

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
  - Adverse key financial ratios.
  - Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
  - Arrears or discontinuance of dividends.
  - Inability to pay creditors on due dates.
  - Inability to comply with the terms of loan agreements.
  - Change from credit to cash-on-delivery transactions with suppliers.
  - Inability to obtain financing for essential new product development or other essential investments.

<u>Operating</u>

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

<u>Other</u>

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

6. Evaluating Management's Assessment.

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7. What are the Audit procedure applied in performing going concern review?

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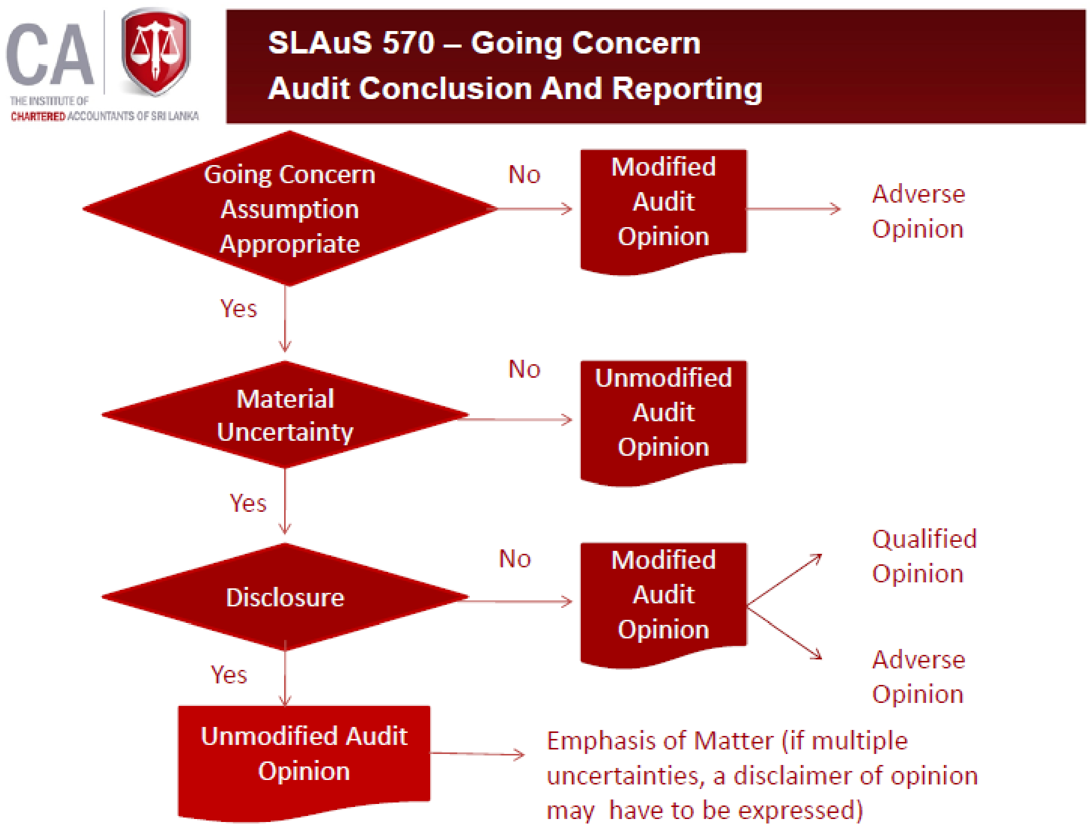
8. Audit Conclusion and Reporting.



ISA 505 - External Confirmations

1. What is external confirmation?

External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertion16110

s in the financial statements or related disclosures.

2. Situations where external confirmations may be used

External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. The following are examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.

- Stocks held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments purchased from stockbrokers but not delivered at the balance sheet date.
- Loans from lenders.
- Accounts payable balances.

3. Assertions Addressed by External Confirmations

External confirmation of an account receivable provides reliable and relevant audit evidence regarding the existence of the account as at a certain date.

Confirmation also provides audit evidence regarding the operation of cutoff procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

Similarly, in the case of goods held on consignment, external confirmation is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions, but might not provide audit evidence that supports the valuation assertion.

4. Use of Positive and Negative Confirmations

A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information

A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request.

5. Management Requests

When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.

If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.

6. No Response to a Positive Confirmation Request

The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.

7. **External Confirmation Process**

When the auditor decides to request positive or negative confirmations, the auditor shall plan, design, undertake and control the external confirmation procedures, including:

a) Identification of the member or members of the audit team responsible for controlling the external confirmation process, the resources assigned and the timing of the related procedures;

b) Selection of items for which external confirmations will be requested;

c) Design and preparation of the confirmation requests;

d) Communication of the confirmation requests to the appropriate confirming party;

e) Consideration of the results (responses, non-responses and exceptions) of confirmation requests; and

f) Evaluation of the evidence obtained from the confirmation requests. (Ref: Para. A15-A26)

The auditor shall only use negative confirmations to reduce the risk of financial statement misstatement to an acceptable level without also performing other substantive procedures when:

a) The assessed risk of material misstatement associated with the relevant financial statement assertion is low;

b) A large number of small balances is involved;

c) A substantial number of errors is not expected; and

d) The auditor believes that respondents will not disregard the confirmation requests.

SLAUS - 580 Written Representations

1. **Written Representations about Management's Responsibilities.**

Preparation of the Financial Statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.

2. **Date of and Period(s) Covered by Written Representations**

The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

3. **Requested Written Representations Not Provided**

If management does not provide one or more of the requested written representations, the auditor shall:

a) Discuss the matter with management;

b) Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with ISA 705.

4. Doubt as to the Reliability of Written Representations

In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.