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# SLAUS 500 : Audit Evidence

## Chartered Accountancy
## Corporate Level
Advanced Audit & Assurance (AAA)

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# SLAUS 500 -Audit Evidence

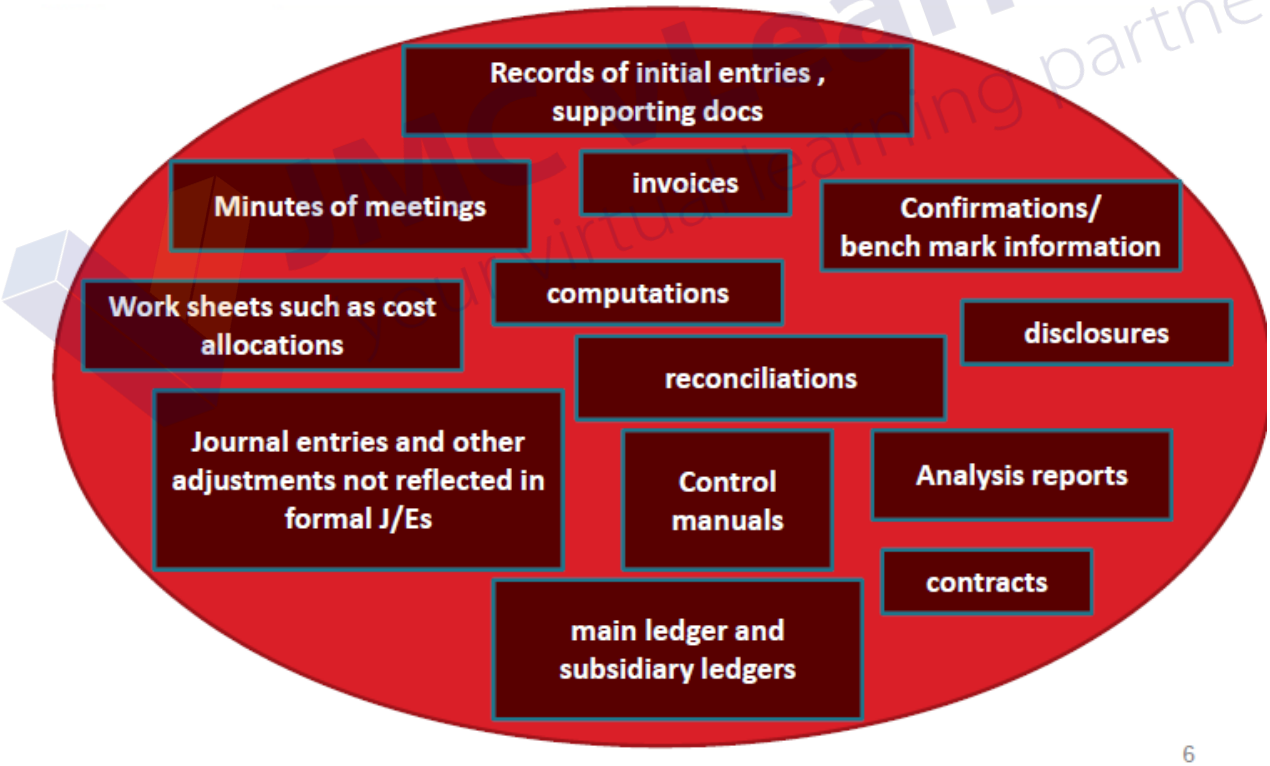
## *Think – Remember that sometimes not getting what you want is a wonderful stroke of luck*

