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Audit techniques and audit evidence

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Abstract

Auditors uses various techniques to control accounts in order to get valid and relevant samples. There are many ways to obtain an relevant audit evidence and auditors have to use: Physical examination, Confirmations, Documentation, Analytical Procedures, Inquiries of the Client, Reperformance, Observation. Another major technique used in audit is audit sampling. The purpose of audit procedures is to offer detailed audit steps which are to be performed during the audit fieldwork and which will achieve the explicit audit objectives. These procedures are to be developed by the auditor and approved by audit management, and in the case of a decision of not performing a procedure, a comment with the reason for that decision needs to be included in the audit procedures.

Keywords: audit evidence, documentation, external confirmation, audit sampling

Introduction

"Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users" (American Accounting Association, 1972). [7]
In order to give an assurance about the financial statements of an entity, the auditor receives assertions from the management about these reports. These assertions cannot be trusted and the auditor needs to collect evidence that confirms that the information produced by the management is accurate. In this case, the auditors' opinion is based on the collected evidence (as see in Fig. 1.).
Audit evidence includes written and electronic information that permits the auditor to reach conclusions through reasoning. In this respect, audit evidence help auditors to establish a starting point from which an auditor expresses audit opinion on the accounts and financial operations of the company being audited. Such evidence is obtained from tests that determine how well accounting controls work and from tests of accounting details (such as completeness and disclosure of information).

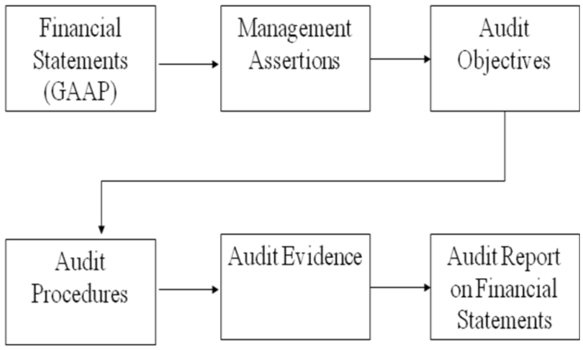


Fig. 1. Relationship of Financial Statement Assertions and the Audit evidence

Concept of Audit Evidence

The International Standard on Auditing (ISA) 500 [5] describe what constitutes audit evidence in an audit of financial statements, and promote the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence. Audit evidence must give to the auditor a reasonable assurance that the financial statements do not contain a material misstatement.

The formula 'reasonable assurance' is an important aspect of the auditor's report because this refers to the fact that the financial statements may be not correct in absolute terms [2]. Sometimes, the financial statements could contains a material misstatement because of the limitations inherent in an audit, such as:

- It is not suitable to test 100% of every item within the financial statements in order to keep a balance between costs and benefits.
- Inherent limitations in accounting and internal controls of the client firm.
- Possibilities that client staff and management may not be entirely honest.
- Estimates used in the financial statements.
- Judgements made on behalf of auditors including risk assessments and materiality as well as judging which tests are appropriate and which tests are not.

A reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. It is for the above reasons that auditors 'express an opinion' rather than confirm the accounts are completely accurate.

According to the ISA, audit evidence need to be 'sufficient' and 'appropriate'. 'Sufficient' refers to the quantity, as well as the quality, of the audit evidence. 'Appropriateness' of audit evidence is related to the nature and timing of audit procedures. Appropriateness (the quality of evidence) is achieved if the evidence obtained is relevant and reliable. Also, the audit evidence should be sufficiently documented so that they can be used before issuing the auditor's report.

Audit evidence needs to support the auditors opinion in the auditor's report and the audit file should indicate how the auditor has arrived at their audit opinion. Regarding this aspect, in the past audit firms (like Arthur Andersen in Enron scandal) have been accused by public opinion and regulatory bodies because the audit evidence that they have obtained has not been sufficient or appropriate enough to justify their audit opinion. Auditors must ensure that when planning and performing audit procedures, they believes that these procedures are adequate enough in order to obtain sufficient and appropriate audit evidence (because audit procedure and audit evidence are not the same – auditors use procedures to generate evidence). Other aspects that auditors need to consider are relevance and reliability of the information to be used as audit evidence.

