CHAPTER 7

NATURE AND TYPE OF AUDIT EVIDENCE

Fraud in an Asian Multinational

Generally, auditors would review the contract document of large amounts compared to the total net profit of the company. However, there are times all contracts are reviewed regardless of how large or small they are. Sometimes they might also review contract documents on an ad hoc basis. On one occasion, one of the biggest instances of fraud occurred in an Asian multinational company. The fraud amounted to US$10 million. The deputy director and his colleague had submitted false invoices through various shell companies set up by five accomplices for fictitious information technology and goods at the company. This went on for a decade.

Usually auditors do not look at every transaction performed by the company as it is time consuming. So they will set a limit, otherwise known as a materiality level. Any amount above that amount will be reviewed, and anything below will not be reviewed except when the auditor decides to perform random testing. In this case, the invoices billed to this Asian multinational company were below the materiality level and largely went unchecked. However, the auditors changed their auditing method to randomly check this set of invoices and they uncovered services that had been paid but not performed.

The deputy director and his colleague had used the money to buy apartments and three luxury cars costing over a million dollars each. Approximately 80% of the money stolen was recovered. The two criminals were sentenced to 10 years in jail.

LEARNING OBJECTIVES

After studying this chapter, you should be able to

7-1 Contrast audit evidence with evidence used by other professions.

7-2 Identify the four audit evidence decisions that are needed to create an audit program.

7-3 Specify the characteristics that determine the persuasiveness of evidence.

7-4 Identify and apply the eight types of evidence used in auditing.

7-5 Understand the purposes of audit documentation.

7-6 Prepare organized audit documentation.

7-7 Describe how technology affects audit evidence and audit documentation.

The foundation of any audit is the evidence obtained and evaluated by the auditor. The auditor must have the knowledge and skill to accumulate sufficient appropriate evidence on every audit to meet the standards of the profession. New technologies can improve the quality of audit evidence, but can also create new opportunities for evidence to be compromised. This chapter deals with the types of evidence decisions auditors make, the evidence available to auditors, and the use of that evidence in performing audits and documenting the results.

NATURE OF EVIDENCE

OBJECTIVE 7-1

Contrast audit evidence with evidence used by other professions.

Evidence was defined in Chapter 1 as any *information used by the auditor* to determine whether the information being audited is stated in accordance with the established criteria. The information varies greatly in the extent to which it persuades the auditor whether financial statements are fairly stated. Evidence includes information that is highly persuasive, such as the auditor's count of marketable securities, and less persuasive information, such as responses to questions of client employees.

Audit Evidence Contrasted with Legal and Scientific Evidence

The use of evidence is not unique to auditors. Evidence is also used extensively by scientists, lawyers, and historians. For example, most people are familiar with legal dramas on television in which evidence is collected and used to argue for the guilt or innocence of a party charged with a crime. In legal cases, there are well-defined rules of evidence enforced by the judge for the protection of the innocent. In scientific experiments, researchers obtain evidence to test hypotheses using controlled experiments, such as a drug trial to test the effectiveness of a new medical treatment. Similarly, gathering evidence is a large part of what auditors do. Although these professionals rely on different types of evidence, and use evidence in different settings and in different ways, lawyers, scientists, and auditors all use evidence to help them draw conclusions.

Table 7-1 illustrates six key characteristics of evidence from the perspectives of a scientist doing an experiment, an attorney prosecuting an accused thief, and an auditor of financial statements. There are six bases of comparison. Notice the similarities and differences among these three professions.

TABLE 7-1 **Characteristics of Evidence for a Scientific Experiment, Legal Case, and Audit of Financial Statements**

Basis of Comparison	Scientific Experiment Involving Testing a Medicine	Legal Case Involving an Accused Thief	Audit of Financial Statements
Use of the evidence	Determine effects of using the medicine	Decide guilt or innocence of accused	Determine whether statements are fairly presented
Nature of evidence used	Results of repeated experiments	Direct evidence and testimony by witnesses and parties involved	Various types of audit evidence generated by the auditor, third parties, and the client
Party or parties evaluating evidence	Scientist	Jury and judge	Auditor
Certainty of conclusions from evidence	Vary from uncertain to near certainty	Requires guilt beyond a reasonable doubt	High level of assurance
Nature of conclusions	Recommend or not recommend use of medicine	Innocence or guilt of party	Issue one of several alternative types of audit reports
Typical consequences of incorrect conclusions from evidence	Society uses ineffective or harmful medicine	Guilty party is not penalized or innocent party is found guilty	Statement users make incorrect decisions and auditor may be sued

AUDIT EVIDENCE DECISIONS

OBJECTIVE 7-2

Identify the four audit evidence decisions that are needed to create an audit program.

A major decision facing every auditor is determining the *appropriate types and amounts* of evidence needed to be satisfied that the client's financial statements are fairly stated. There are four *decisions* about what evidence to gather and how much of it to accumulate:

1. Which audit procedures to use
2. What sample size to select for a given procedure
3. Which items to select from the population
4. When to perform the procedures

Audit Procedures

An **audit procedure** is the detailed instruction that explains the audit evidence to be obtained during the audit. It is common to spell out these procedures in sufficiently specific terms so an auditor may follow these instructions during the audit. For example, the following is an audit procedure for the verification of cash disbursements:

- Examine the cash disbursements journal in the accounting system and compare the payee, name, amount, and date with online information provided by the bank about checks processed for the account.

Sample Size

Once an audit procedure is selected, auditors can vary the sample size from one to all the items in the population being tested. In an audit procedure to verify cash disbursements, suppose 6,600 checks are recorded in the cash disbursements journal. The auditor might select a sample size of 50 checks for comparison with the cash disbursements journal. The decision of how many items to test must be made by the auditor for each audit procedure. The sample size for any given procedure is likely to vary from audit to audit, depending on client characteristics such as the extent of automated controls and the required level of assurance from the procedure.

Items to Select

After determining the sample size for an audit procedure, the auditor must decide which items in the population to test. If the auditor decides, for example, to select 50 cancelled checks from a population of 6,600 for comparison with the cash disbursements journal, several different methods can be used to select the specific checks to be examined. The auditor can (1) select a week and examine the first 50 checks, (2) select the 50 checks with the largest amounts, (3) select the checks randomly, or (4) select those checks that the auditor thinks are most likely to be in error. Or, a combination of these methods can be used.

Timing

An audit of financial statements usually covers a period such as a year. Normally, an audit is not completed until several weeks or months after the end of the period. The timing of audit procedures can therefore vary from early in the accounting period to long after it has ended. In part, the timing decision is affected by when the client needs the audit to be completed. In the audit of financial statements, the client normally wants the audit completed 1 to 3 months after year-end. The SEC currently requires that all public companies file audited financial statements with the SEC within 60 to 90 days of the company's fiscal year-end, depending on the company's size. However, timing is also influenced by when the auditor believes the audit evidence will be most effective and when audit staff is available. For example, auditors often prefer to do counts of inventory as close to the balance sheet date as possible.

Audit procedures often incorporate sample size, items to select, and timing into the procedure. The following is a modification of the audit procedure previously used to include all four audit evidence decisions. (Italics identify the timing, items to select, and sample size decisions.)

- Obtain the *October* cash disbursements journal and compare the payee name, amount, and date on the cancelled check with the cash disbursements journal for a *randomly selected sample of 40* check numbers.

Audit Program

The list of audit procedures for an audit area or an entire audit is called an **audit program**. The audit program always includes a list of the audit procedures, and it usually includes sample sizes, items to select, and the timing of the tests. Normally, there is an audit program, including several audit procedures, for each component of the audit. Therefore, there will be an audit program for accounts receivable, one for sales, and so on. (To see an example of an audit program that includes audit procedures, sample size, items to select, and timing, turn to page 439 and see Table 13-4. The right side of the audit program also includes the balance-related audit objectives for each procedure, which were discussed in Chapter 6.)

Many auditors use electronic audit software packages to generate audit programs. These software programs are not to be used to generate generic or standardized audit programs. Instead, they help the auditor address risks and other audit planning considerations and select appropriate audit procedures.

PERSUASIVENESS OF EVIDENCE

OBJECTIVE 7-3

Specify the characteristics that determine the persuasiveness of evidence.

Audit standards require the auditor to accumulate *sufficient appropriate evidence to support the opinion issued.* Because of the nature of audit evidence and the cost considerations of doing an audit, it is unlikely that the auditor will be completely convinced that the opinion is correct. However, the auditor must be persuaded that the opinion is correct with a high level of assurance. By combining all evidence from the entire audit, the auditor is able to decide when he or she is persuaded to issue an audit report. The two determinants of the **persuasiveness of evidence** are *appropriateness* and *sufficiency.*

Appropriateness

Appropriateness of evidence is a measure of the quality of evidence, meaning its relevance and reliability in meeting audit objectives for classes of transactions, account balances, and related disclosures. If evidence is considered highly appropriate, it is a great help in persuading the auditor that financial statements are fairly stated.

Note that appropriateness of evidence deals only with the audit procedures selected. Appropriateness cannot be improved by selecting a larger sample size or different population items. It can be improved only by selecting audit procedures that are more relevant or provide more reliable evidence.

Relevance of Evidence Evidence must *pertain to or be relevant to the audit objective* that the auditor is testing before it can be appropriate. For example, assume that the auditor is concerned that a client is failing to bill customers for shipments (completeness transaction objective). If the auditor selects a sample of duplicate sales invoices and traces each to related shipping documents, the evidence is *not relevant* for the completeness objective and therefore is not appropriate evidence for that objective. A relevant procedure is to trace a sample of shipping documents to related duplicate sales invoices to determine whether each shipment was billed. The second audit procedure is relevant because the shipment of goods is the normal criterion used for determining whether a sale has occurred and should have been billed. By tracing from shipping documents to duplicate sales invoices, the auditor can determine whether shipments have been billed to customers. In the first procedure, when the auditor traces from duplicate sales invoices to shipping documents, it is impossible to find unbilled shipments.

Relevance can be considered only in terms of specific audit objectives, because evidence may be relevant for one audit objective but not for a different one. In the previous shipping example, when the auditor traced from the duplicate sales invoices to related shipping documents, the evidence was relevant for the occurrence transaction objective. Most evidence is relevant for more than one, but not all, audit objectives.

Reliability of Evidence **Reliability of evidence** refers to the degree to which evidence can be believable or worthy of trust. Like relevance, if evidence is considered reliable it is a great help in persuading the auditor that financial statements are fairly stated. For example, if an auditor counts inventory, that evidence is more reliable than if management gives the auditor its own count amounts.

Reliability, and therefore appropriateness, depends on the following six characteristics of reliable evidence:

1. *Independence of provider.* Evidence obtained from a source outside the entity is more reliable than that obtained from within. Communications from banks, attorneys, or customers is generally considered more reliable than answers obtained from inquiries of the client. Similarly, documents that originate from outside the client's organization, such as an insurance policy, are considered more reliable than are those that originate within the company and have never left the client's organization, such as a purchase requisition.
2. *Effectiveness of client's internal controls.* When a client's internal controls are effective, evidence obtained is more reliable than when they are not effective. For example, if internal controls over sales and billing are effective, the auditor can obtain more reliable evidence from sales invoices and shipping documents than if the controls were inadequate.
3. *Auditor's direct knowledge.* Evidence obtained directly by the auditor through physical examination, observation, recalculation, and inspection is more reliable than information obtained indirectly. For example, if the auditor calculates the gross margin as a percentage of sales and compares it with previous periods, the evidence is more reliable than if the auditor relies on the calculations of the controller.
4. *Qualifications of individuals providing the information.* Although the source of information is independent, the evidence will not be reliable unless the individual providing it is qualified to do so. Therefore, communications from attorneys and bank confirmations are typically more highly regarded than accounts receivable confirmations from persons not familiar with the business world. Also, evidence obtained directly by the auditor may not be reliable if the auditor lacks the qualifications to evaluate the evidence. For example, examining an inventory of diamonds by an auditor not trained to distinguish between diamonds and cubic zirconia is not reliable evidence for the existence of diamonds.
5. *Degree of objectivity.* Objective evidence is more reliable than evidence that requires considerable judgment to determine whether it is correct. Examples of objective evidence include confirmation of accounts receivable and bank balances, the physical count of securities and cash, and adding (footing) a list of accounts payable to determine whether it agrees with the balance in the general ledger. Examples of subjective evidence include a letter written by a client's attorney discussing the likely outcome of outstanding lawsuits against the client, observation of obsolescence of inventory during physical examination, and inquiries of the credit manager about the collectibility of noncurrent accounts receivable. When the reliability of subjective evidence is being evaluated, it is essential for auditors to assess the qualifications of the person providing the evidence.
6. *Timeliness.* The timeliness of audit evidence can refer either to when it is accumulated or to the period covered by the audit. Evidence is usually more reliable for balance sheet accounts when it is obtained as close to the balance sheet date as possible. For example, the auditor's count of marketable securities on the balance sheet date is more reliable than a count 2 months earlier. For income statement accounts, evidence is more reliable if there is a sample from the entire period under audit, such as a random sample of sales transactions for the entire year, rather than from only a part of the period, such as a sample limited to only the first 6 months.