**01. 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".

**02. 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 or 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

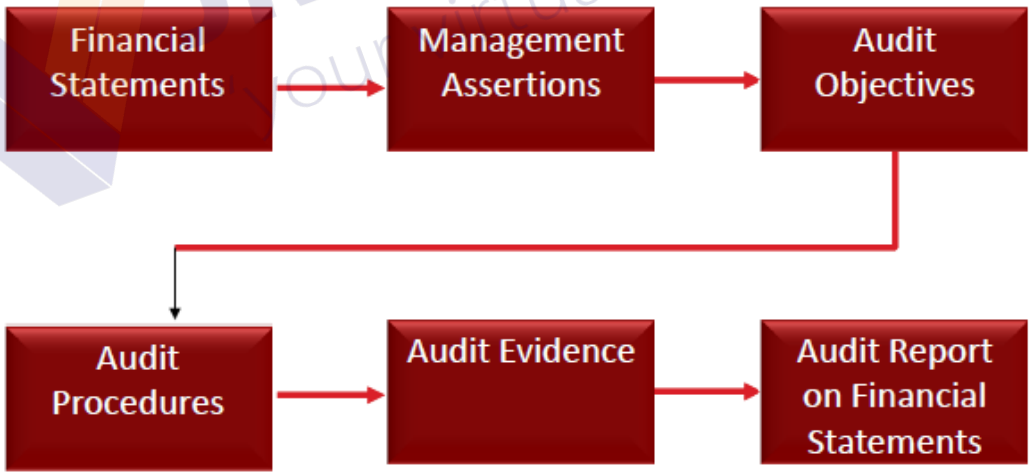


*Table 10.4: Typical audit tests, by assertion type*

| Audit assertion | Type of assertion | Typical audit tests |
|---|---|---|
| **Completeness** | Classes of transactions<br>Account balances<br>Presentation and disclosure | (a) Review of post-year-end items<br>(b) Cut-off testing<br>(c) Analytical procedures<br>(d) Confirmations<br>(e) Reconciliations to control accounts |
| **Rights and obligations** | Account balances<br>Presentation and disclosure | (a) Reviewing invoices for proof that item belongs to the company<br>(b) Confirmations with third parties |
| **Valuation and allocation** | Account balances<br>Presentation and disclosure | (a) Matching amounts to invoices<br>(b) Recalculation<br>(c) Confirming accounting policy is consistent and reasonable<br>(d) Review of post-year-end payments and invoices<br>(e) Expert valuation |
| **Existence** | Account balances | (a) Physical verification<br>(b) Third-party confirmations<br>(c) Cut-off testing |
| **Occurrence** | Classes of transactions<br>Presentation and disclosure | (a) Inspection of supporting documentation<br>(b) Confirmation from directors that transactions relate to business<br>(c) Inspection of items purchased |
| **Accuracy** | Classes of transactions<br>Presentation and disclosure | (a) Recalculation of correct amounts<br>(b) Third-party confirmation<br>(c) Analytical procedures |
| **Classification and understandability** | Classes of transactions<br>Presentation and disclosure | (a) Confirming compliance with law and accounting standards<br>(b) Reviewing notes for understandability |
| **Cut-off** | Classes of transactions | (a) Cut-off testing<br>(b) Analytical procedures |

**Directional testing**

The concept of directional testing derives from the principle of double-entry bookkeeping, in that for every **debit** there should be a **corresponding credit**. Therefore, any **misstatement** of a **debit entry** will result in either a corresponding **misstatement** of a **credit entry** or a **misstatement** in the opposite direction, of **another debit entry**.

| Test item | Example |
|---|---|
| Test **debit items** (expenditure or assets) for overstatement by selecting debit entries recorded in the general ledger and checking value, existence and ownership | If a non-current asset entry in the general ledger of Rs.10,000,000 is selected, it would be overstated if it should have been recorded at anything less than Rs.10,000,000 or if the company did not own it, or indeed if it did not exist (eg it had been sold or the amount of Rs.10,000,000 in fact represented a revenue expense). |
| Test **credit items** (income or liabilities) for understatement by selecting items from appropriate sources independent of the general ledger and ensuring that they result in the correct general ledger entry | Select a goods despatched note and agree that the resultant sale has been recorded in the general ledger sales account. Sales would be understated if the general ledger did not reflect the transaction at all (completeness) or reflected it at less than full value (say if goods valued at Rs.10,000,000 were recorded in the sales account at Rs.9,000,000, there would be an understatement of Rs.1,000,000). |

## SLAUS 520 - Analytical procedures

SLAuS 520 *Analytical procedures* provides guidance to auditors on the use of analytical procedures as substantive procedures. Remember from Chapter 7 that analytical procedures include:

(a) The consideration of comparisons with:

- **Comparable information** for prior periods
- **Anticipated results** of the entity, from budgets or forecasts
- **Expectations** prepared by the auditors (eg estimation of depreciation)
- **Industry information**

(b) Those between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales
(c) Those between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees

**Suitability of analytical procedures**
Substantive analytical procedures are usually more applicable to large volumes of transactions that tend to be predictable over time. The suitability of a particular analytical procedure will depend on the auditor's assessment of how effective it will be in detecting material misstatements. Determining the suitability will be influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement.

**Acceptable differences**
The amount of the difference of recorded amounts from the expected value that is acceptable depends on **materiality** and **consistency with the desired level of assurance**, having taken into account that a misstatement may cause the financial statements to be materially misstated. Therefore, as the **assessed risk increases**, the **amount of the difference that is acceptable** without further investigation **decreases**.

**Practical techniques**
Analytical procedures can be performed using various techniques, ranging from simple comparisons to complex analyses using advanced statistical techniques. In this section we look at some of the techniques that can be used to carry out analytical procedures.

