**CHAPTER ONE**

**AUDIT PROCESS**

**1.0 Aims and objectives**

When you have studied this unit you should be able to:

* describe why auditors seek audit evidence
* explain audit evidence in terms of its competence and relative strength of persuasiveness.
* indicate the factors that affect the sufficiency and competency of evidential matter.
* explain the nature and purpose of audit working papers.
  1. **Introduction**

When auditors are employed to express an opinion on the financial statements of an entity, they must ensure that they have **sufficient competent** evidence on which to base such an opinion. In this unit you will learn to answer the question what constitute sufficient competent evidence.

Audit evidence is a fundamental concept in auditing. Audit evidence consists of underlying accounting data and all corroborative information available to the auditor.

Both categories of evidential matter are required in making an audit in accordance with GAAS.

The principal types of corroborating information areas follow:

**Analytical evidence**

Analytical evidence involves comparison of current period client data, such as total revenues or return on assets, with expected values for the data based on (1)historical or budgeted amounts for the client or (2) industry data.

The reliability of analytical evidence is dependent on the relevance of the comparable data.

**Documentary Evidence**

Documentary evidence includes a wide variety source documents as well as such items as minutes of board of director or executive committee meetings, lease agreements various other contracts, and bank statements.

**Confirmations**

Confirmations constitute a special class of documentary evidence involving direct written responses by knowledgeable third parties to specific requests for factual information.

**Written representations**

Written representations are signed statements by responsible and knowledgeable individuals that bear on one or more of management’s assertions.

**Mathematical evidence**

Mathematical evidence results from recompilations by the auditor and comparison of those results the client’s computations.

**Oral evidence**

During the audit, an auditor receives oral responses to numerous inquiries directed to officers and employees of the client and others.

**Physical evidence**

Physical evidence is obtained from the physical examination or inspection of tangible assets.

**1.2 DOCUMENTS and record examination**

In the early stages of an audit, the external auditors must become familiar with many aspects of the client’s business. For example, the auditors must obtain knowledge of the client’s organization plan, financial structure, physical facilities, products, accounting policies, and the control procedures. However, information about the internal activities of the client is not in itself sufficient.

If this information is to be interpreted and evaluated in a proper perspective, the auditor must also understand the business environment in which the client operates. The auditors can gain considerable information about both the client’s business environment and internal operations by examining the client’s general records. The term general records is used to include the following categories:

**1.** **Non-financial records**

* + Articles and certificates of corporations and bylaws
  + Partnership contract
  + Minutes of directors and shareholders meetings
  + Contracts with customers and suppliers
  + Contracts with officers and employees
  + Government regulations directly affecting the enterprise
  + Correspondence files

**2. Financial records**

* + Income tax returns of prior years.
  + Financial statements and annual reports of prior years.

**3. Accounting records**

* + General ledger.
  + General journal.

## Check Your Progress Exercise -1

1. Identify the two categories of evidential matter.

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1. List the types of corroborative information that may be obtained in an audit.

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**1.3 Audit evidence**

During financial statement audits, the auditors gather and evaluate evidence to form an opinion on whether financial statements follow the appropriate criteria, usually **IFRS.**

Gathering sufficient appropriate audit evidence is the very essence of auditing. The third standard of fieldwork states:

*Sufficient appropriate evidence should be obtained by such means as inspection, observation, enquiry, confirmation, computation and analysis, to afford a reasonable basis to support the content of the report*

* + 1. **Sufficient, Appropriate Evidence**

The auditor’s judgment as to what constitutes sufficient appropriate evidence is influenced by such factors as:

* 1. Materiality of the item.
  2. Inherent risk and control risk considerations.
  3. The experience gailed during previous audit examination as to the reliability of the client’s records and representation.
  4. The persuasions of the evidence.
  5. Fraud or error while performing as audit procedures.

## Check Your Progress Exercise -2

* + 1. What are the three general records that the auditors can examine to obtain understanding of the client’s internal activities and the business environment?

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* + 1. List three factors, which may influence the sufficiency and appropriateness of evidence?

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* + 1. **Procedures to Obtain Evidence**

Audit evidence is any information that corroborates or refutes an assertion. Here we will briefly recap a number of audit procedures.

***Physical examination: -*** means to review physical evidence of an asset. For example, the auditors might physically examine plant equipment or inventory items to obtain evidence as to their existence or condition.

***Confirmation: -*** is the process of obtaining evidence by written, direct communication with the debtor, creditor, or other party of the transaction.

***Tracing: -*** is the proof establishing the completeness of transaction processing by following a transaction forward through the accounting records.

***Vouching: -*** is the process of establishing other accuracy of recorded transactions by following a transaction back to supporting documents from a prior processing step.