Sufficiency

The *quantity* of evidence obtained determines its sufficiency. **Sufficiency of evidence** is measured primarily by the sample size the auditor selects. For a given audit procedure, the evidence obtained from a sample of 100 is ordinarily more sufficient than from a sample of 50.

Several factors determine the appropriate sample size in audits. The two most important ones are the auditor's expectation of misstatements and the effectiveness of the client's internal controls. To illustrate, assume in the audit of Jones Computer Parts Co. that the auditor concludes that there is a high likelihood of obsolete inventory because of the nature of the client's industry. The auditor will sample more inventory items for obsolescence in this audit than one where the likelihood of obsolescence is low. Similarly, if the auditor concludes that a client has effective rather than ineffective internal controls over recording fixed assets, a smaller sample size in the audit of acquisitions of fixed assets may be warranted.

In addition to sample size, the individual items tested affect the sufficiency of evidence. Samples containing population items with large dollar values, items with a high likelihood of misstatement, and items that are representative of the population are usually considered sufficient. In contrast, most auditors usually consider samples insufficient that contain only the largest dollar items from the population unless these items make up a large portion of the total population amount.

Combined Effect

The persuasiveness of evidence can be evaluated only after considering the combination of appropriateness and sufficiency, including the effects of the factors influencing appropriateness and sufficiency. A large sample of evidence provided by an independent party is not persuasive unless it is relevant to the audit objective being tested. A large sample of evidence that is relevant but not objective is also not persuasive. Similarly, a small sample of only one or two pieces of highly appropriate evidence also typically lacks persuasiveness. When determining the persuasiveness of evidence, the auditor must evaluate the degree to which both appropriateness and sufficiency, including all factors influencing them, have been met.

Direct relationships among the four evidence decisions and the two qualities that determine the persuasiveness of evidence are shown in Table 7-2. To illustrate these relationships, assume an auditor is verifying inventory that is a major item in the financial statements. Auditing standards require that the auditor be reasonably persuaded that inventory is not materially misstated. The auditor must therefore obtain a sufficient amount of relevant and reliable evidence about inventory. This means deciding which

DRAFT vs. FINAL: A BIG DIFFERENCE

Star Technologies, Inc., a manufacturer of scientific computers, entered into a joint venture arrangement to loan funds to Glen Culler & Associates, a supercomputer developer, for the development of a new computer called the Culler 8. The loan repayment terms restricted Glen Culler's use of the funds to research and development on the Culler 8.

Star Technology reported its advance of funds to Glen Culler as a note receivable on its balance sheet. Star Technology's auditors obtained a draft of the loan agreement and used that as the primary audit evidence to support the accounting treatment. The auditors, however, failed to obtain the final executed loan agreement. Unfortunately, there were big differences between the draft and final versions of the agreement that materially impacted the substance of the transaction. Instead of supporting the inclusion of the advanced funds as a receivable on Star Technology's balance sheet, the terms of the final executed agreement supported treatment of the loaned funds as research and development expense to be reported on the income statement.

The audit firm learned about its oversight when its national office received an anonymous memo alleging the audit failure. The audit firm's follow-up on the matter ultimately led to an SEC investigation. The SEC eventually charged the audit firm partner for failure to obtain sufficient appropriate evidence and for failing to exercise due professional care. As a result of the partner's negligence, the SEC barred him from working in any capacity with a public company for a period of five years, among other penalties imposed by the SEC and the audit firm.

Source: Based on *Accounting and Auditing Enforcement Release No. 455*, Commerce Clearing House, Inc., Chicago.

TABLE 7-2 Relationships Among Evidence Decisions and Persuasiveness

Audit Evidence Decisions	Qualities Affecting Persuasiveness of Evidence
Audit procedures and timing	Appropriateness Relevance Reliability Independence of provider Effectiveness of internal controls Auditor's direct knowledge Qualifications of provider Objectivity of evidence Timeliness When procedures are performed Portion of period being audited
Sample size and items to select	Sufficiency Adequate sample size Selection of proper population items

procedures to use for auditing inventory, as well as determining the sample size and items to select from the population to satisfy the sufficiency requirement. The combination of these four evidence decisions must result in sufficiently persuasive evidence to satisfy the auditor that inventory is materially correct. The audit program section for inventory will reflect these decisions. In practice, the auditor applies the four evidence decisions to specific audit objectives in deciding sufficient appropriate evidence.

Persuasiveness and Cost

In making decisions about evidence for a given audit, both persuasiveness and cost must be considered. It is rare when only one type of evidence is available for verifying information. The persuasiveness and cost of all alternatives should be considered before selecting the best type or types of evidence. The auditor's goal is to obtain a sufficient amount of appropriate evidence at the lowest possible total cost. However, cost is never an adequate justification for omitting a necessary procedure or not gathering an adequate sample size.

TYPES OF AUDIT EVIDENCE

OBJECTIVE 7-4

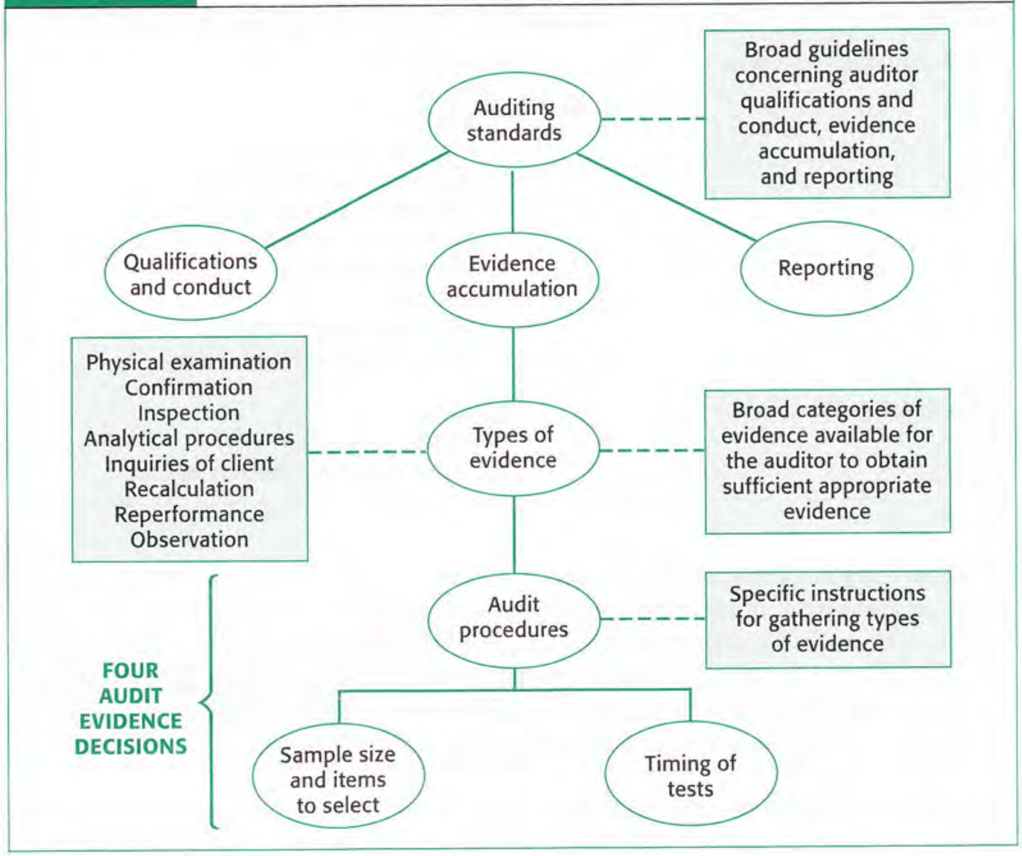
Identify and apply the eight types of evidence used in auditing.

In deciding which audit procedures to use, the auditor can choose from eight broad categories of evidence, which are called *types of evidence*. Every audit procedure obtains one or more of the following types of evidence:

1. Physical examination
2. Confirmation
3. Inspection
4. Analytical procedures
5. Inquiries of the client
6. Recalculation
7. Reperformance
8. Observation

Figure 7-1 (p. 200) shows the relationships among auditing standards, types of evidence, and the four evidence decisions. Auditing standards provide general guidance in three categories, including evidence accumulation. The types of evidence are broad categories of the evidence that can be accumulated. Audit procedures include the four evidence decisions and provide specific instructions for the accumulation of evidence.

FIGURE 7-1 **Relationships Among Auditing Standards, Types of Evidence, and the Four Audit Evidence Decisions**



Physical Examination

Physical examination is the inspection or count by the auditor of a *tangible asset.* This type of evidence is most often associated with inventory and cash, but it is also applicable to the verification of securities, notes receivable, and tangible fixed assets. There is a distinction in auditing between the physical examination of assets, such as marketable securities and cash, and the examination of documents, such as cancelled checks and sales documents. If the object being examined, such as a sales invoice, has no inherent value, the evidence is called documentation. For example, before a check is signed, it is a document; after it is signed, it becomes an asset; and when it is cancelled, it becomes a document again. For correct auditing terminology, physical examination of the check can occur only while the check is an asset.

Physical examination is a direct means of verifying that an asset actually exists (existence objective), and to a lesser extent whether existing assets are recorded (completeness objective). It is considered one of the most reliable and useful types of audit evidence. Generally, physical examination is an objective means of ascertaining both the quantity and the description of the asset. In some cases, it is also a useful method for evaluating an asset's condition or quality. However, physical examination is not sufficient evidence to verify that existing assets are owned by the client (rights and obligations objective), and in many cases the auditor is not qualified to judge qualitative factors such as obsolescence or authenticity (realizable value objective). Also, proper valuation for financial statement purposes usually cannot be determined by physical examination (accuracy objective).

Confirmation

Confirmation describes the *receipt* of a *direct written response* from a *third party* verifying the accuracy of information that was *requested by the auditor.* The response may be in paper form or electronic or other medium, such as the auditor's direct access to information held by the third party. The request is made to the client, and the client asks the third party to respond directly to the auditor. Because confirmations come from third-party sources instead of the client, they are a highly regarded and often-used type of evidence. However, confirmations are relatively costly to obtain and may cause some inconvenience to those asked to supply them. Therefore, they are not used in every instance in which they are applicable.

Auditors decide whether or not to use confirmations depending on the reliability needs of the situation as well as the alternative evidence available. Traditionally, confirmations are seldom used in the audit of fixed asset additions because these can be verified adequately by inspection and physical examination. Similarly, confirmations are ordinarily not used to verify individual transactions between organizations, such as sales transactions, because the auditor can use documents for that purpose. Naturally, there are exceptions. Assume the auditor determines that there are two extraordinarily large sales transactions recorded 3 days before year-end. Confirmation of these two transactions may be appropriate.

When practical and reasonable, U.S. auditing standards require the confirmation of a sample of accounts receivable. This requirement exists because accounts receivable usually represent a significant balance on the financial statements, and confirmations are a highly reliable type of evidence. Confirmation of accounts receivable is not required by international auditing standards, and is one example of differences between U.S. and international auditing standards. Confirmation of accounts receivable is discussed further in Chapter 16.