Sometimes it is indicate to obtain audit evidence from other sources outside of the entity being subject to audit. This source is more appropriate than an internal one. For example, bank confirmations can offer audit evidence concerning the existence of bank accounts at the reporting date and this kind of audit evidence is more important than a bank statement even that one is signed and stamped.

Obtaining Audit Evidence

Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. In representing that the financial statements are fairly presented in conformity with generally accepted accounting principles, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures.
Assertions used by the auditor could be classsified into the following categories [1]:

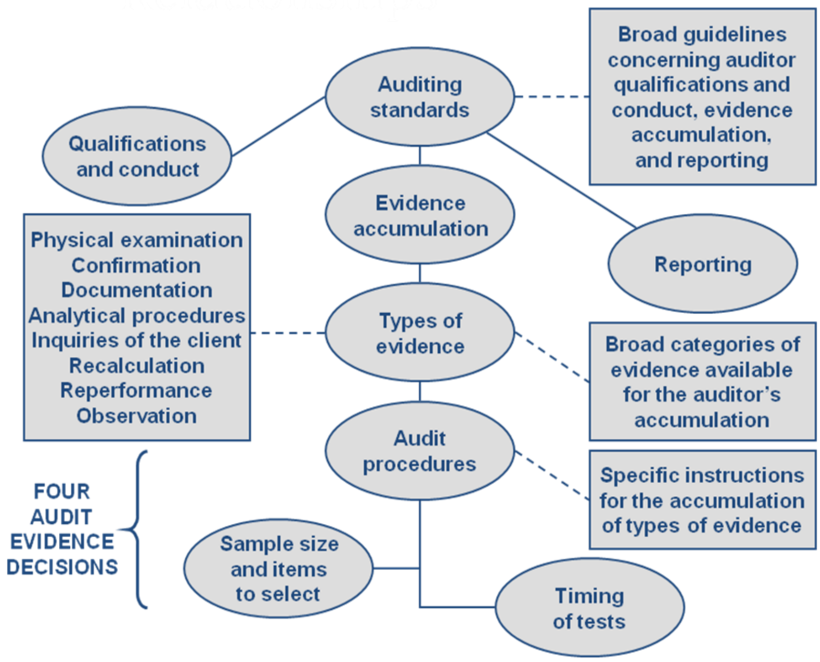
a. Assertions about classes of transactions and events for the period under audit:
   - Occurrence. Transactions and events that have been recorded have occurred and pertain to the entity.
   - Completeness. All transactions and events that should have been recorded have been recorded.
   - Accuracy. Amounts and other data relating to recorded transactions and events have been recorded appropriately.
   - Cutoff. Transactions and events have been recorded in the correct accounting period.
   - Classification. Transactions and events have been recorded in the proper accounts.
b. Assertions about account balances at the period end:
   - Existence. Assets, liabilities, and equity interests exist.
   - Rights and obligations. The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
   - Completeness. All assets, liabilities, and equity interests that should have been recorded have been recorded.
   - Valuation and allocation. Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
c. Assertions about presentation and disclosure:
   - Occurrence and rights and obligations. Disclosed events and transactions have occurred and pertain to the entity.
   - Completeness. All disclosures that should have been included in the financial statements have been included.
   - Classification and understandability. Financial information is appropriately presented and described and disclosures are clearly expressed.
   - Accuracy and valuation. Financial and other information are disclosed fairly and at appropriate amounts.

