**AUDIT EVIDENCE (ISA 500)**

Audit evidence is information obtained by the auditor to draw conclusions to support opinion on the FS.

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information.

ISA 500’ the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain **sufficient appropriate audit evidence** to be able to draw reasonable conclusions on which to base the audit opinion.

**Examples of audit evidence**

Physical observation, accounting records, internal and external documents, results of test of controls and substantive tests, confirmation letters (Debtor’s circularization), analytical procedures.

The auditor needs **sufficient, relevant and reliable evidence** so that he can formulate an opinion.

Audit evidence is proofs, facts, information about something. It convinces external auditor that something is true and fair or false. It gives external auditor **reasonable assurance** (as auditor do a sample test) and **NOT absolute assurance** about something, enable EA to draw reasonable conclusion and support the audit opinion.

**Note:** obtained audit evidence (inspection, confirmation) to support the audit assertions (completeness, accuracy) in order to form an opinion.

**Audit assertions=characteristics/feature of an item**

E.g. one assertion=ownership=evidence=title deed

Assertion = existence=evidence=physical examination

This means that to support the assertion **existence** we need to obtain **audit evidence** that’s inspection e.g. Inventory count at year end.

**Sufficient and appropriate evidence.**

Sufficiency and appropriateness are interrelated and apply to audit evidence obtained from both tests of controls and substantive tests.

Sufficient relates to quantity of evidence

Appropriate relates to quality of reliability and relevance of evidence.

Sufficient and appropriate evidence is influenced by:

- Materiality of the item.
- Assessment of the inherent risk of the FS, individual balance and class of transactions.
- Control risk- poor, cannot rely-more quantity and more quality.
- Internal control system.
- Previous audit experience.
- The results of audit test carried out.
- Source of information/ evidence available.
- Sources and reliability of information provided.

**Note:** assessment of risk affects the amount of evidence required. The higher the risk, the higher the amount of evidence required to assure the auditor.

**Sources of evidence**

- **Internally generated**- physical inventory count
- **Externally generated**- confirmation of balance
- **Self generated**- test of controls, substantive procedures

The auditor will obtain and CORROBORATE evidences from the different sources to reach a conclusion.

**Reliability of audit evidence.**

*It depends on source, where held and type.*

More reliable- documentary evidence, external evidence, self generated by auditor, external sources evidence (3rd party direct confirmation of receivable balance to auditors) , documentary created by 3rd parties and held by auditor.

Less reliable- oral evidence, internally generated, entity records, documentary evidence created and held by the client.

**Important**

**Where risk is high:**

- Reduced reliance on internally generated evidence
- Increased focus on externally evidence.
- If senior mgmt is involved: cannot rely on mgmt representations.

**Techniques of gathering audit evidence**

- **Inspection:** physical review or examination of records and tangible assets. It may include examination of records for evidence of controls in the form of compliance test. E.g. test of control: examine sales invoice for authorization. E.g. substantive procedure: check physical existence of an asset and inventory.
- **Observation:** looking at a process or procedure being performed to ensure that the process actually works as documented e.g. distribution of wages packet, physical inventory, cash collection.
- **Enquiry and confirmation:** seeking relevant information (both financial and non financial) from knowledgeable persons inside or outside the entity whether formally or
informally, orally or in writing. The reliability of this technique depends on the qualification and integrity of the source e.g. letter of representation. Confirmation consist of seeking to corroborate responses to information in the accounting records e.g. direct confirmation of receivable balances or payables balances.

- **Recalculation/computation**: checking the arithmetical accuracy of source documents and accounting records or performing independent calculations e.g. checking the addition of the trial balance, additions in cash book.
- **Analytical procedures**: analyze significant ratios and investigate material fluctuations and variances. Analyze trends and relationships in financial and non financial data by means of plausible relationships.

**Why audit evidence is likely to be persuasive rather than conclusive?**

- The auditor gathers evidence on a test basis (the sample may or may not be representative).
- People make mistakes - both client and auditor.
- Documents could be forged - increasingly easily with digital technology.
- The client’s personnel may not always tell the truth.