Although confirmation is currently not required for any account other than accounts receivable, this type of evidence is useful in verifying many types of information. The major types of information that are often confirmed, along with the source of the confirmation, are indicated in Table 7-3.

TABLE 7-3 Information Often Confirmed

Information	Source
Assets	
Cash in bank	Bank
Marketable securities	Investment custodian
Accounts receivable	Customer
Notes receivable	Maker
Owned inventory out on consignment	Consignee
Inventory held in public warehouses	Public warehouse
Cash surrender value of life insurance	Insurance company
Liabilities	
Accounts payable	Creditor
Notes payable	Lender
Advances from customers	Customer
Mortgages payable	Mortgagor
Bonds payable	Bondholder
Owners' Equity	
Shares outstanding	Registrar and transfer agent
Other Information	
Insurance coverage	Insurance company
Contingent liabilities	Bank, lender, and client's legal counsel
Bond indenture agreements	Bondholder
Collateral held by creditors	Creditor

ELECTRONIC CONFIRMATIONS

Confirmations have traditionally been mailed in paper form, but several factors have helped promote the use of electronic confirmations of bank balances and other information. An interpretation of an earlier confirmation standard indicated that confirmation requests may be transmitted and received electronically. In 2008, Bank of America announced that it would only respond to bank confirmation requests submitted electronically through a designated third-party service provider. The third party provides a secure environment for transmitting the confirmation to authenticated confirmation respondents, reducing the risk of interception and response time.

The clarified confirmation standard indicates that direct access to information held by the third party (the confirming party) may meet the definition of an external confirmation if the electronic access codes or information necessary to access a secure Web site is provided to the auditor by the confirming party or third-party service provider. However, if the access information is provided to the auditor by management, the evidence obtained from accessing the information does not meet the definition of an external confirmation.

Sources: 1. AU-C Section 505, *External Confirmations*; 2. *Guidance for Dealing with Electronic Confirmations*, November 13, 2008 (www.journalofaccountancy.com).

To be considered reliable evidence, confirmations must be controlled by the auditor from the time they are prepared until they are returned. If the client controls the preparation of the confirmation, does the mailing, or receives the responses, the auditor has lost control and with it independence; thus reducing the reliability of the evidence. Auditors often attempt to validate the identity of the confirmation respondent, especially for facsimile or electronic confirmation responses.

Inspection

Inspection is the auditor's examination of the *client's documents and records* to substantiate the information that is, or should be, included in the financial statements. The documents examined by the auditor are the records used by the client to provide information for conducting its business in an organized manner, and may be in paper form, electronic form, or other media. Because each transaction in the client's organization is normally supported by at least one document, a large volume of this type of evidence is usually available. For example, the client often retains a customer order, a shipping document, and a duplicate sales invoice for each sales transaction. These same documents are useful evidence for the auditor to verify the accuracy of the client's records for sales transactions. Documentation is widely used as evidence in audits because it is usually readily available at a relatively low cost. Sometimes, it is the only reasonable type of evidence available.

Documents can be conveniently classified as internal and external. An **internal document** has been prepared and used within the client's organization and is retained without ever going to an outside party. Internal documents include duplicate sales invoices, employees' time reports, and inventory receiving reports. An **external document** has been handled by someone outside the client's organization who is a party to the transaction being documented, but which is either currently held by the client or readily accessible. In some cases, external documents originate outside the client's organization and end up in the hands of the client. Examples of external documents include vendors' invoices, cancelled notes payable, and insurance policies. Some documents, such as cancelled checks, originate with the client, go to an outsider, and are finally returned to the client.

The primary determinant of the auditor's willingness to accept a document as reliable evidence is whether it is internal or external and, when internal, whether it was created and processed under conditions of effective internal control. Internal documents created and processed under conditions of deficient internal control may not constitute reliable evidence. Original documents are considered more reliable than photocopies or facsimiles. Although auditors should consider the reliability of documentation, they rarely verify the authenticity of documentation. Auditors are not expected to be trained or be experts in document authentication.

Because external documents have been in the hands of both the client and another party to the transaction, there is some indication that both members are in agreement about the information and the conditions stated on the document. Therefore, external documents are considered more reliable evidence than internal ones. Some external documents, such as title to land, insurance policies, indenture agreements, and contracts, have exceptional reliability because they are almost always prepared with considerable care and often have been reviewed by attorneys or other qualified experts.

When auditors use documentation to support recorded transactions or amounts, the process is often called **vouching.** To vouch recorded acquisition transactions, the auditor might, for example, verify entries in the acquisitions journal by examining supporting vendors' invoices and receiving reports and thereby satisfy the occurrence objective. If the auditor traces from receiving reports to the acquisitions journal to satisfy the completeness objective, however, it is not appropriate to call it vouching. This latter process is called **tracing**.

Analytical Procedures

Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among financial and nonfinancial data. For example, an auditor may compare the gross margin percent in the current year with the preceding year's. Analytical procedures are used extensively in practice, and are *required during the planning and completion phases on all audits.* We introduce the purposes of analytical procedures here and discuss the different types of analytical procedures more extensively in Chapter 8.

Understand the Client's Industry and Business Auditors must obtain knowledge about a client's industry and business as a part of planning an audit. By conducting analytical procedures in which the current year's unaudited information is compared with prior years' audited information or industry data, changes are highlighted. These changes can represent important trends or specific events, all of which will influence audit planning. For example, a decline in gross margin percentages over time may indicate increasing competition in the company's market area and the need to consider inventory pricing more carefully during the audit. Similarly, an increase in the balance in fixed assets may indicate a significant acquisition that must be reviewed.

Assess the Entity's Ability to Continue as a Going Concern Analytical procedures are often a useful indicator for determining whether the client company has financial problems. Certain analytical procedures can help the auditor assess the likelihood of failure. For example, if a higher-than-normal ratio of long-term debt to net worth is combined with a lower-than-average ratio of profits to total assets, a relatively high risk of financial failure may be indicated. Not only will such conditions affect the audit plan, they may indicate that substantial doubt exists about the entity's ability to continue as a going concern, which, as discussed in Chapter 3, requires a report modification.

Indicate the Presence of Possible Misstatements in the Financial Statements Significant unexpected differences between the current year's unaudited financial data and other data used in comparisons are commonly called **unusual fluctuations.** Unusual fluctuations occur when significant differences are not expected but do exist, or when significant differences are expected but do not exist. In either case, the presence of an accounting misstatement is one possible reason for the unusual fluctuation. If the unusual fluctuation is large, the auditor must determine the reason and be satisfied that the cause is a valid economic event and not a misstatement. For example, in comparing the ratio of the allowance for uncollectible accounts receivable to gross accounts receivable with that of the previous year, suppose that the ratio has decreased while, at the same time, accounts receivable turnover also decreased. The combination of these two pieces of information indicates a possible understatement of the allowance. This aspect of analytical procedures is often called "attention directing" because it results in more detailed procedures in the specific audit areas where misstatements might be found.

Reduce Detailed Audit Tests When an analytical procedure reveals no unusual fluctuations, this implies the possibility of a material misstatement is minimized. In such cases, the analytical procedure constitutes substantive evidence in support of the fair statement of the related account balances, and it is possible to perform fewer detailed tests in connection with those accounts. In other cases, certain audit procedures can be eliminated, sample sizes can be reduced, or the timing of the procedures can be moved farther away from the balance sheet date.

Inquiries of the Client

Inquiry is the obtaining of *written* or *oral* information from the client in response to questions from the auditor. Although considerable evidence is obtained from the client through inquiry, it usually cannot be regarded as conclusive because it is not from an independent source and may be biased in the client's favor. Therefore, when the auditor obtains evidence through inquiry, it is normally necessary to obtain corroborating evidence through other procedures. (Corroborating evidence is additional evidence to support the original evidence.) As an illustration, when the auditor wants to obtain information about the client's method of recording and controlling accounting transactions, the auditor usually begins by asking the client how the internal controls operate. Later, the auditor performs audit tests using inspection and observation to determine whether the transactions are recorded (completeness objective) and authorized (occurrence objective) in the manner stated.

Recalculation

Recalculation involves rechecking a sample of calculations made by the client. Rechecking client calculations consists of testing the client's arithmetical accuracy and includes such procedures as extending sales invoices and inventory, adding journals and subsidiary records, and checking the calculation of depreciation expense and prepaid expenses. A considerable portion of auditors' recalculation is done by computer-assisted audit software.

Reperformance

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. Whereas recalculation involves rechecking a computation, reperformance involves checking other procedures. For example, the auditor may compare the price on an invoice to an approved price list, or may reperform the aging of accounts receivable. Another type of reperformance is for the auditor to recheck transfers of information by tracing information included in more than one place to verify that it is recorded at the same amount each time. For example, 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.

Observation

Observation consists of looking at a process or procedure being performed by others. The auditor may tour the plant to obtain a general impression of the client's facilities, or watch individuals perform accounting tasks to determine whether the person assigned a responsibility is performing it properly. Observation provides evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place. Observation is rarely sufficient by itself because of the risk of client personnel changing their behavior because of the auditor's presence. They may perform their responsibilities in accordance with company policy but resume normal activities once the auditor is not in sight. Therefore, it is necessary to follow up initial impressions with other kinds of corroborative evidence. Nevertheless, observation is useful in most parts of the audit.

Appropriateness of Types of Evidence

As discussed earlier in this chapter, the characteristics for determining the appropriateness of evidence are relevance and reliability. Table 7-4 includes the eight types of evidence related to five of the six criteria that determine the reliability of evidence. Note that two of the characteristics that determine the appropriateness of evidence—relevance and timeliness—are not included in Table 7-4. Each of the

TABLE 7-4	Appropriateness of Types 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
Inspection	Varies—external documents more independent than internal documents	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

eight types of evidence included in the table has the potential to be both relevant and timely, depending on its source and when the evidence is obtained. Several other observations are apparent from studying Table 7-4.

- First, the effectiveness of a client's internal controls has significant influence on the reliability of most types of evidence. Obviously, internal documentation from a company with effective internal control is more reliable because the documents are more likely to be accurate. Conversely, analytical procedures will not be reliable evidence if the controls that produced the data provide inaccurate information.
- Second, both physical examination and recalculation are likely to be highly reliable if the internal controls are effective, but their use differs considerably. This effectively illustrates that two completely different types of evidence can be equally reliable.
- Third, a specific type of evidence is rarely sufficient by itself to provide appropriate evidence to satisfy any audit objective.

Cost of Types of Evidence

The two most expensive types of evidence are physical examination and confirmation. Physical examination is costly because it normally requires the auditor's presence when the client is counting the asset, often on the balance sheet date. For example, physical examination of inventory can result in several auditors traveling to scattered geographical locations. Confirmation is costly because the auditor must follow careful procedures in the confirmation preparation, mailing or electronic transmittal, receipt, and in the follow-up of nonresponses and exceptions.

Inspection, analytical procedures, and reperformance are moderately costly. If client personnel provide documents and electronic files for the auditor and organize them for convenient use, inspection usually has a fairly low cost. When auditors must find those documents themselves, however, inspection can be extremely costly. Even under ideal circumstances, information and data on documents are sometimes complex and require interpretation and analysis. It is usually time-consuming for an auditor to read and evaluate a client's contracts, lease agreements, and minutes of the board of directors meetings. Because analytical procedures are considerably less expensive than confirmations and physical examination, most auditors prefer to replace tests of details with analytical procedures when possible. For example, it may be far less expensive to calculate and review sales and accounts receivable ratios than to confirm accounts receivable. If it is possible to reduce the use of confirmations by performing analytical procedures, considerable cost savings can be achieved. But analytical procedures require the auditor to decide which analytical procedures to use, make the calculations, and evaluate the results. Doing so often takes considerable time. The cost of reperformance tests depends on the nature of the procedure being tested. Comparatively simple tests such as reperforming the comparison of invoices to price lists are likely to take minimal time. However, reperforming procedures such as the client's bank reconciliation are likely to take considerable time.