**Ratio analysis** can be a useful technique. However, ratios mean very little when used in isolation. They should be calculated for previous periods and for comparable companies. This may involve a certain amount of initial research, but subsequently it is just a matter of adding new statistics to the existing information each year. The permanent file should contain a section with summarized accounts and the chosen ratios for prior years.

In addition to looking at the more usual ratios, the auditors should consider examining other ratios that may be relevant to the particular clients' business. Other analytical techniques include:

(a) **Examining related accounts** in conjunction with each other. Often revenue and expense accounts are related to accounts in the statement of financial position and comparisons should be made to ensure relationships are reasonable.
(b) **Trend analysis**. Sophisticated statistical techniques can be used to compare this period with previous periods.
(c) **Reasonableness test**. This involves calculating the **expected value** of an item and comparing it with its actual value, for example, for straight-line depreciation.

(Cost + Additions – Disposals) □ Depreciation % = Charge in statement of profit or loss

*Table 10.8: Ratios and areas for consideration*

| | |
|---|---|
| **Important accounting ratios** | • Gross profit margins, in total and by product, area and months/quarter (if possible)<br>• Operating profit margin<br>• Receivables collection period (average collection period in days)<br>• Payables payment period (average payment period in days)<br>• Inventory holding period (average number of days inventory is held)<br>• Inventory revenue ratio (revenue divided into cost of sales)<br>• Current ratio (current assets to current liabilities)<br>• Quick or acid test ratio (liquid assets to current liabilities)<br>• Gearing ratio (debt capital to equity capital)<br>• Return on capital employed (profit before tax to total assets less current liabilities) |
| **Related items** | • Payables and purchases<br>• Inventories and cost of sales<br>• Non-current assets and depreciation, repairs and maintenance expense<br>• Intangible assets and amortisation<br>• Loans and interest expense<br>• Investments and investment income<br>• Receivables and irrecoverable debt expense<br>• Receivables and sales |

| **Other areas for consideration** |
|---|
| • **Examine changes** in **products, customers and levels** of **returns** |
| • **Assess** the effect of **price and mix changes** on the cost of sales |
| • **Consider** the effect of **inflation, industrial disputes, changes in production methods** and **changes in activity** on the charge for wages |
| • **Obtain explanations** for all **major variances** analysed using a standard costing system. Particular attention should be paid to those relating to the over or under absorption of overheads since these may, *inter alia*, affect inventory valuations |
| • **Compare trends in production and sales** and assess the effect on any provisions for obsolete inventory |
| • **Ensure** that **changes in the percentage labour or overhead content** of production costs are also reflected in the inventory valuation |

- **Review other expenditure**, comparing:
  - Rent with annual rent per rental agreement
  - Rates with previous year and known rates increases
  - Interest payable on loans with outstanding balance and interest rate per loan agreement
  - Hire or leasing charges with annual rate per agreements
  - Vehicle running expenses with those expected for the company's vehicles
  - Other items related to activity level with general price increase and change in relevant level of activity (for example telephone expenditure will increase disproportionately if export or import business increases)
  - Other items not related to activity level with general price increases (or specific increases if known)
- **Review** statement of profit or loss and other comprehensive income for **items** which may have been **omitted** (eg scrap sales, training levy, special contributions to pension fund, provisions for dilapidation etc)
- **Ensure expected variations** arising from the following have occurred:
  - Industry or local trends
  - Known disturbances of the trading pattern (for example, strikes, depot closures, failure of suppliers)



The working papers must contain the completed results of analytical procedures.
They should include:

- The outline **programme** of the work
- The summary of **significant figures** and relationships for the period
- A summary of **comparisons** made with budgets and with previous years
- Details of all **significant fluctuations** or **unexpected relationships** considered
- Details of the **results of investigations** into such fluctuations/relationships
- The audit **conclusions** reached
- **Information considered** necessary for assisting in the **planning** of subsequent audits

**Investigating the results of analytical procedures**

SLAuS 520 states that where analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information, or that differ significantly from the expected results, the auditor shall investigate by:

- **Enquiries of management** and obtaining appropriate audit evidence relevant to **management's responses**
- Performing **other audit procedures** if necessary (eg if management cannot provide an explanation or the explanation is not adequate)

**QUESTION**
You are part of the audit team auditing the financial statements of Sweep Ltd, a small office supplies business, for the year ended 31 March 20X9. The company employed the following staff at the start of the financial year: 7 office and warehouse managers, 20 warehouse staff and 25 office staff.
The pay ranges for each category of staff is shown below:

Office and warehouse managers: Rs. 3,500,000 to Rs. 5,000,000 per year
Warehouse and office staff: Rs. 1,800,000 to Rs. 2,500,000 per year

You have been asked to audit the wages and salaries expense for the year. All staff were given a 4% pay rise in the year, backdated to the start of the year. One of the office managers left the company part-way through the year. There were two new members of warehouse staff and three new members of office staff.
The expense for the year is shown in the draft statement of profit or loss as Rs. 124,945,000.