***Re-performance: -*** is the process of repeating a client activity.

***Observation: -*** is the process of viewing a client activity. For example, the auditors may observe the application of internal control procedures.

***Inspection:*** *-* involves a reading or point – by – point review of a document or second. For example, the auditors may inspect a loan agreement.

***Reconciliation:*** - are used to establish agreement between two sets of independently maintained but related records.

***Enquiries:*** - are questions directed toward appropriate client reasoned. The responses to the question may be oral or in written.

***Analytical procedures: -*** are evaluations of financial information made by a study of expected relationships among financial and non-financial data.

## Check Your Progress Exercise - 3

1. Define audit evidence.

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**1.3.3 Sufficiency of Evidence**

The term sufficient relates to the quantity of evidence the auditors should obtain. The amount of evidence that is considered sufficient to support the auditor’s opinion is a matter of professional judgment. However, the following considerations may be useful in evaluating the sufficiency of audit evidence.

1. The amount of evidence that is sufficient in a specific situation varies inversely with the appropriateness of evidence available. Thus, the more appropriate the evidence, the less the amount of evidence that is needed to support the auditors’ opinion.
2. The need for audit evidence is closely related to the concept of materiality. The more material a financial statement amount, the greater the need for more evidence as to its validity.
3. As the relative risk associated with a particular engagement increases, the auditors should require more evidence to support their opinion.

**1.3.4 Appropriateness of Audit Evidence**

The appropriateness of audit evidence refers to its quality or reliability. To be appropriate, evidence must be both valid and relevant.

The competency (or reliability) of accounting records is directly related to the effectiveness of the client’s internal controls. Strong internal controls enhance the accuracy and reliability of the financial records.

The competency of corroborative information depends on many factors. The considerations that have the widest applicability in audit are:

* + - * relevance
      * source
      * timeliness
      * objectivity

Several factors contribute to the quality of evidence, including the following:

1. When auditors obtain evidence from independent sources outside of the client company, the reliability of the evidence is increased.
2. Strong internal control contributes substantially to the quality of accounting records and other evidence created within the client organization.
3. The quality of evidence is enhanced when the auditors obtain information directly, - that is, by first hand observation, correspondence, or computation, rather than by obtaining the information second hand.

**1.4 Working papers**

Working papers are vitally important tools of the auditing profession.

Working papers are the connecting link between the client's accounting records and the auditors report. They document all of the work performed by the auditors and provide the justification for the auditors’ report.

The documentation of audit evidence is provided in working papers. Working papers provide

* + - * The principal support for the auditor’s report.
      * A means for coordinating and supervising the audit.
      * Evidence that the audit was made in accordance with GAAS.

**1.4.1 Functions of working Papers**

Audit working papers assist auditors in several major ways: they

1. Provide a means of assigning and coordinating audit work;
2. Aid seniors, managers, and partners in supervising and reviewing the work of assistants;
3. Provide the support for the auditors’ report;
4. Document the auditors’ compliance with GAAS; and
5. Aid in planning and conducting future audits of the client.

**1.4.2 Confidential Nature of Working Papers**

Much of the information gained in confidence by the auditors is recorded in their working papers; consequently, the working papers are confidential in nature.

Since audit working papers are highly confidential, they must be safeguarded at all times.

**1.4.3 Organization of the Working Papers**

The auditors usually maintain two files of working papers for each client:

1. Current files for every completed examination and
2. A permanent file of relatively unchanging data.

**1.4.4 Contents of Working Papers**

Working papers would normally include the following matters:

* Information concerning the legal and organizational structure of the entity.
* Copies of important legal documents, agreements and minutes.
* Information concerning the industry, and economic environment.
* Evidence of the planning process.
* Evidence of the auditors’ understanding of the accounting and internal control systems.
* Evidence of inherent and control risk asses ments.
* Analysis of transactions and balances.
* Analysis of significant ratios and trends.
* Details of procedures regarding components whose financial statements are audited by other auditors.
* Copies of communications with other auditors, experts, and other third parties.
* Letters of representation by the client’s management.
* Copies of the approved financial statements and auditors’ reports.

#### Check Your Progress Exercise - 4

1. Which of the following is not a primary purpose of audit working papers?
   1. To coordinate the examination.
   2. To assist in preparation of audit report.
   3. To support the financial statements.
   4. To provide evidence of audit work performed.
      1. Which of the following is the most persuasive evidence?
         1. Information detained through inquiry direct from independent sourced audit the client organization.
         2. Information obtained through inquiry from the management the organization.
         3. Evidence obtained by re-performing calculations and reconciliation made by the client.
         4. Evidence obtained by observing employment while performing their tasks..