The three least-expensive types of evidence are observation, inquiries of the client, and recalculation. Observation is normally done concurrently with other audit procedures. Auditors can easily observe whether client personnel are following appropriate inventory counting procedures at the same time they count a sample of inventory (physical examination). Inquiries of clients are done extensively on every audit and normally have a low cost, although certain inquiries may be costly, such as obtaining written statements from the client documenting discussions throughout the audit. Recalculation is usually low cost because it involves simple calculations and tracing that can be done at the auditor's convenience. Often, the auditor's computer software is used to perform many of these tests.

Application of Types of Evidence to the Four Evidence Decisions

Table 7-5 shows an application of three types of evidence to the four evidence decisions for one balance-related audit objective—inventory quantities on the client's perpetual records agree with items physically on hand. Take a moment to turn back to Table 6-4 (p. 181) and examine column 3. These are the balance-related audit objectives for the audit of inventory for Hillsburg Hardware Co. The overall objective is to obtain persuasive evidence at minimum cost to verify that inventory is materially correct. The auditor must therefore decide:

- Which audit procedures to use to satisfy each balance-related audit objective
- What the sample size should be for each procedure
- Which items from the population to include in the sample
- When to perform each procedure

TABLE 7-5 Types of Evidence and Four Evidence Decisions for a Balance-Related Audit Objective for Inventory*

	Evidence Decisions			
Type of Evidence	**Audit Procedure**	**Sample Size**	**Items to Select**	**Timing**
Observation	Observe client's personnel counting inventory to determine whether they are properly following instructions	All count teams	Not applicable	Balance sheet date
Physical examination	Count a sample of inventory and compare quantity and description to client's counts	120 items	40 items with large dollar value, plus 80 randomly selected	Balance sheet date
Inspection	Compare quantity on client's perpetual records to quantity on client's counts	70 items	30 items with large dollar value, plus 40 randomly selected	Balance sheet date

*Balance-related audit objective: Inventory quantities on the client's perpetual records agree with items physically on hand.

For the objective "inventory quantities on the client's perpetual records agree with items physically on hand," the auditor selected the three types of evidence included in Table 7-5. The auditor decided that the other types of evidence studied in this chapter were not relevant or necessary for this objective. Only one audit procedure is included for each type of evidence, and illustrative decisions for sample size, items to select, and timing are shown for each procedure.

Terms Used in Audit Procedures

As stated earlier, audit procedures are the detailed steps, usually written in the form of instructions, for the accumulation of the eight types of audit evidence. They should be sufficiently clear to enable all members of the audit team to understand what is to be done.

TABLE 7-6 Terms, Audit Procedures, and Types of Evidence

Term and Definition	Illustrative Audit Procedure	Type of Evidence
Examine—A reasonably detailed study of a document or record to determine specific facts about it.	*Examine* a sample of vendors' invoices to determine whether the goods or services received are reasonable and of the type normally used by the client's business.	Inspection
Scan—A less-detailed examination of a document or record to determine whether there is something unusual warranting further investigation.	*Scan* the sales journal, looking for large and unusual transactions.	Analytical procedures
Read—An examination of written information to determine facts pertinent to the audit.	*Read* the minutes of a board of directors meeting and summarize all information that is pertinent to the financial statements in an audit file.	Inspection
Compute—A calculation done by the auditor independent of the client.	*Compute* inventory turnover ratios and compare with those of previous years as a test of inventory obsolescence.	Analytical procedures
Recompute—A calculation done to determine whether a client's calculation is correct.	*Recompute* the unit sales price times the number of units for a sample of duplicate sales invoices and compare the totals with the calculations.	Recalculation
Foot—Addition of a column of numbers to determine whether the total is the same as the client's.	*Foot* the sales journal for a 1-month period and compare all totals with the general ledger.	Recalculation
Trace—An instruction normally associated with inspection or reperformance. The instruction should state what the auditor is tracing and where it is being traced from and to. Often, an audit procedure that includes the term *trace* will also include a second instruction, such as *compare* or *recalculate*.	*Trace* a sample of sales transactions from sales invoices to the sales journal, and *compare* customer name, date, and the total dollar value of the sale. *Trace* postings from the sales journal to the general ledger accounts.	Inspection Reperformance
Compare—A comparison of information in two different locations. The instruction should state which information is being compared in as much detail as practical.	Select a sample of sales invoices and *compare* the unit selling price as stated on the invoice to the list of unit selling prices authorized by management.	Inspection
Count—A determination of assets on hand at a given time. This term should be associated only with the type of evidence defined as physical examination.	*Count* a sample of 100 inventory items and compare quantity and description to client's counts.	Physical examination
Observe—The act of observation should be associated with the type of evidence defined as observation.	*Observe* whether the two inventory count teams independently count and record inventory counts.	Observation
Inquire—The act of inquiry should be associated with the type of evidence defined as inquiry.	*Inquire* of management whether there is any obsolete inventory on hand at the balance sheet date.	Inquiries of client
Vouch—The use of documents to verify recorded transactions or amounts.	*Vouch* a sample of recorded acquisition transactions to vendors' invoices and receiving reports.	Inspection

Several terms commonly used to describe audit procedures are defined in Table 7-6 (p. 207). To illustrate each term, an audit procedure and associated type of evidence are also shown.

AUDIT DOCUMENTATION

OBJECTIVE 7-5

Understand the purposes of audit documentation.

Auditing standards state that **audit documentation** is the *record of the audit procedures performed, relevant audit evidence, and conclusions the auditor reached.* Audit documentation should include all the information the auditor considers necessary to adequately conduct the audit and to provide support for the audit report. Audit documentation may also be referred to as working papers or workpapers, although audit documentation is often maintained in computerized files.

Purposes of Audit Documentation

The overall objective of audit documentation is to aid the auditor in providing reasonable assurance that an adequate audit was conducted in accordance with auditing standards. More specifically, audit documentation, as it pertains to the current year's audit, provides:

A Basis for Planning the Audit If the auditor is to plan an audit adequately, the necessary reference information must be available in the audit files. The files may include such diverse planning information as descriptive information about internal control, a time budget for individual audit areas, the audit program, and the results of the preceding year's audit.

A Record of the Evidence Accumulated and the Results of the Tests Audit documentation is the primary means of documenting that an adequate audit was conducted in accordance with auditing standards. If the need arises, the auditor must be able to demonstrate to regulatory agencies and courts that the audit was well planned and adequately supervised; the evidence accumulated was appropriate and sufficient; and the audit report was proper, considering the results of the audit.

When audit procedures involve sampling of transactions or balances, the audit documentation should identify the items tested. The audit files should also document significant audit findings or issues, actions taken to address them, and the basis for the conclusions reached. For example, the auditor should document specific transactions at year-end to determine whether transactions were recorded in the proper period. If misstatements are detected during these cutoff tests, the auditor should document the additional procedures performed to determine the extent of cutoff misstatements, the conclusion as to whether the account balances affected are fairly stated, and whether any audit adjustments should be proposed.

Data for Determining the Proper Type of Audit Report Audit documentation provides an important source of information to assist the auditor in deciding whether sufficient appropriate evidence was accumulated to justify the audit report in a given set of circumstances. The data in the files are equally useful for evaluating whether the financial statements are fairly stated, given the audit evidence.

A Basis for Review by Supervisors and Partners The audit files are the primary frame of reference used by supervisory personnel to review the work of assistants. The careful review by supervisors also provides evidence that the audit was properly supervised. Audit documentation should indicate who performed the audit work, the date the work was performed, who reviewed the work, and the date of that review.

In addition to the purposes directly related to the audit report, the audit files often serve as the basis for preparing tax returns, filings with the SEC, and other reports. They are also a source of information for issuing communications to management and those charged with governance, such as the audit committee, concerning various matters such as internal control deficiencies or operational recommendations. Audit files are also a useful frame of reference for training personnel and as an aid in planning and coordinating subsequent audits.

DON'T CHANGE THOSE AUDIT FILES

AICPA auditing standards indicate that the auditor should assemble the final audit file within 60 days after the audit report release date. After this date, the auditor should not delete or discard any audit documentation within the record retention period, which is a minimum of five years for nonpublic entities and seven years for a public company. The auditor should document the reasons for any changes after the file completion date.

Trauger was the audit partner for the year 2000 audit of NextCard, an internet-based credit card issuer located in San Francisco. In the summer of 2001, the Office of the Comptroller of the Currency (OCC) requested some of the audit files for the NextCard audit. On October 31, 2001, NextCard announced that the OCC had asked NextCard to make certain changes in its accounting practices, including the classification of losses on credit cards. The company also announced that it intended to sell NextBank because it was unable to raise sufficient capital to meet bank regulatory requirements. Following the company's press release, its stock price declined by approximately 84 percent.

In November 2001, Trauger became concerned that the audit work would be examined by regulatory agencies. He then investigated how to de-archive the electronically archived workpapers. Trauger asked Flanagan, the manager on the engagement, to gather the electronic and hard copy audit files and meet him on Saturday morning. Trauger altered a summary review memorandum and documentation regarding NextCard's allowance for loan and lease losses and securitizations of receivables to make it appear that there was a more satisfactory basis for the audit firm's conclusions. Flanagan entered the revised information on his laptop computer and reset the date on his computer so that the revised documents would reflect a date in early 2001. Later in November 2001, Trauger asked Flanagan and a second audit manager to make additional alterations to the workpapers that indicated problems with NextCard's loan charge-offs.

The scheme was revealed when Flanagan turned a diskette over to authorities, revealing the alteration. Trauger was arrested and charged with one count of obstructing the examination of a financial institution, and one count charging falsification of records in violation of the Sarbanes–Oxley Act of 2002. NextCard was liquidated in 2003.

Sources: 1. Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 1871, September 25, 2003 (www.sec.gov/litigation/admin/34-48542.htm); 2. Securities and Exchange Commission Release 2003-125, September 25, 2003 (www.sec.gov/news/press/2003-123.htm)

Ownership of Audit Files

Audit documentation prepared during the engagement, including schedules prepared by the client for the auditor, is the *property of the auditor.* The only time anyone else, including the client, has a legal right to examine the files is when they are subpoenaed by a court as legal evidence. At the completion of the engagement, audit files are retained on the CPA's premises for future reference and to comply with auditing standards related to document retention.

Confidentiality of Audit Files

The need to maintain a confidential relationship with the client is expressed in Rule 301 of the *Code of Professional Conduct*, which states

- A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client.[1]

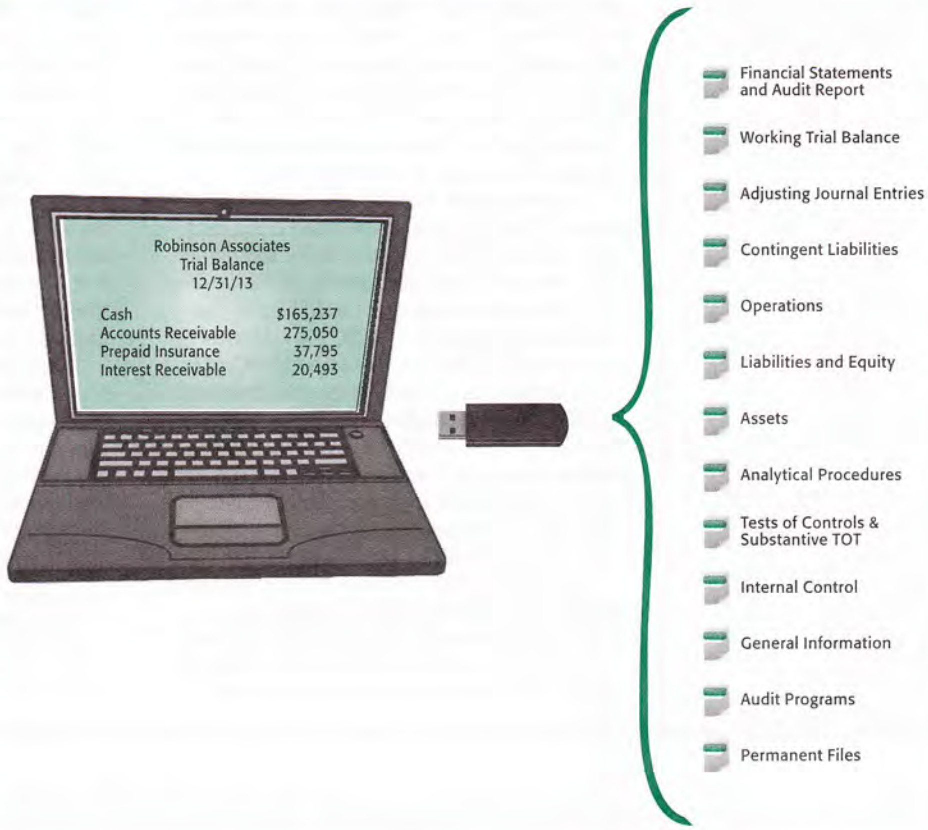
During the course of the audit, auditors obtain a considerable amount of information of a confidential nature, including officers' salaries, product pricing and advertising plans, and product cost data. If auditors divulged this information to outsiders or to client employees who have been denied access, their relationship with management would be seriously strained. Furthermore, having access to the audit files would give employees an opportunity to alter the files. For these reasons, care must be taken to safeguard the audit files at all times.

