TOPIC 12: PART 1 – WAYS OF GATHERING AUDIT EVIDENCE

ISA 500 is the relevant auditing standard for audit evidence. 7 basic ways for the auditor to gather audit evidence throughout the audit process:

1. Observation (look at a process)

2. Analytical Review (comparison of data with previous year, budget, industry standards)

3. Reperformance (auditor executing controls that were originally performed as part of the entity’s internal control) / Recalculation (checking the mathematical accuracy of documents or records)

4. Inspection of Documentation

5. Confirmations (i.e. ask someone outside/inside the company)

6. Enquiry (i.e. ask someone inside the company)

7. Inspection of Assets (including the accounting system itself)

Memory Aid: “OAR ICE I”

SOURCES OF EVIDENCE
There are many sources of audit evidence, and the precise list will depend on the objective being tested, and the nature of the client. However, a useful list of typical sources is:

The accounting system
Underlying documentation
Tangible assets
Management and employees
Third Parties (experts?)
Customers
Suppliers
Solicitors
Valuers
Insurers
SUFFICIENT & APPROPRIATE AUDIT EVIDENCE
The auditor is obliged to gather **sufficient appropriate** evidence to support their Audit opinion. (ISA 500 Audit Evidence).

![Diagram of Sufficient & Appropriate Audit Evidence](image)

- **Sufficiency** → **Quantity of Audit Evidence**
- **Appropriateness** → **Quality/Reliability of Audit Evidence**

Some general principles on appropriateness/reliability:

- Original documents better than copies
- If possible, auditor-generated (rather than client-generated)
- From 3rd Party where possible (rather than client)
- Written better than oral

Hence, a **written** statement from a **customer** (from 3rd Party) of their agreement of a balance owing, **sent to the auditor direct**, is very reliable evidence – so long as the auditor is assured that the customer is themselves reliable.

Also, note that where the auditor has to rely on a director’s representation, it will be documented in the Letter of Representation/Written representation (ISA 580)

Auditors should evaluate the overall quality of the evidence they have collected. To decide whether sufficient appropriate evidence has been collected:

- Evidence is less useful if it contradicts other evidence obtained on the same matter
- Riskier areas are likely to demand more conclusive evidence
- More material areas (e.g. inventory) are likely to demand more conclusive evidence.
- Previous experience of the auditor will help the assessment
- The more reliable the evidence, the less is needed

No single source of evidence is ever conclusive and at best adds to the auditors confidence in the accuracy/validity of the item under review
ANALYTICAL PROCEDURES

Analytical Procedures as Substantive Procedures.

As noted above, there are 7 basic forms of audit test. Most are considered tests of detail of transactions or balances. However, analytical procedures are not tests of detail:

- Analytical Procedures can be considered a more **global approach** to substantive testing. Instead of selecting a sample of transactions or balances that make up the overall figures in the Accounts, the overall figure itself can be analysed for accuracy using various techniques.

Analytical Procedures involve the analysis of relationships between:

- Balances within the Accounts
- Balances in the Accounts with other internal data
- Balances in the Accounts with other external data

Specific examples could include:

- Monitoring the trend in key ratios over time
- Comparing key ratios with similar companies or with industry averages
- Comparing balances with other known information
- Comparing the results of an entity over time (trend analysis)
- Comparing the results of an entity with an industry average
- Comparing actual results with auditor generated forecasts.

The approach to analytical procedures is:

- Identify relationships between data, ensuring they are fully understood
- Develop expectation of balance in the Accounts
- Compare expectation to actual balance
- Seek explanations for material differences

Factors that will affect the use of analytical procedures:

- Strength of relationships
- Reliability of the data being used in the analysis
- Depth of knowledge auditor has of client
  - Makes analytical procedures difficult for new clients !!
- Nature of the company
  - A company with many similar divisions (e.g. a chain of shops) provides great scope for comparison of data

Comparison of data is one of the general types of internal control procedure (Budget v Actual). In other words, many companies will be doing their own regular analytical procedures themselves.
It may be possible for the external auditor to rely on the analysis carried out by the company.....but this will depend on the reliability of those who did the work. For example, we could get evidence as to the accuracy of the current year Payroll expense in the Statement of Profit or Loss by:

a. Comparing the figure with last year’s figure, noting:
   - Starters and leavers
   - Any pay rises / tax changes during the year

b. Comparing payroll with other related figures in the FS. This will depend on the specific company, but could include:
   - Turnover (especially if staff time is charged to clients)
   - Profit (especially if staff get profit-related bonuses)
   - Staff entertainment expenses (i.e. for a given head count we should expect a consistent level of staff entertainment expenses)

COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)
The auditor will also need to consider whether it is appropriate to use CAATs as part of the strategy for obtaining sufficient appropriate audit evidence.

Computer-assisted audit techniques (CAATs) involve using a computer to perform audit work. Computers can be used to perform either substantive tests (tests of detail or substantive analytical procedures) or tests of controls.

Audit software is primarily used for substantive procedures, although it can also be used for tests of control. Client data is processed though the auditor’s programs. These programs can, for example:

- check additions (recast!);
- select high value, static, or negative transactions and balances, for review;
- perform, or re-perform the ageing of a ledger;
- select samples for further testing.

The data can be downloaded directly from the client’s system, or re-input into the auditor’s system. Obviously, the better the communications between auditor and client systems, the more efficient this process will be.

Major considerations when deciding to use file interrogation software are

- Auditors will need to consider how easy it is to transfer the client’s data onto the auditors PC
- Auditors will require a basic understanding of data processing and the entity’s computer application, together with a detailed knowledge of the audit software and the computer files to be used.
By using audit software, the auditors may scrutinise large volumes of data and concentrate skilled manual resources on the investigation of results, rather than on the extraction of information and selection of samples.

2 main types of CAAT’s are Embedded Audit Facilities and Test Data

Embedded audit facilities

‘Embedded audit facilities’ amount to audit software that has been written into the client’s system, to trap items as they are processed for further testing at a later date.

Two example of Embedded Audit facilities are Integrated Test Facility (ITF) and Systems Control and Review File (SCARF).

Consists of computer programs used by the auditor, as part of his auditing procedures, to process data of audit significance from the entity's accounting system. Embedded audit facilities can be used to

- Read and extract data from a client's system and produce a report in a specified format
- Select information (eg a sample)
- Perform calculations (eg casting)
- Print reports in specified formats

Auditor will need to ensure that the data sent to the auditors system, from an Embedded Audit Facility is free from hacking.

Test data

- Used primarily to test the operating effectiveness of the internal control activities of the client.
  - Test data techniques are audit procedures which enter data into an entity's computer system, and compare the results obtained with pre-determined results.
  - Test data is a fictitious set of test transactions which are input to the client's system in order to determine whether the internal controls within the entity's computer systems have operated effectively throughout the period.
  - This will require significant co-operation from the client, especially in terms of computer access time.
  - A problem with test data is that any resulting corruption of the data files has to be corrected. This is difficult with modern real time systems, which have built in controls to ensure that data entered cannot easily be removed without leaving a mark.
  - A weakness of tests data is that it only tests the operation of the system at a single point in time.