The auditor may use the relevant assertions as they are described above or may express them differently provided aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.
As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.
The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.
Relevant assertions are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertion separately in connection with the period-end financial reporting process.
For each significant class of transactions, account balance, and presentation and disclosure, the auditor should determine the relevance of each of the financial statement assertions. To identify

relevant assertions, the auditor should determine the source of likely potential misstatements in each significant class of transactions, account balance, and presentation and disclosure. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate [3]:
a. The nature of the assertion;
b. The volume of transactions or data related to the assertion; and
c. The nature and complexity of the systems, including the use of information technology, by which the entity processes and controls information supporting the assertion.
For the auditors, obtaining an assurance above these assertions involve a combination of audit procedures used to obtain audit evidence during the conduct of financial audits. These include:

- Physical examination (inspection) - examining or count by the auditor of a tangible asset or examining records or documents in paper or electronic form
- Observation - looking at a process or procedure being performed by others
- Documentation - refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of the audit.
- Inquiry - seeking information from knowledgeable people within and outside the entity, ranging from formal written enquiries to informal discussions
- External confirmation—obtaining a written confirmation directly from a third party, such as a bank or debtor
- Recalculation - checking the mathematical accuracy of documents or records
- Reperformance - independently re-performing procedures or controls that were originally performed as part of the entity's internal control
- Analytical procedures - evaluating financial information made by a study of plausible relationships among both financial and nonfinancial data.

  The above procedures identified for the purposes of obtaining audit evidence can be linked into the financial statement assertions as shown below.



Inspection consists of **examining records or documents,** whether internal or external, in paper form, electronic form, or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records or documents for evidence of authorization.
Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not

necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition.

Inspection of tangible assets – that consists of physical examination of the assets. Inspection of tangible assets may provide appropriate audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets [4]. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting. For example, when observing an inventory count, the auditor may inspect individual inventory items (such as opening containers included in the inventory count to ensure that they are not empty) to verify their existence. Confirmation that assets seen are recorded in accounting records gives evidence of completeness.

Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.

The form and content of audit **documentation** should be designed to meet the circumstances of the particular audit. The information contained in audit documentation constitutes the principal record of the work that the auditors have performed in accordance with standards and the conclusions that the auditors have reached. The quantity, type, and content of audit documentation are a matter of the auditors' professional judgment. The audit documentation therefore is not restricted to being only on papers, but can also be on electronic media.

Generally the factors that determine the form and content of documentations for a particular engagement are:

- The nature of the engagement
- The nature of the business activity of the client
- The status of the client
- Reporting format
- Relevant legislations applicable to the client
- Records maintained by the client
- Internal controls in operation
- Quality of audit assistants engaged in the particular assignment and the need to direct and supervise their work

The need for audit documentation is very important. For example, documents believed to be related to Enron were destroyed, focusing the attention of regulators and lawmakers on the contents and retention of audit documentation.

The audit working papers (current and permanent) for a client audit engagement should be sufficiently detailed to enable another appropriately experienced and competent auditor who is not familiar with the client to obtain an overall understanding of the engagement. The auditor should retain the working papers for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

One of the principal methods of obtaining corroborative evidence available to auditors is by inquiry. **Inquiry** involves seeking information from knowledgeable persons inside or outside the entity. Confirmation is the name given to a specific form of inquiry that is particularly widely used. It involves obtaining written confirmation from a third party, typically, although not exclusively, in relation to an account balance in which the third party has an interest.

External confirmations involve seeking information from external sources such as bank audit letters or circularisation of receivables.

Confirmations are best used where there is a knowledgeable party, independent of the entity and where alternative reliable evidence is not readily available. The most knowledgeable parties are those in a commercial relationship with the entity holding reciprocal information as to entity balances. These include debtors, creditors, banks, lenders, borrowers and custodians of entity assets such as stocks and securities. It is in their own interest for such parties to maintain reliable records of their