Requirements for Retention of Audit Documentation

Auditing standards require that records for audits of private companies be retained for a minimum of five years. The Sarbanes–Oxley Act requires auditors of public companies to prepare and maintain audit files and other information related to any audit report in sufficient detail to support the auditor's conclusions, for a period of not less than seven years. The law makes the knowing and willful destruction of audit documentation within the seven-year period a criminal offense subject to financial fines and imprisonment up to ten years.

[1]Source: Copyright American Institute of CPAs. All rights reserved. Used with permission.

FIGURE 7-2 **Audit File Contents and Organization**



SEC rules require public company auditors to maintain the following documentation:

- Working papers or other documents that form the basis for the audit of the company's annual financial statements or review of the company's quarterly financial statements
- Memos, correspondence, communications, other documents and records, including electronic records, related to the audit or review

These rules significantly increase the audit documentation that must be retained for audits of public companies. For example, auditors of public companies are required to retain e-mail correspondence that contains information meeting the preceding criteria.

Contents and Organization

OBJECTIVE 7-6

Prepare organized audit documentation.

Each CPA firm establishes its own approach to preparing and organizing audit files, and the beginning auditor must adopt the firm's approach. This text emphasizes general concepts common to all audit documentation.

Figure 7-2 illustrates the contents and organization of a typical set of audit files. They contain virtually everything involved in the audit. There is logic to the type of audit documentation prepared for an audit and the way it is arranged in the files, though different firms may follow somewhat different approaches. In the figure, the audit files start with general information, such as corporate data in the permanent files, and end with the financial statements and audit report. In between are the audit files supporting the auditor's tests.

Permanent Files

Permanent files contain data of a *historical or continuing nature* pertinent to the current audit. These files provide a convenient source of information about the audit that is of continuing interest from year to year. The permanent files typically include the following:

- *Extracts or copies of such company documents of continuing importance as the articles of incorporation, bylaws, bond indentures, and contracts.* The contracts may include pension plans, leases, stock options, and so on. Each of these documents is significant to the auditor for as many years as it is in effect.
- *Analyses from previous years of accounts that have continuing importance to the auditor.* These include accounts such as long-term debt, stockholders' equity accounts, goodwill, and fixed assets. Having this information in the permanent files enables the auditor to concentrate on analyzing only the changes in the current year's balance while retaining the results of previous years' audits in a form accessible for review.
- *Information related to understanding internal control and assessing control risk.* This includes organization charts, flowcharts, questionnaires, and other internal control information, including identification of controls and deficiencies in the system. These records are used as a starting point for documenting the auditor's understanding of the control system, since aspects of the systems are often unchanged from year to year.
- *The results of analytical procedures from previous years' audits.* Among these data are ratios and percentages computed by the auditor and the total balance or the balance by month for selected accounts. This information is useful in helping the auditor decide whether there are unusual changes in the current year's account balances that should be investigated more extensively.

Documenting analytical procedures, understanding of internal control, and assessing control risk are included in the current period audit files rather than in the permanent file by many CPA firms.

Current Files

The **current files** include all audit documentation applicable to the year under audit. There is one set of permanent files for the client and a set of current files for each year's audit. The following are types of information often included in the current file:

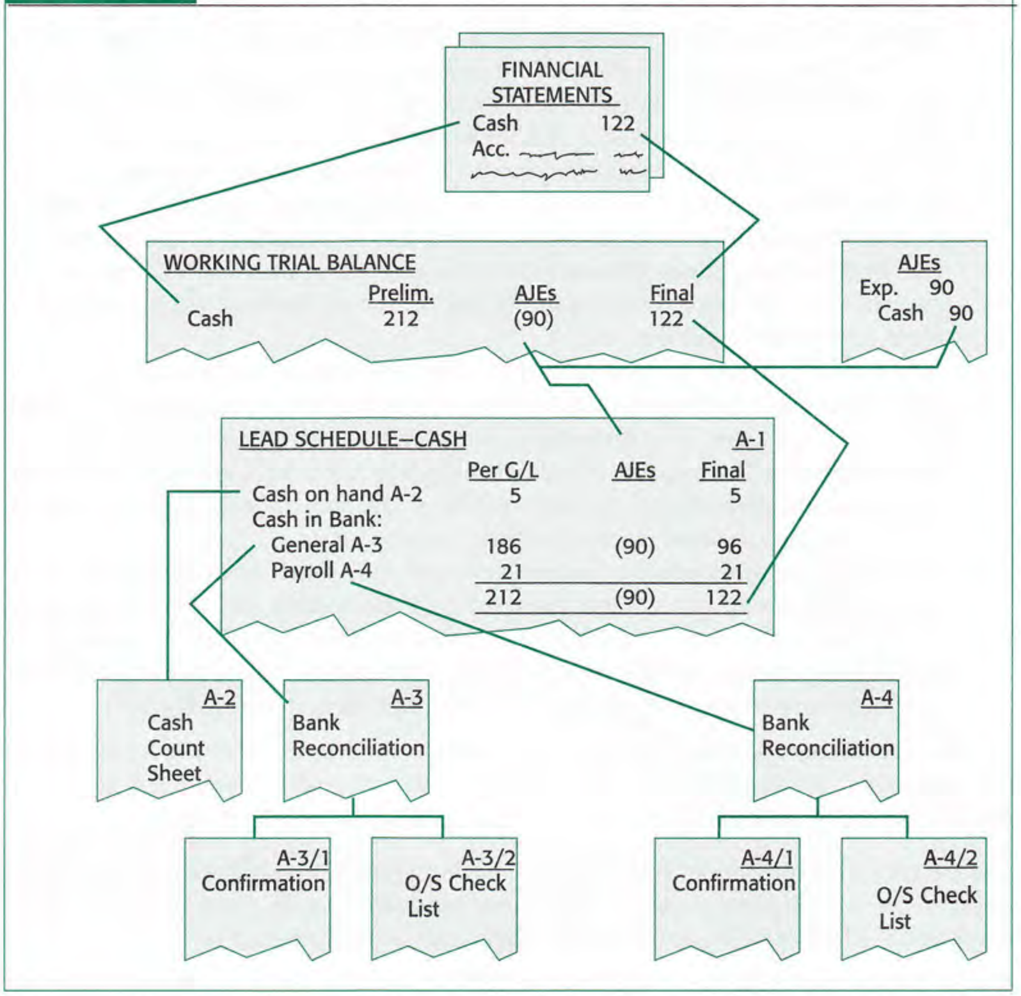
Audit Program Auditing standards require a written audit program for every audit. The audit program is ordinarily maintained in a separate file to improve the coordination and integration of all parts of the audit, although some firms also include a copy of the audit program with each audit section's audit documentation. As the audit progresses, each auditor initials or electronically signs the program for the audit procedures performed and indicates the date of completion. The inclusion in the audit files of a well-designed audit program completed in a conscientious manner is evidence of a high-quality audit.

General Information Some audit files include current period information of a general nature rather than evidence designed to support specific financial statement amounts. This includes such items as audit planning memos, abstracts or copies of minutes of the board of directors meetings, abstracts of contracts or agreements not included in the permanent files, notes on discussions with the client, supervisors' review comments, and general conclusions.

Working Trial Balance Because the basis for preparing the financial statements is the general ledger, the amounts included in that record are the focal point of the audit. As early as possible after the balance sheet date, the auditor obtains or prepares a listing of the general ledger accounts and their year-end balances. This schedule is the **working trial balance**. Software programs enable the auditor to download the client's ending general ledger balances into a working trial balance file.

The technique used by many firms is to have the auditor's working trial balance in the same format as the financial statements. Each line item on the trial balance is supported by a **lead schedule**, containing the detailed accounts from the general

FIGURE 7-3 **Relationship of Audit Documentation to Financial Statements**



ledger making up the line item total. Each detailed account on the lead schedule is, in turn, supported by proper schedules supporting the audit work performed and the conclusions reached. For example, the relationship between cash as it is stated on the financial statements, the working trial balance, the lead schedule for cash, and the supporting audit documentation is presented in Figure 7-3. As indicated, cash on the financial statements is the same as on the working trial balance and the total of the detail on the cash lead schedule. Initially, amounts for the lead schedule were taken from the general ledger. The audit work performed resulted in an adjustment to cash that will be shown in the detail schedules and is reflected on the lead schedule, the working trial balance, and the financial statements.

Adjusting and Reclassification Entries When the auditor discovers material misstatements in the accounting records, the financial statements must be corrected. For example, if the client failed to properly reduce inventory for obsolete raw materials, the auditor can propose an adjusting entry to reflect the realizable value of the inventory. Even though adjusting entries discovered in the audit are often prepared by the auditor, they must be approved by the client because management has primary responsibility for the fair presentation of the statements. Figure 7-3 illustrates an adjustment of the general cash account for $90 (thousand).

Reclassification entries are frequently made in the statements to present accounting information properly, even when the general ledger balances are correct. A common example is the reclassification for financial statement purposes of material credit balances in accounts receivable to accounts payable. Because the balance in accounts receivable in the general ledger reflects the accounts receivable properly from the point of view of operating the company on a day-to-day basis, the reclassification entry is not included in the client's general ledger.

Only those adjusting and reclassification entries that significantly affect the fair presentation of financial statements must be recorded. Auditors decide when a misstatement should be adjusted based on materiality. At the same time, auditors must keep in mind that several immaterial misstatements that are not adjusted could, when combined, result in a material overall misstatement. It is common for auditors to summarize all entries that have not been recorded in a separate audit schedule as a means of assessing their cumulative effect.

Supporting Schedules The largest portion of audit documentation includes the detailed **supporting schedules** prepared by the client or the auditors in support of specific amounts on the financial statements. Auditors must choose the proper type of schedule for a given aspect of the audit in order to document the adequacy of the audit and to fulfill the other objectives of audit documentation. Here are the major types of supporting schedules:

- *Analysis.* An analysis is designed to show the *activity in a general ledger* account during the entire period under audit, tying together the beginning and ending

FIGURE 7-4 **Common Characteristics of Proper Audit Documentation**

Client name → Renaldo Machine Co. Schedule: C-1 ← Audit file reference
Audit area → Notes Receivable–Customers Preparer: J.B. ← Initials of preparer
Balance sheet date → 11/30/13 Date: 12/23/13 ← Date prepared

Customer's Name	Interest Rate (percent)	Issue Date	Maturity Date		Face Amount 11-30-13		Accrued Interest 11-30-13	
Graham Metal Works	6.0	10/04/13	12/03/13	x	300,000	p	2,850.00	@
Lopez Hardware Co.	7.0	11/15/13	01/07/14	x	178,000	p	519.17	@
Boise Hinge	5.5	10/09/13	12/08/13	x	400,000	p	3,177.78	@
Eastam Mfg. Co.	7.5	11/10/13	01/02/14	x	144,000	p	600.00	@
Toledo Fabricators	7.0	11/20/13	01/12/14	x	250,000	p	486.11	@
Manor Appliance Co.	6.5	10/21/13	12/20/13	x	112,000	p	808.89	@
Commercial Copper	6.0	10/30/13	12/29/13	x	340,000	p	1,756.67	@
					1,724,000		10,198.62	
					f, t/b		f, t/b	

Cross-reference to general ledger trial balance

Tick mark symbols

x Agreed face amount, interest rate, issue and maturity dates to note receivable document.