**QUESTION JUN05-BearsWorld**

You are the auditor of BearsWorld, a limited liability company which manufactures and sells small cuddly toys by mail order. The company is managed by Mr Kyto and two assistants. Mr. Kyto authorises important transactions such as wages and large orders, one assistant maintains the payables ledger and orders inventory and pays suppliers, and the other assistant receives customer orders and despatches cuddly toys. Due to other business commitments Mr Kyto only visits the office once per week.

At any time, about 100 different types of cuddly toys are available for sale. All sales are made cash with order – there are no receivables. Customers pay using credit cards and occasionally by sending cash. Turnover is over $5·2 million. You are planning the audit of BearsWorld and are considering using some of the procedures for gathering audit evidence recommended by ISA500 as follows:

(i) Analytical Procedures
(ii) Inquiry
(iii) Inspection
(iv) Observation
(v) Re-calculation

**Required:**

(a) For EACH of the above procedures:

(i) **Explain its use in gathering audit evidence.** (5 marks)
(ii) **Describe one example for the audit of BearsWorld.** (5 marks)

(b) **Discuss the suitability of each procedure for BearsWorld, explaining the limitations of each.** (10 marks)
The answers should refer to the specific scenario of BearsWorld:

(a)

- **Inspection**: to inspect its assets (toys) held as inventory at the end of year to ensure that all inventory is recorded and that the toys are saleable in their current condition.
- **Observation**: look at the process of opening of the post and recording of customer orders to ensure that the administrator is recording all orders in the sales day book and cash book.
- **Enquiry and confirmation**: obtain statement from suppliers to check for completeness of liabilities at the year end. As there are no controls over purchases, invoices could have been misplaced resulting in lower purchases and trade payables figures.
- **Computation**: check additions in the cash book to confirm that the total amount of cash recorded in the cash book is accurate and can be included in the sales figure. Here cash receipts equals to sales as there are no debtors.
- **Analytical procedures**: review from sales during several years to try to identify whether income has been understated, possibly by cash being taken prior to banking. There is no control over the opening of the post so cash could be withdrawn by one assistant, and the deficit made up by fraud on customers.

(b)

**Analytical procedures**

This method of collecting evidence will be useful in BearsWorld because it will help to identify unusual changes in income and expenditure. As BearsWorld is a relatively small company, monitoring gross profit will show relatively small changes in sales margin or purchasing costs. Decisions by Mr Kyto to amend margins can therefore be traced into the actual sales made. However, the technique may be limited in its application because it will not detect errors or omissions made consistently year on year. If either assistant is defrauding the company (for example by removing cash) each year, then analytical procedures will not detect this.

**Inquiry**

Inquiry evidence will be very useful in the audit of BearsWorld, especially where this is derived from third parties. Third party evidence is generally more reliable than client originated evidence as there is a decreased likelihood of bias. Suppliers can therefore be verified using supplier statement reconciliations. A review of any customer complaints file (if these letters are kept) will also help to identify any orders that have not been despatched. External inquiry evidence will be less useful in the audit of sales and receivables because goods are paid for prior to dispatch – there are no receivables. Internal evidence will be available from Mr Kyto and the assistant; however the lack of segregation of duties means that this will not be so reliable.

**Inspection**

Inspection of documents within BearsWorld will be useful, particularly regarding checking whether expenses are *bona fide*. All purchase invoices, for example, should be addressed to BearsWorld and relate to purchases expected from that company e.g. cuddly toys for resale, office expenses etc.

Inspection of documents can take a long time; however, given the poor internal control system within BearsWorld, the auditor may have no choice but to use this method of gathering evidence.
The fact that an invoice is addressed to the company does not confirm completeness of recording so inspection of the cash book for unusual payments verified by checking the purchase invoice will also be required. Additional substantive testing would also be required due to poor controls.

**Observation**

Observation may be useful because it will show how the assistants check documents. However, no information is provided on any internal controls within BearsWorld so simply viewing how documents are checked without any evidence of checking has limited benefit.

Observation tests will be of limited usefulness because the assistants may act differently when an auditor is present. The same problem will apply to any observation checking carried out by Mr Kyto.

**Re-calculation**

Re-calculation evidence is very useful for checking additions on invoices, balancing of control accounts etc. This means that the arithmetical accuracy of the books and records in BearsWorld can be confirmed.

The main weakness of re-calculation checking is that calculations can only be carried out on figures that have been recorded. If there are any omissions then checks cannot be carried out.