relationship with the entity. It is also in their interest to respond to an auditor’s request for confirmation to ensure that any differences are identified and resolved.
The use of confirmation evidence is usually very important in the audit of trade debtors because there are few other sources of external corroborative evidence. It is usually suitable when the majority of the credit customers are reasonable-sized businesses. Because existence is an important assertion being verified, it is important that the source from which the sample is selected is tested for completeness. This usually requires selecting the sample from a list of balances that has been tested against the sales ledger and totalled and agreed with the general ledger balance.
The list of debtors is usually subdivided into current due balances and overdue balances. Each present separate audit risks. Overdue balances are more likely to contain errors and thus require a proportionately larger sample.
It is necessary to verify non-responses with alternative reliable evidence of the outstanding balance in order to maintain the integrity of the sample where positive confirmations are used. Such evidence includes delivery notes signed for by the customer, written customer sales orders and, if subsequently paid, a remittance advice accompanying the payment identifying the specific invoices being paid.
Creditors are much less frequently confirmed than debtors. The auditor already has external evidence in the form of supplier invoices and statements. Although held by the entity and thus potentially at risk from being manipulated, they are likely to provide sufficient appropriate evidence in the absence of any suspicious circumstances. In addition, the principal assertion verified by confirmation evidence would be that of completeness. The available population (creditor balances recorded by the entity), is not a suitable starting point for selecting a sample for confirmation when verifying completeness. If time is available, auditors tend to prefer to use the complementary/reciprocal population of purchases (or payment transactions recorded after the period end) when verifying the completeness of recorded creditors.
In many countries, the auditing profession has come to a mutual agreement with the banking industry on the method to be employed in seeking confirmations. A standardised form is commonly used with open questions for the bank to complete. The evidence should be reliable because banks usually maintain a high level of internal control over records of customer balances. However, because the task of completing the confirmation is often entrusted to relatively junior personnel and is not subject to independent checks, auditors must be alert for the possibility of clerical errors when making use of the evidence obtained by confirmation.
Another consideration when confirming bank balances is that they involve both debit and credit balances and contingencies. Therefore, evidence of both completeness and existence is sought. Although balances with each bank are usually individually material (in that all banks are confirmed – not just a sample), the auditors must take reasonable care that all banks which the entity has had dealings with during the year are identified. Auditors should request confirmations from each bank, not just those with recorded balances outstanding at the period end.
Recalculation involves checking the arithmetic accuracy of client’s records [2]. Auditors commonly recalculate a company's accounting reports or documents as part of the audit process. These procedures apply to financial statements, reconciliations, cost reports and other documents. Auditors use these technical procedures to ensure a company is accurately applying basic accounting principles to its financial transactions. Conducting these recalculations independently also allows auditors to review information in individual financial accounts to ensure these items are correctly entered into the accounting ledger.
Reperformance is the auditor's independent tests of client accounting procedures or controls that were originally done as part of the entity's accounting and internal control system. This involves reperforming various reconciliations as at the reporting date or at interim periods to check controls have been operating effectively, for example reperforming a bank reconciliation statement.
Whereas recalculation involves rechecking a computation, reperformance involves checking other procedures.
The auditor normally makes limited tests to ascertain that the information in the sales journal has been included for the proper customer and at the correct amount in the subsidiary accounts receivable records and is accurately summarized in the general ledger.
Analytical procedures consist of comparing items, for example, current year financial information with prior year financial information and analysing predictable relationships such as the relationship

of trade receivables with revenue. It can also be used to help identify any unusual trends or characteristics within the financial statements.
What determines whether audit evidence is sufficient and appropriate will depend on a number of factors, such as:

- The risk assessment.
- The nature of the accounting and internal control systems.
- Materiality.
- The auditor's experience of previous audits including the auditor's knowledge of the business and the environment in which it operates.
- The results of audit procedures.
- The source and reliability of the information available.

In figure 2 below it is shown the criteria to determine appropriateness of type of evidence.