P Positive confirmation received. No exceptions noted in face amount, issue and maturity dates, interest rate, and accrued interest (w/p C-2).

@ Recalculated accrued interest. No exceptions noted.

f Footed.

t/b Traced and agreed to trial balance.

Explanation of audit procedures performed

Conclusion: Notes receivable balance at 11/30/13 appears fairly stated. The collectibility of all notes was discussed with the controller. Per our conversation, all appear to be collectible. In my opinion, no loss provision is necessary. J.B. ← Auditor's conclusion

WILL IT STAND UP IN COURT?

Rhonda McMillan had been the in-charge auditor on the audit of Blaine Construction Company in 2008. Now she is sitting here, in 2014, in a room full of attorneys who are asking her questions about the 2008 audit. Blaine was sold to another company in 2009 at a purchase price that was based primarily on the 2008 audited financial statements. Several of the large construction contracts showed a profit in 2008 using the percentage of completion method, but they ultimately resulted in large losses for the buyer. Because Rhonda's firm audited the 2008 financial statements, the buyer is trying to make the case that Rhonda's firm failed in their audit of contract costs and revenues.

The buyer's attorney is taking Rhonda's deposition and is asking her about the audit work she did on contracts. Referring to the audit files, his examination goes something like this:

ATTORNEY Do you recognize this exhibit, and if you do, would you please identify it for us?

RHONDA Yes, this is the summary of contracts in progress at the end of 2008.

ATTORNEY Did you prepare this schedule?

RHONDA I believe the client prepared it, but I audited it. My initials are right here in the upper right-hand corner.

ATTORNEY When did you do this audit work?

RHONDA I'm not sure, I forgot to date this one. But it must have been about the second week in March, because that's when we did the field work.

ATTORNEY Now I'd like to turn your attention to this tick mark next to the Baldwin contract. You see where it shows Baldwin, and then the red sort of cross-like mark?

RHONDA Yes.

ATTORNEY In the explanation for that tick mark it says: "Discussed status of job with Elton Burgess. Job is going according to schedule, and he believes that the expected profit will be earned." Now my question is, Ms. McMillan, what exactly was the nature and content of your discussion with Mr. Burgess?

RHONDA Other than what is in the explanation to this tick mark, I have no idea. I mean, this all took place over 5 years ago. I only worked on the engagement that 1 year, and I can hardly even remember that.

Rhonda's work was not adequately documented, and what was there indicated that her testing relied almost exclusively on management inquiry without any required corroboration. Her audit firm was required to pay a significant settlement for damages to the buyer.

balances. This type of schedule is normally used for accounts such as marketable securities; notes receivable; allowance for doubtful accounts; property, plant, and equipment; long-term debt; and all equity accounts. The common characteristic of these accounts is the significance of the activity in the account during the year. In most cases, the analysis has cross-references to other audit files.

- *Trial balance or list.* This type of schedule consists of the *details that make up a year-end balance* of a general ledger account. It differs from an analysis in that it includes only those items making up the end-of-the-period balance. Common examples include trial balances or lists in support of trade accounts receivable, trade accounts payable, repair and maintenance expense, legal expense, and miscellaneous income. An example is included in Figure 7-4 (p. 213).
- *Reconciliation of amounts.* A reconciliation *supports a specific amount* and is normally expected to tie the amount recorded in the client's records to another source of information. Examples include the reconciliation of cash balances with bank statements, the reconciliation of subsidiary accounts receivable balances with confirmations from customers, and the reconciliation of accounts payable balances with vendors' statements. See the bank reconciliation example on page 750.
- *Tests of reasonableness.* A test of reasonableness schedule, as the name implies, contains information that enables the auditor to evaluate whether the client's balance appears to include a misstatement considering the circumstances in the engagement. Frequently, auditors test depreciation expense, the provision for federal income taxes, and the allowance for doubtful accounts using tests of reasonableness. These tests are primarily analytical procedures.

- *Summary of procedures.* Another type of schedule *summarizes the results* of a specific audit procedure. A summary schedule documents the extent of testing, the misstatements found, and the auditor's conclusion based on the testing. Examples are the summary of the results of accounts receivable confirmations and the summary of inventory observations.
- *Examination of supporting documents.* A number of special-purpose schedules are designed to *show detailed tests performed*, such documents examined during tests of controls and substantive tests of transactions. These schedules show no totals, and they do not tie in to the general ledger because their purpose is document the tests performed and the results found. However, the schedules must state a positive or negative conclusion about the objective of the test.
- *Informational.* This type of schedule contains information as opposed to audit evidence. These schedules include information for tax returns and SEC Form 10-K and data such as time budgets and the client's working hours, which are helpful in administration of the engagement.
- *Outside documentation.* Much of the content of the audit files consists of outside documentation gathered by auditors, such as confirmation replies and copies of client agreements. Although not "schedules" in the usual sense, they are indexed and filed. Audit procedures are indicated on them in the same manner as on other schedules.

Preparation of Audit Documentation

Read the story on the preceding page about Rhonda McMillan and imagine yourself in her position several years after completing an audit. The proper preparation of schedules to document the audit evidence accumulated, the results found, and the conclusions reached is an important part of the audit. The documentation should be prepared in sufficient detail to provide an experienced auditor with no connection to the audit a clear understanding of the work performed, the evidence obtained and its source, and the conclusions reached. Although the design depends on the objectives involved, audit documentation should possess certain characteristics:

- Each audit file should be properly identified with such information as the client's name, the period covered, a description of the contents, the initials of the preparer, the date of preparation, and an index code.
- Audit documentation should be indexed and cross-referenced to aid in organizing and filing. One type of indexing is illustrated in Figure 7-3 (p. 212). The lead schedule for cash has been indexed as A-1, and the individual general ledger accounts making up the total cash on the financial statements are indexed as A-2 through A-4. The final indexing is for the schedules supporting A-3 and A-4.
- Completed audit documentation must clearly indicate the audit work performed. This is accomplished in three ways: by a written statement in the form of a memorandum, by initialing the audit procedures in the audit program, and by notations directly on the schedules. Notations on schedules are accomplished by the use of **tick marks**, which are symbols adjacent to the detail on the body of the schedule. These notations must be clearly explained at the bottom of the schedule.
- Audit documentation should include sufficient information to fulfill the objectives for which it was designed. To properly prepare audit documentation, the auditor must know his or her goals. For example, if a schedule is designed to list the detail and show the verification of support of a balance sheet account, such as prepaid insurance, it is essential that the detail on the schedule reconciles with the trial balance.
- The conclusions that were reached about the segment of the audit under consideration should be plainly stated.

The common characteristics of proper audit documentation preparation are indicated in Figure 7-4 (p. 213).

Effect of Technology on Audit Evidence and Audit Documentation

OBJECTIVE 7-7

Describe how technology affects audit evidence and audit documentation.

Audit evidence is often available only in electronic form, and auditors must evaluate how this affects their ability to gather sufficient appropriate evidence. In certain instances, electronic evidence may exist only at a point in time. That evidence may not be retrievable later if files are changed and if the client lacks backup files. Therefore, auditors must consider the availability of electronic evidence early in the audit and plan their evidence gathering accordingly.

When evidence can be examined only in machine-readable form, auditors use computers to read and examine evidence. Commercial audit software programs, such as ACL and Interactive Data Extraction and Analysis (IDEA) software, are designed specifically for use by auditors. These programs are typically Windows-based and can easily be operated on the auditor's desktop or notebook computer. The auditor obtains copies of client databases or master files and uses the software to perform a variety of tests of the client's electronic data. These audit software packages are relatively easy to use, even by auditors with little IT training, and can be applied to a wide variety of clients with minimal customization. Auditors may also use spreadsheet software to perform audit tests.

Auditors often use engagement management software to organize and analyze audit documentation. Using audit management software, an auditor can prepare a trial balance, lead schedules, supporting audit documentation, and financial statements, as well as perform ratio analysis. The software also facilitates tracking audit progress by indicating the performance and review status of each audit area. Tick marks and other explanations, such as reviewer notes, can be entered directly into computerized files. In addition, data can be imported and exported to other applications, so auditors may download a client's general ledger or export tax information to a commercial tax preparation package. Auditors also use local area networks and groupshare software programs to access audit documentation simultaneously from remote locations.

SUMMARY

An important part of every audit is determining the proper types and amounts of audit evidence to gather. Auditors use eight types of evidence in an audit. The persuasiveness of the evidence depends on both its appropriateness and sufficiency. The appropriateness of audit evidence is determined by its relevance in meeting audit objectives and its reliability.

Audit documentation is an essential part of every audit for effectively planning the audit, providing a record of the evidence accumulated and the results of the tests, deciding the proper type of audit report, and reviewing the work of assistants. CPA firms establish their own policies and approaches to audit documentation to make sure that these objectives are met. High-quality CPA firms make sure that audit documentation is properly prepared and is sufficient for the circumstances in the audit.

ESSENTIAL TERMS

Analytical procedures—evaluations of financial information through analysis of plausible relationships among financial and nonfinancial data

Appropriateness of evidence—a measure of the quality of evidence; appropriate evidence is relevant and reliable in meeting audit objectives for classes of transactions, account balances, and related disclosures

Audit documentation—record of the audit procedures performed, relevant audit evidence, and conclusions the auditor reached

Audit procedure—detailed instruction for the collection of a type of audit evidence

Audit program—list of audit procedures for an audit area or an entire audit; the audit program always includes audit procedures and may also include sample sizes, items to select, and timing of the tests

Confirmation—the auditor's receipt of a direct written or electronic response from a third party verifying the accuracy of information requested

Current files—all audit files applicable to the year under audit

External document—a document, such as a vendor's invoice, that has been used by an outside party to the transaction being documented and that the client now has or can easily obtain

Inquiry—the obtaining of written or oral information from the client in response to specific questions during the audit

Inspection—the auditor's examination of the client's documents and records to substantiate the information that is or should be included in the financial statements

Internal document—a document, such as an employee time report, that is prepared and used within the client's organization

Lead schedule—an audit schedule that contains the detailed accounts from the general ledger making up a line item total in the working trial balance

Observation—looking at a process or procedure being performed by others

Permanent files—auditors' files that contain data of a *historical or continuing nature* pertinent to the current audit such as copies of articles of incorporation, bylaws, bond indentures, and contracts

Persuasiveness of evidence—the degree to which the auditor is convinced that the evidence supports the audit opinion; the two determinants of persuasiveness are the appropriateness and sufficiency of the evidence

Physical examination—the auditor's inspection or count of a tangible asset

Recalculation—the rechecking of a sample of the computations made by the client, including mathematical accuracy of individual transactions and amounts and the adding of journals and subsidiary records

Reliability of evidence—the extent to which evidence is believable or worthy of trust; evidence is reliable when it is obtained (1) from an independent provider, (2) from a client with effective internal controls, (3) from the auditor's direct knowledge, (4) from qualified providers such as law firms and banks, (5) from objective sources, and (6) in a timely manner

Reperformance—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

Sufficiency of evidence—the quantity of evidence; proper sample size

Supporting schedules—detailed schedules prepared by the client or the auditor in support of specific amounts on the financial statements

Tick marks—symbols used on an audit schedule that provide additional information or details of audit procedures performed

Tracing—the use of documentation to determine if transactions or amounts are included in the accounting records

Unusual fluctuations—significant unexpected differences indicated by analytical procedures between the current year's unaudited financial data and other data used in comparisons

Vouching—the use of documentation to support recorded transactions or amounts

Working trial balance—a listing of the general ledger accounts and their year-end balances

REVIEW QUESTIONS

7-1 (Objective 7-1) Discuss the similarities and differences between evidence in a legal case and evidence in an audit of financial statements.