**Required**
Using analytical procedures, **perform** a proof in total on the wages and salaries expense for the year.



## SLAUS 530 - Sampling & Audit procedures

**Introduction to audit sampling**

**Audit sampling** is the application of audit procedures to less than 100% of items within a population of audit relevance, such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected, in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.
The **population** is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Audit sampling can be done using either **statistical sampling** or **non-statistical sampling** methods.
**Statistical sampling** is an approach to sampling that involves random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk.
**Non-statistical sampling** is a sampling approach that does not have these characteristics.

The auditor may, alternatively, select certain items from a population because of specific characteristics they possess. The results of items selected in this no statistical way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- **High-value or key items.** The auditor may select high-value items or items that are suspicious, unusual or prone to error.

- **All items over a certain amount**. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- **Items to obtain information** about the client's business, the nature of transactions, or the client's accounting and control systems.
- **Items to test procedures,** to see whether particular procedures are being performed.

**Design of the sample**

**Sampling risk** arises from the possibility that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

**Non-sampling risk** arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample such as, for example, the use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

**Sampling unit** is the individual items constituting a population. It may be a physical item (eg credit entries on bank statements, sales invoices, receivables' balances) or a monetary unit.

**Stratification** is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics, often monetary value.

## Methods of Sample selection

Main methods of selecting samples are **random selection, systematic selection** and **haphazard selection**. We discuss these, and other methods, below.

(a) **Random selection** ensures that all items in the population have an equal chance of selection, eg by use of random number tables or random number generators.

(b) **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

(c) **Haphazard selection,** in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling

(d) **Block selection** may be used to check whether certain items have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year. Block sampling may, however, produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.

(e) **Monetary unit sampling** is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

### Performing audit procedures

Once the sample has been selected, the auditor must perform **appropriate audit procedures** on each item in the sample. If the audit procedure is not applicable to the selected item, the test must be performed on a **replacement item**. This could happen if, for example, a voided cheque is selected when testing for evidence of authorisation of payment.
If the auditor cannot apply the designed audit procedures (eg if documentation relating to the item has been lost), or suitable alternative audit procedures, to the selected item, that item must be treated as a **deviation** from the prescribed control (for tests of controls) or a **misstatement** (for tests of details).

### Deviations and Misstatements

The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud

### Evaluating the results

**Tolerable misstatement** is a monetary amount set by the auditor, in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

**Tolerable rate of deviation** is a rate of deviation from prescribed internal control procedures set by the auditor, in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

## Computer-assisted audit techniques (CAATs)

CAATs are the use of computers for audit work. The two most commonly used CAATs are **audit software** and **test data**.

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool.

CAATs may be used in performing various auditing procedures, including the following.

- **Tests of details** of transactions and balances

- **Analytical review procedures**
- **Tests of computer information system controls**

The advantages of using CAATs are:

- Auditors can test programme controls as well as general internal controls associated with computers.
- Auditors can test a greater number of items more quickly and accurately than would be the case otherwise.
- Auditors can test transactions rather than paper records of transactions that could be incorrect.
- CAATs are cost-effective in the long term if the client does not change its systems.
- Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased.

The disadvantages associated with using CAATs include:

- Setting up the software needed for CAATs can be time consuming and expensive
- Audit staff will need to be trained so they have a sufficient level of IT knowledge to apply CAATs
- Not all client systems will be compatible with the software used with CAATs
- There is a risk that live client data is corrupted and lost during the use of CAATs

**Audit software**

**Audit software** consists of computer programs used by the auditors, as part of their auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of generalised audit software or custom audit software. Audit software is used for substantive procedures.

**Generalized audit software** allows auditors to perform tests on computer files and databases, such as reading and extracting data from a client's systems for further testing, selecting data that meets certain criteria, performing arithmetical calculations on data, facilitating audit sampling and producing documents and reports. Examples of generalized audit software are ACT and IDEA.