	Criteria to Determine Appropriateness				
Type of Evidence	Independence of Provider	Effectiveness of Client's Internal Controls	Auditor's Direct Knowledge	Qualifications of Provider	Objectivity of Evidence
Physical examination	High (auditor does)	Varies	High	Normally high (auditor does)	High
Confirmation	High	Not applicable	Low	Varies—usually high	High
Documentation	Varies—external more independent than internal	Varies	Low	Varies	High
Analytical procedures	High/low (auditor does/ client responds)	Varies	Low	Normally high (auditor does/ client responds)	Varies—usually low
Inquiries of client	Low (client provides)	Not applicable	Low	Varies	Varies—low to high
Recalculation	High (auditor does)	Varies	High	High (auditor does)	High
Reperformance	High (auditor does)	Varies	High	High (auditor does)	High
Observation	High (auditor does)	Varies	High	Normally high (auditor does)	Medium

Fig. 2. Appropriateness of type of evidence

The Use of Experts as Audit Evidence

In many cases, the auditor's expertise will be limited and therefore it will be necessary to employ someone with different expert knowledge to enable the auditor to gain sufficient appropriate audit evidence. It is important that where the auditor's experience is limited, that they do employ the work of an expert to ensure that the risk of material misstatement can be reduced to an acceptable level. For example, if an entity operates a defined benefit pension scheme, then actuarial information will be required from the Actuaries. Experts can also be used to:

- Provide specialist advice on a particular matter which affects the financial statements, for example the valuations placed on complex financial instruments, such as derivatives.
- Enable the auditors to obtain sufficient appropriate audit evidence concerning certain financial statement assertions.

ISA 620 [6] deals with the specific issues concerning the use of an auditor's expert, but ISA 500 requires the auditor to evaluate the technical competencies of the expert as well as the objectivity of the expert (it is particularly important that the expert is 'independent' of the entity). In recognition of this requirement, the auditor should gain an understanding as to the specific matters the expert will undertake and evaluate the appropriateness of the expert's work to determine whether it is sufficiently reliable. The auditor should also have regard to whether the expert has any financial interest in the

entity or whether he has any business or personal relationships or if there are any other circumstances which may affect the independence and objectivity of the expert.
In determining whether the work undertaken by the expert is sufficient and appropriate the auditor should consider the following matters:

- The nature and complexity of the matter which requires the expert.
- The expert's experience and reputation in the field in which the auditor is seeking audit evidence.
- The independency and objectivity of the expert – for example is the expert employed by the entity?
- The professional qualifications of the expert.
- Whether any alternative sources of audit evidence are available.
- Whether management have any influence over the performance of the work by the expert or whether they wholly rely on the expert.
- The auditor's previous experience with the work of the expert.

The auditors need to evaluate whether the work of the expert and the evidence gained is sufficient and appropriate. Where the audit evidence from the expert is insufficient and there are no satisfactory alternative sources of evidence, then the auditors should consider the implications for their audit report.
In arriving at their conclusion as to whether the expert's work is sufficient and appropriate, the auditor needs to take into consideration various factors such as:

- Whether the findings and conclusions reached by the expert are consistent with other sources of audit evidence gained.
- Where judgements and assumptions are used (as in the defined benefit pension scheme scenario above), whether these judgements and assumptions are reasonable based on other audit evidence obtained.
- Where source data is used, the relevance and completeness of that source data.

Selection and Sampling Techniques

A significant method used in gaining sufficient appropriate audit evidence is the use of selection and sampling techniques. ISA 500 [5] suggests three methods of obtaining audit evidence:

- Selecting all items (100% sampling)
- Selecting specific items
- Audit sampling

Selection of all items is only appropriate for certain items. For example, it would be impossible to select 100% testing on sales invoices for a large, multi-national listed entity as clearly this would be uneconomical. 100% selection of all items can be used when there are only a few items which would warrant 100% testing. Other audit procedures such as 'proof in total' calculations (often referred to as 'reasonableness tests') can also achieve 100% testing such as the recalculation of depreciation charges in the period and comparing the auditor's outcome to the charges calculated by the client.
The selection of specific items is generally more common in auditing. This involves testing specific items such as high value or key items. Auditors often select high risk items or items material in nature when devising which specific items to test.
It is important to understand that the selection of specific items is not the same as audit sampling, hence the reason why ISA 500 distinguishes audit sampling separately. Sampling is where the auditor applies audit procedures to less than 100% of the population. For example, the auditor may obtain the aged list of receivables at the reporting date. The total amount of receivables shown in the financial statements as 'trade receivables' is known as the 'population'. The auditor may only sample 70% of this population.
If sampling is used and errors are discovered in samples, it will be necessary to 'project' these errors, so as to form an opinion as to the number of errors likely to exist in the total population. Selection of specific items differs from sampling because the results from the selection of specific items cannot be projected to the entire population and as such are not representative.