7-2 (Objective 7-2) List the four major evidence decisions that must be made on every audit.

7-3 (Objective 7-2) Describe what is meant by an audit procedure. Why is it important for audit procedures to be carefully worded?

7-4 (Objective 7-2) Describe what is meant by an audit program for accounts receivable. What four things should be included in an audit program?

7-5 (Objective 7-3) Explain why the auditor can be persuaded only with a reasonable level of assurance, rather than convinced, that the financial statements are correct.

7-6 (Objective 7-3) Identify the two factors that determine the persuasiveness of evidence. How are these two factors related to audit procedures, sample size, items to select, and timing?

7-7 (Objective 7-3) Identify the six characteristics that determine the reliability of evidence. For each characteristic, provide one example of a type of evidence that is likely to be reliable.

7-8 (Objective 7-4) List the eight types of audit evidence included in this chapter and give two examples of each.

7-9 (Objective 7-4) What are the characteristics of a confirmation? Distinguish between a confirmation and external documentation.

7-10 (Objective 7-4) Distinguish between internal documentation and external documentation as audit evidence and give three examples of each.

7-11 (Objective 7-4) Explain the importance of analytical procedures as evidence in determining the fair presentation of the financial statements.

7-12 (Objective 7-4) Identify the most important reasons for performing analytical procedures.

7-13 (Objective 7-4) Your client, Harper Company, has a contractual commitment as a part of a bond indenture to maintain a current ratio of 2.0. If the ratio falls below that level on the balance sheet date, the entire bond becomes payable immediately. In the current year, the client's financial statements show that the ratio has dropped from 2.6 to 2.05 over the past year. How should this situation affect your audit plan?

7-14 (Objective 7-4) Distinguish between attention-directing analytical procedures and those intended to eliminate or reduce detailed substantive procedures.

7-15 (Objective 7-5) List the purposes of audit documentation and explain why each purpose is important.

7-16 (Objectives 7-5, 7-6) For how long does the Sarbanes–Oxley Act require auditors of public companies to retain audit documentation?

7-17 (Objective 7-6) Explain why it is important for audit documentation to include each of the following: identification of the name of the client, period covered, description of the contents, initials of the preparer and the reviewer, dates of the preparation and review, and an index code.

7-18 (Objective 7-6) Define what is meant by a permanent file, and list several types of information typically included. Why does the auditor not include the contents of the permanent file with the current year's audit file?

7-19 (Objective 7-6) Distinguish between the following types of current period supporting schedules and state the purpose of each: analysis, trial balance, and tests of reasonableness.

7-20 (Objective 7-6) Why is it essential that the auditor not leave questions or exceptions in the audit documentation without an adequate explanation?

7-21 (Objective 7-6) Define what is meant by a tick mark. What is its purpose?

7-22 (Objective 7-5) Who owns the audit files? Under what circumstances can they be used by other people?

7-23 (Objective 7-7) How does the auditor read and evaluate information that is available only in machine-readable form?

7-24 (Objective 7-7) Explain the purposes and benefits of audit documentation software.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

7-25 (Objectives 7-5, 7-6) The following questions concern audit documentation. Choose the best response.

a. Which of the following is *not* a primary purpose of audit documentation?
   (1) To coordinate the audit.

(2) To assist in preparation of the audit report.
(3) To support the financial statements.
(4) To provide evidence of the audit work performed.

b. During an audit engagement, pertinent data are compiled and included in the audit files. The audit files primarily are considered to be
(1) a client-owned record of conclusions reached by the auditors who performed the engagement.
(2) evidence supporting financial statements.
(3) support for the auditor's representations as to compliance with auditing standards.
(4) a record to be used as a basis for the following year's engagement.

c. Although the quantity, type, and content of audit documentation will vary with the circumstances, audit documentation generally will include the
(1) copies of those client records examined by the auditor during the course of the engagement.
(2) evaluation of the efficiency and competence of the audit staff assistants by the partner responsible for the audit.
(3) auditor's comments concerning the efficiency and competence of client management personnel.
(4) auditing procedures followed and the testing performed in obtaining audit evidence.

7-26 (Objectives 7-3, 7-4) The following questions concern persuasiveness of evidence. Choose the best response.

a. Which of the following types of documentary evidence should the auditor consider to be the most reliable?
(1) A sales invoice issued by the client and supported by a delivery receipt from an outside trucker.
(2) Confirmation of an account payable balance mailed by and returned directly to the auditor.
(3) A check, issued by the company and bearing the payee's endorsement, that is included with the bank statements mailed directly to the auditor.
(4) An audit schedule prepared by the client's controller and reviewed by the client's treasurer.

b. Which of the following statements concerning audit evidence is true?
(1) To be appropriate, audit evidence should be either persuasive or relevant, but need not be reliable.
(2) The measure of the quantity and quality of audit evidence lies in the auditor's judgment.
(3) The difficulty and expense of obtaining audit evidence concerning an account balance is a valid basis for omitting the test.
(4) A client's accounting records can be sufficient audit evidence to support the financial statements.

c. Audit evidence can come in different forms with different degrees of persuasiveness. Which of the following is the least persuasive type of evidence?
(1) Vendor's invoice
(2) Bank statement obtained from the client
(3) Computations made by the auditor
(4) Prenumbered sales invoices

d. Which of the following presumptions is correct about the reliability of audit evidence?
(1) Information obtained indirectly from outside sources is the most reliable audit evidence.
(2) To be reliable, audit evidence should be convincing rather than merely persuasive.
(3) Reliability of audit evidence refers to the amount of corroborative evidence obtained.
(4) Effective internal control provides more assurance about the reliability of audit evidence.

DISCUSSION QUESTIONS AND PROBLEMS

7-27 (Objective 7-4) The following are examples of documentation typically obtained by auditors:

1. Duplicate sales invoices
2. Subsidiary accounts receivable records
3. Vendors' invoices
4. General ledgers
5. Title insurance policies for real estate
6. Notes receivable
7. Bank statements
8. Cancelled payroll checks
9. Cancelled notes payable
10. Payroll time cards
11. Purchase requisitions
12. Articles of incorporation
13. Receiving reports (documents prepared when merchandise is received)
14. Minutes of the board of directors
15. Signed W-4s (Employee's Withholding Exemption Certificates)
16. Remittance advices
17. Signed lease agreements
18. Duplicate copies of bills of lading

Required

a. Classify each of the preceding items according to type of documentation: (1) internal or (2) external.

b. Explain why external evidence is more reliable than internal evidence.

7-28 (Objective 7-4) As auditor of the Star Manufacturing Company, you have obtained

a. A trial balance taken from the books of Star one month before year-end:

	Dr. (Cr.)		Dr. (Cr.)
Cash in bank	$ 87,000	Mortgages payable	(400,000)
Trade accounts receivable	345,000	Capital stock	(300,000)
Notes receivable	125,000	Retained earnings	(510,000)
Inventories	317,000	Sales	(3,130,000)
Land	66,000	Cost of sales	2,300,000
Buildings, net	350,000	General and administrative expenses	622,000
Furniture, fixtures, and equipment, net	325,000	Legal and professional fees	3,000
Trade accounts payable	(235,000)	Interest expense	35,000

b. There are no inventories consigned either in or out.

c. All notes receivable are due from outsiders and held by Star.

Required

Which accounts should be confirmed with outside sources? Briefly describe from whom they should be confirmed and the information that should be confirmed. Organize your answer in the following format:*

Account Name	From Whom Confirmed	Information to Be Confirmed

7-29 (Objective 7-4) List two examples of audit evidence the auditor can use in support of each of the following:

a. Recorded amount of entries in the acquisitions journal

b. Physical existence of inventory

c. Accuracy of accounts receivable

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d. Ownership of fixed assets
e. Liability for accounts payable
f. Obsolescence of inventory
g. Existence of petty cash

7-30 (Objective 7-4) The following are examples of audit procedures:

1. Review the accounts receivable with the credit manager to evaluate their collectibility.
2. Compare a duplicate sales invoice with the sales journal for customer name and amount.
3. Add the sales journal entries to determine whether they were correctly totaled.
4. Count inventory items and record the amount in the audit files.
5. Obtain a letter from the client's attorney addressed to the CPA firm stating that the attorney is not aware of any existing lawsuits.
6. Extend the cost of inventory times the quantity on an inventory listing to test whether it is accurate.
7. Obtain a letter from an insurance company to the CPA firm stating the amount of the fire insurance coverage on buildings and equipment.
8. Examine an insurance policy stating the amount of the fire insurance coverage on buildings and equipment.
9. Calculate the ratio of cost of goods sold to sales as a test of overall reasonableness of gross margin relative to the preceding year.
10. Obtain information about internal control by requesting the client to fill out a questionnaire.
11. Trace the total in the cash disbursements journal to the general ledger.
12. Watch employees count inventory to determine whether company procedures are being followed.
13. Examine a piece of equipment to make sure that a major acquisition was actually received and is in operation.
14. Calculate the ratio of sales commission expense to sales as a test of sales commissions.
15. Examine corporate minutes to determine the authorization of the issue of bonds.
16. Obtain a letter from management stating that there are no unrecorded liabilities.
17. Review the total of repairs and maintenance for each month to determine whether any month's total was unusually large.
18. Obtain a written statement from a bank stating that the client has $15,671 on deposit and liabilities of $500,000 on a demand note.

Required

Classify each of the preceding items according to the eight types of audit evidence: (1) physical examination, (2) confirmation, (3) inspection, (4) analytical procedures, (5) inquiries of the client, (6) recalculation, (7) reperformance, and (8) observation.

7-31 (Objective 7-4) The following audit procedures were performed in the audit of inventory to satisfy specific balance-related audit objectives as discussed in Chapter 6. The audit procedures assume that the auditor has obtained the inventory count sheets that list the client's inventory. The general balance-related audit objectives from Chapter 6 are also included.

Audit Procedures

1. Trace selected quantities from the inventory list to the physical inventory to make sure that it exists and the quantities are the same.
2. Compare the quantities on hand and unit prices on this year's inventory count sheets with those in the preceding year as a test for large differences.
3. Test extend unit prices times quantity on the inventory list, test foot the list, and compare the total to the general ledger.
4. Question operating personnel about the possibility of obsolete or slow-moving inventory.
5. Send letters directly to third parties who hold the client's inventory, and request that they respond directly to the auditors.

6. Select a sample of quantities of inventory in the factory warehouse and trace each item to the inventory count sheets to determine if it has been included and if the quantity and description are correct.
7. Examine sales invoices and contracts with customers to determine whether any goods are out on consignment with customers. Similarly, examine vendors' invoices and contracts with vendors to determine whether any goods on the inventory listing are owned by vendors.

General Balance-Related Audit Objectives

Existence	Cutoff
Completeness	Detail tie-in
Accuracy	Realizable value
Classification	Rights and obligations

Required

a. Identify the type of audit evidence used for each audit procedure.

b. Identify the general balance-related audit objective or objectives satisfied by each audit procedure.

7-32 (Objective 7-4) The following are various audit procedures performed to satisfy specific transaction-related audit objectives as discussed in Chapter 6. The general transaction-related audit objectives from Chapter 6 are also included.

Audit Procedures

1. Trace from receiving reports to vendors' invoices and entries in the acquisitions journal.
2. Add the sales journal for the month of July and trace amounts to the general ledger.
3. Examine expense voucher packages and related vendors' invoices for approval of expense account classification.
4. Observe opening of cash receipts to determine that cash receipts are promptly deposited and recorded.
5. Ask the accounts payable clerk about procedures for verifying prices, quantities, and extensions on vendors' invoices.
6. Vouch entries in sales journal to sales invoices and related shipping documents.

General Transaction-Related Audit Objectives

Occurrence	Posting and summarization
Completeness	Classification
Accuracy	Timing

Required

a. Identify the type of audit evidence used for each audit procedure.

b. Identify the general transaction-related audit objective or objectives satisfied by each audit procedure.