**Custom audit software** is written by auditors for specific tasks when generalized audit software cannot be used.

*Table 11.1: Use of audit software*

| Audit software: examples of use |
| --- |
| • Perform calculations and comparisons in analytical procedures<br>• Sampling programs to extract data for audit testing, eg select a sample of receivables for confirmation<br>• Scan a file to ensure that all documents in a series have been accounted for, or to search for large and unusual items<br>• Compare data elements in different files for agreement, eg prices on sales invoices to authorised prices in master file<br>• Re-perform calculations, eg totalling sales ledger<br>• Prepare documents and reports, eg produce receivables' confirmation letters and monthly statements |

***Benefits of using audit software***

(a) Audit software can perform calculations and comparisons more quickly than those done manually.

(b) Audit software makes it possible to test more transactions than when simply manually scanning printouts. For example, audit software may facilitate searches for exceptions, such as negative or very high quantities, when auditing inventory listings. The additional information will give the auditor increased comfort that the figure being audited is reasonably stated.

(c) Audit software may allow the actual computer files (the source files) to be tested from the originating program, rather than printouts from spool or previewed files which are dependent on other software (and therefore could contain errors or could have been tampered with following export).

(d) Using audit software is likely to be **cost-effective in the long term** if the client does not change its systems.

*Difficulties of using audit software*

(a) The **costs** of designing tests using audit software can be substantial, as a great deal of planning time will be needed in order to gain an in-depth understanding of the client's systems so that appropriate software can be produced.

(b) The **audit costs in general may increase,** because experienced and specially trained staff will be required to design the software, perform the testing and review the results of the testing.

(c) If errors are made in the design of the audit software, **audit time, and hence costs, can be wasted** in investigating anomalies that have arisen because of flaws in how the software was put together rather than by errors in the client's processing.

(d) If audit software has been designed to carry out procedures during live running of the client's system, there is a risk that this **disrupts** the client's systems. If the procedures are to be run when the system is not live, extra costs will be incurred by carrying out procedures to verify that the version of the system being tested is identical to that used by the client in live situations.

# SLAuS 510 Initial audit engagements – opening balances

Auditors must ensure that the **opening balances** and **comparative information** are fairly stated in the financial statements.

**Opening balances** are those account balances that exist at the beginning of the period.

An **initial audit engagement** is one in which either the financial statements for the prior period were not audited or one in which the financial statements for the prior period were audited by a predecessor auditor.

The SLAuS states that, for initial audit engagements, the auditor's objective is to obtain sufficient appropriate audit evidence whether:

- Opening balances contain **misstatements** that **materially** affect the current period's financial statements.
- **Appropriate accounting policies are consistently** applied, or changes have been properly accounted for and adequately presented and disclosed.

## Audit evidence for opening balances

SLAuS 510 states that the auditor shall **read** the most recent financial statements and the predecessor auditor's report for information relevant to opening balances.
The auditor shall obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements by:

- Determining whether the prior period's closing balances have been correctly brought forward or restated
- Determining whether the opening balances reflect the application of appropriate accounting policies
- Performing one or more of the following:
  - Where the prior period's financial statements were audited, reviewing the predecessor auditor's working papers
  - Evaluating whether audit procedures performed in the current period provide evidence relevant to opening balances
  - Performing specific audit procedures to obtain evidence regarding opening balances

## Audit conclusions and reporting

If the auditor cannot obtain **sufficient appropriate audit evidence** for opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion.
If the opening balances contain misstatements that **materially affect** the current year's financial statements, the auditor shall express a qualified opinion or an adverse opinion.

If the auditor concludes that the current period's **accounting policies** are not consistently applied in relation to opening balances, or changes have not been properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion.

If a prior-period modification remains **relevant and material** to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements accordingly.

## SLAuS 710 Comparative information – corresponding figures and comparative financial statements

**Comparative information** is amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework. There are two methods of presentation:
**corresponding figures**, where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period; and **comparative financial statements** where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's report.

### Auditor's responsibilities for comparative information

The SLAuS states that the auditor must determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether it is appropriately classified. This includes an evaluation of whether:

- The **accounting policies** used for corresponding figures or comparative financial statements are consistent with the current period.
- The corresponding figures or comparative financial statements **agree** with the amounts and other disclosures presented in the prior period.

SLAuS 710 requires the auditor to obtain a **written representation** for all periods referred to in the auditor's opinion and a specific written representation regarding any restatements made to correct a material misstatement in prior period financial statements that affect the comparative information.

**Corresponding figures – reporting**

In terms of reporting, the audit report does not specifically refer to the corresponding figures because the opinion is on the current period's financial statements as a whole, and this includes the corresponding figures.

**Comparative financial statements – reporting**

Comparative financial statements are not required in Sri Lanka. The only requirement is to include corresponding figures.