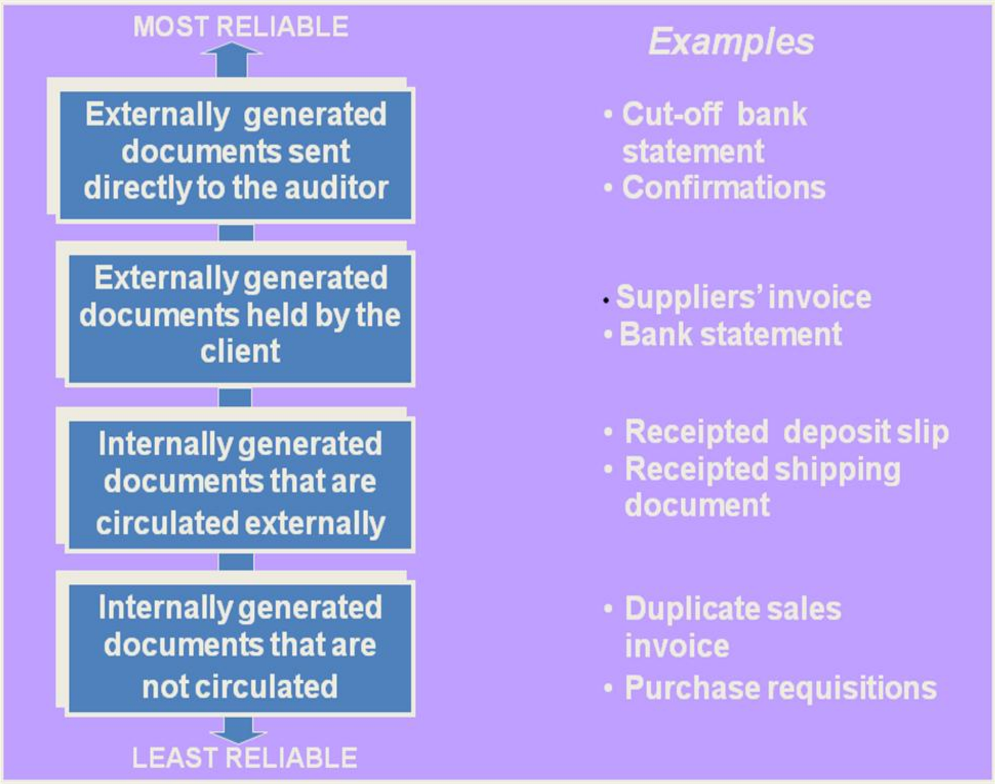


Fig.3. Reliability of documentary evidence

Conclusion

In an audit, most work is affected by auditor to obtain and evaluate evidence, using various procedures (inspection, observation, investigation, confirmation, recalculation, re-performance, etc.). The nature, timing and extent of audit procedures necessary to be applied is determined essentially by reasoning professionally established procedures (selected). These procedures must satisfy the audit objectives and reduce enough detection risk of errors in financial statements.
Obtain audit evidence (sufficient and appropriate) is one of the most important steps that auditors should make and that is crucial in shaping the overall standard governing audit evidence. Audit evidence should be properly documented to ensure that the objective of the audit was achieved. If the objectives were not achieved, the working papers must contain documentation of failure. Also, the use of experts could be considered as an audit evidence and auditors must know when their expertise is exceeded.

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