7-33 (Objective 7-4) Eight different types of evidence were discussed. The following questions concern the reliability of that evidence:

Required

a. Give three examples of relatively reliable documentation and three examples of less reliable documentation. What characteristics distinguish the two?

b. Explain why confirmations are normally more reliable evidence than inquiries of the client.

c. Explain why recalculation tests are highly reliable but of relatively limited use.

d. Explain why analytical procedures are important evidence even though they are relatively unreliable by themselves.

e. Describe a situation in which confirmation will be considered highly reliable and another in which it will not be reliable.

f. Under what circumstances is the physical observation of inventory considered relatively unreliable evidence?

g. Give several examples in which the qualifications of the respondent or the qualifications of the auditor affect the reliability of the evidence.

7-34 (Objective 7-4) Following are 10 audit procedures with words missing and a list of several terms commonly used in audit procedures.

Audit Procedures

1. _____ the unit selling price times quantity on the duplicate sales invoice and compare the total to the amount on the duplicate sales invoice.
2. _____ whether the accounts receivable bookkeeper is prohibited from handling cash.
3. _____ the ratio of cost of goods sold to sales and compare the ratio to previous years.
4. _____ the sales journal and _____ the total to the general ledger.
5. _____ the sales journal, looking for large and unusual transactions requiring investigation.
6. _____ of management whether all accounting employees are required to take annual vacations.
7. _____ all marketable securities as of the balance sheet date to determine whether they equal the total on the client's list.
8. _____ the balance in the bank account directly with the East State Bank.
9. _____ a sample of duplicate sales invoices to determine if the controller's approval is included and _____ each duplicate sales invoice to the sales journal for agreement of name and amount.
10. _____ the agreement between Johnson Wholesale Company and the client to determine whether the shipment is a sale or a consignment.

Terms

a. Examine	e. Recompute	i. Count
b. Scan	f. Foot	j. Observe
c. Read	g. Trace	k. Inquire
d. Compute	h. Compare	l. Confirm

Required

a. For each of the 12 blanks in procedures 1 through 10, identify the most appropriate term. No term can be used more than once.

b. For each of the procedures 1 through 10, identify the type of evidence that is being used.

7-35 (Objectives 7-3, 7-4) The following are nine situations, each containing two means of accumulating evidence:

1. Confirm receivables with consumers versus confirming accounts receivable with business organizations.
2. Physically examine 3-inch steel plates versus examining electronic parts.
3. Examine duplicate sales invoices when several competent people are checking each other's work versus examining documents prepared by a competent person on a one-person staff.
4. Physically examine inventory of parts for the number of units on hand versus examining them for the likelihood of inventory being obsolete.
5. Discuss the likelihood and amount of loss in a lawsuit against the client with client's in-house legal counsel versus discussion with the CPA firm's own legal counsel.
6. Confirm the oil and gas reserves with a geologist specializing in oil and gas versus confirming a bank balance.
7. Confirm a bank balance versus examining the client's bank statements.
8. Physically count the client's inventory held by an independent party versus confirming the count with an independent party.
9. Obtain a physical inventory count from the company president versus physically counting the client's inventory.

Required

a. Identify the six factors that determine the reliability of evidence.

b. For each of the nine situations, state whether the first or second type of evidence is more reliable.

c. For each situation, state which of the six factors affected the reliability of the evidence.

Vandervoort Company
A/C # 110—Notes Receivable
12-31-13

Schedule N-1 **Date**
Prepared by JD 1-21-14
Approved by PP 2-15-14

	APEX CO.		AJAX, INC.		J.J. CO.		P. SMITH		MARTIN-PETERSON		TENT CO.		TOTALS	
Date made	6/15/12		11/21/12		11/1/12		7/26/13		5/12/12		9/3/13			
Date due	6/15/14		Demand		$ 200/mo.		$1,000/mo.		Demand		$400/mo.			
Paid to date	None		Paid		12/31/13		9/30/13		Paid		11/30/13			
Face amount	$5,000	x	$ 3,591	x	$ 13,180	x	$ 25,000	x	$ 2,100	x	$ 12,000	x		
Interest rate	5%		5%		5%		5%		5%		6%			
Value of security	None		None		$ 24,000		$ 50,000		None		$ 10,000			
Note Receivable:														
12/31/12 bal.	$4,000	py	$ 3,591	py	$ 12,780	py	$ 0		$ 2,100	py	$ 0			
Additions							25,000				12,000			
Payments	(1,000)	x	$(3,591)	x	(2,400)	x	(5,000)	x	(2,100)	x	(1,600)	x		
12/31/13 bal.	$3,000		$ 0		$ 10,380		$ 20,000		$ 0		$ 10,400			
Current	$3,000		–		$ 2,400		$ 12,000		–		$ 4,800		$22,200	tb
Long-term	–		–		7,980		8,000		–		5,600		21,580	tb
Total end. bal.	$3,000	@	$ 0		$ 10,380	@	$ 20,000	@	$ 0		$ 10,400	@	$43,780	tb
Interest Receivable:														
12/31/12 bal.	$ 104	py	$ 0	py	$ 24	py	$ 0		$ 0	py	$ 0		$ 128	
Interest earned	175	x	102	x	577	x	468	x	105	x	162	x	1,589	#
Interest received	0		(102)	x	(601)	x	(200)	x	(105)	x	(108)	x	(1,116)	
12/31/13 bal.	$ 279		$ 0		$ 0		$ 268		$ 0		$ 54		$ 601	a/r

x = Tested
py = Agrees with prior year's audit schedules.
tb = Agrees with working trial balance.
# = Agrees with miscellaneous income analysis in operations w/p.
a/r = Agrees with A/R lead schedule.

7-36 (Objectives 7-5, 7-6) You are the in-charge on the audit of Vandervoort Company and are to review the audit schedule shown above.

Required

a. List the deficiencies in the audit schedule.

b. For each deficiency, state how the audit schedule could be improved.

c. Prepare an improved audit schedule, using an electronic spreadsheet software program. Include an indication of the audit work done as well as the analysis of the client data (instructor's option).

7-37 (Objective 7-4) Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. They range from simple comparisons to the use of complex models involving many relationships and elements of data. They involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditors.

Required

a. Describe the broad purposes of analytical procedures.

b. When are analytical procedures required during an audit? Explain why auditors use analytical procedures extensively in all parts of the audit.

c. Describe the factors that influence the extent to which an auditor will use the results of analytical procedures to reduce detailed tests in meeting audit objectives.*

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CASE

7-38 (Objective 7-4) Nefret Stores is a large discount cosmetic department store chain. The company has recently expanded from 5 to 15 stores by borrowing from several large financial institutions and from a public offering of common stock. A recent investigation has disclosed that Nefret materially overstated net income. The company understated their accounts payable and recorded fictitious supplier credits that further reduced accounts payable. As a result, an Income & Sales Tax Department investigation was critical of the evidence gathered by Nefret's audit firm, Abdul & El-Emir, in testing accounts payable and the supplier credits.

1. Nefret created a 250-page list of approximately 1,000 vendors, supporting advertising credits of $500,000. Nefret's auditors selected a sample of 8 of the 2,500 items for direct confirmation. One item was confirmed by telephone, one traced to cash receipts, one to a vendor's credit memo for part of the amount and cash receipts for the rest, and one to a vendor's credit memo. Two of the amounts confirmed differed from the amount on the list, but the auditors did not seek an explanation for the differences because the amounts were not material.

   The rest of the credits were tested by selecting 30 items (several from each page of the list). Fourteen of the items were supported by examining the ads placed, and sixteen were supported by Nefret debit memos charging the vendors for the promotional allowances.
2. Nashwa Credits—Nefret created 28 fictitious credit memos totaling $363,000 from Nashwa Distributions, the main supplier of health and beauty aids to Nefret. Nefret's controller initially told the auditor that the credits were for returned goods, then said they were a volume discount, and finally stated that they were a payment so that Nefret would continue to use Nashwa as a supplier. However, an Abdul & El-Emir staff auditor noticed the amount and concluded that a $257,000 payment to retain Nefret's business was too large to make economic sense.

   The credit memos indicated that the credits were for damaged merchandise, volume rebates, and advertising allowances. The audit firm requested a confirmation of the credits. In response, Ramses Abdullah, the president of Nefret Stores, placed a call to Saria Wasir, the president of Nashwa, and handed the phone to the staff auditor. In fact, the call had been placed to an officer of Nefret. The Nefret officer, posing as Wasir, orally confirmed the credits. Nefret refused to allow Abdul & El-Emir to obtain written confirmation supporting the credits. Although the staff auditor doubted the validity of the credits, the audit partner, Mufti Hussein, accepted the credits based on the credit memoranda, telephone confirmation of the credits, and oral representation of Nefret officers.
3. Zaki Credits—$130,000 in credits based on 35 credit memoranda from Zaki, Inc., were purportedly for the return of overstocked goods from several Nefret stores. An Abdul & El-Emir staff auditor noted the size of the credit and that the credit memos were dated subsequent to year-end. He further noticed that a sentence on the credit memos from Zaki had been obliterated by a felt-tip marker. When held to the light, the accountant could read that the marked-out sentence read, "Do not post until merchandise received." The staff auditor thereafter called Omar Zaki, treasurer of Zaki, Inc., and was informed that the $130,000 in goods had not been returned and the money was not owed to Nefret by Zaki. Abdullah, president of Nefret, advised Hussein, audit partner, not to have anyone call Zaki to verify the amount because of pending litigation between Nefret and Zaki, Inc.
4. Accounts Payable Accrual—Abdul & El-Emir assigned a senior with experience in the retail area to audit accounts payable. Although Nefret had poor internal controls, Abdul & El-Emir selected a sample of 50 for confirmation of the several thousand vendors who did business with Nefret. Twenty-seven responses were received, and 21 were reconciled to Nefret's records. These tests indicated an unrecorded liability of approximately $290,000 when projected to the population of accounts payable.

However, the investigation disclosed that Nefret's president made telephone calls to some suppliers who had received confirmation requests from Abdul & El-Emir and told them how to respond to the request.

Abdul & El-Emir also performed a purchase cutoff test by vouching accounts payable invoices received for nine weeks after year-end. The purpose of this test was to identify invoices received after year-end that should have been recorded in accounts payable. Thirty percent of the sample ($150,000) was found to relate to the prior year, indicating a potential unrecorded liability of approximately $500,000. The audit firm and Nefret eventually agreed on adjustment to increase accounts payable by $260,000.

Required Identify deficiencies in the sufficiency and appropriateness of the evidence gathered in the audit of accounts payable of Nefret Stores.

ACL PROBLEM

7-39 (Objective 7-4) This problem requires the use of ACL software, which is included in the CD attached to the text. Information about installing and using ACL and solving this problem can be found in Appendix, pages 850–854. You should read all of the reference material preceding instructions about "Quick Sort" before locating the appropriate command to answer questions a. through f. For this problem, use the file labeled "Payroll" in the "Payroll_Analysis" subfolder under tables in Sample_Project. The suggested command or other source of information needed to solve the problem requirement is included at the end of each question.

Required

a. Determine the number of payroll transactions in the file. (Read the bottom of the Payroll file screen.)

b. Determine the largest and smallest payroll transaction (gross pay) for the month of September. (Quick Sort)

c. Determine gross pay for September. (Total)

d. Determine and print gross pay by department. (Summarize)

e. Recalculate net pay for each payroll transaction for September and compare it to the amount included in the file. (Filter)

f. Determine if there are any gaps or duplicates in the check (cheque) numbers. If there are gaps or duplicates, what is your concern? (Gaps and Duplicates)

RESEARCH PROBLEM 7-1: USE OF AUDIT SOFTWARE FOR FRAUD DETECTION AND CONTINUOUS AUDITING

The use of audit software has increased dramatically in recent years. Software is now used to fulfill administrative functions in the audit environment, document audit work, and conduct data analysis. This problem requires students to visit the ACL Web site (www.acl.com) to learn how auditors use ACL to address issues of fraud detection and continuous auditing.

Required

a. Read about ACL's solution for fraud detection. What are some of the benefits of ACL for fraud detection?

b. What is continuous monitoring? How might a company use ACL to comply with requirements related to internal control over financial reporting?