Auditing (1)

Collections

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Chapter 1

Nature and Demand for Auditing

Chapter 1: Nature and Demand for Auditing

Learning objectives:

- ✓ Describe auditing.
- ✓ Distinguish between auditing and accounting.
- ✓ Explain the importance of auditing in reducing information risk.
- ✓ List the causes of information risk, and explain how this risk can be reduced
- ✓ Describe assurance services and distinguish audit services from other assurance and non-assurance services provided by CPAs.
- ✓ Differentiate the three main types of audits.
- ✓ Identify the primary types of auditors.
- ✓ Describe the requirements for becoming a CPA.

Introduction

The output of financial accounting, including different financial statements need to be audited in order to reliable and useful in making different economic decisions. Auditing plays a crucial role in ensuring the accuracy of accounting information presented in the financial statements. This chapter introduces auditing and other assurance services provided by auditors, as well as auditors' role in society. These services provide value by offering assurance on financial statements. There is also a discussion of the types of audits and auditors, and determine the causes of information risk & how auditing reduces information risk.

Economic Demand for Auditing:

To illustrate the need for auditing, consider the decision of a bank officer in making a loan to a business. The decision will be based on such factors as previous financial relations with the business and the financial condition of the business as reflected by its financial statements. Assuming the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

1. ***Risk-free interest rate.*** This is approximately the rate the bank could earn by investing in U.S. Treasury bills for the same length of time as the business loan.
2. ***Business risk for the customer***. This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions such as a recession, poor management decisions, or unexpected competition in the industry.
3. ***Information risk***. Information risk reflects the possibility that the information upon which the decision to make the loan was made was inaccurate. A likely cause of the information risk is inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank manager is satisfied that there is minimal information risk because a borrower’s financial statements are audited, the bank’s risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower's ability to obtain capital at a reasonable cost.

Causes of Information Risk:

As society becomes more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this, including the remoteness of information, biases and motives of the provider, voluminous data, and complex exchange transactions.

❖ **Remoteness of Information**

In a global economy, it is nearly impossible for a decision maker to have much firsthand knowledge about the organization with which it does business. Information provided by others must be relied upon. When information is obtained from others, its likelihood of being intentionally or unintentionally misstated increases.

❖ **Biases and Motives of the Provider**

If information is provided by someone whose goals are inconsistent with those of the decision maker, the information may be biased in favor of the provider. The reason can be honest optimism about future events or an intentional omission or emphasis designed to influence users. In either case, the result is a misstatement of information.

For example, when a borrower provides financial statements to a lender, there is considerable likelihood that the borrower will bias the statements to increase the chance of obtaining a loan. The misstatement could be incorrect dollar amounts or inadequate or incomplete disclosures of information.

❖ **Voluminous Data**

As organizations become larger, so does the volume of their exchange transactions. This increases the likelihood that improperly recorded information is included in the records-perhaps buried in a large amount of other information. For example, if a business overpays a vendor's invoice by $2000, the overpayment is unlikely to be uncovered unless the agency has instituted reasonably complex procedures to find this type of misstatement. If many minor misstatements remain undiscovered, the combined total can be significant or even material

❖ **Complex Exchange Transactions**

In the past few decades, exchange transactions between organizations have become increasingly complex and therefore more difficult to record properly. For example, the correct accounting treatment of the acquisition of one entity by another poses relatively difficult accounting problems, especially as it relates to fair value estimations.

Other examples include properly combining and disclosing the results of operations of subsidiaries in different industries and properly valuing and disclosing derivative financial instruments.

Reducing Information Risk

After comparing costs and benefits, business managers and the users of their financial statements may conclude that the best way to deal with information risk is simply to have the risk remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase the costs of reducing information risk.

For larger businesses, it is usually practical to incur such costs to reduce information risk. There are three main ways to do so:

1. **User verifies information**. The user may go to the business premises to examine records and obtain information about the reliability of the statements. Normally, this is impractical because of cost. In addition, it is economically inefficient for all users to verify the information individually. Nevertheless, some users perform their own verification. For example, if a business intends to purchase another business, it is common for the purchaser to use a special audit team to independently verify and evaluate key information of the prospective business.

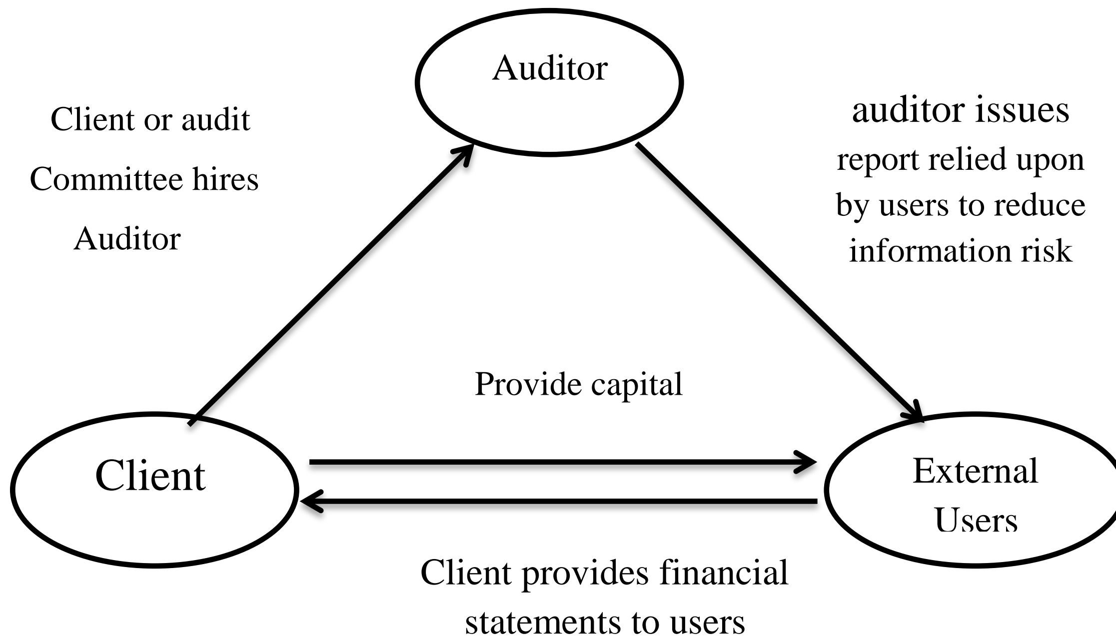
2. **User shares information risk with management**. There is considerable legal precedent indicating that management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result incur a financial loss, they may have the basis for a lawsuit against management. A difficulty with sharing information risk with management is that users may not be able to collect on losses (as in the case of bankruptcy).

3. **Audited financial statements are provided**. The most common way for users to obtain reliable information is to have an independent audit. Typically, management of a private company or the audit committee for a public company engages the external auditor to provide assurances to users that the financial statements are reliable.

External users (such as shareholders and lenders) rely on financial statements to make business decisions look to the independent auditor's report as an indication of the statements' reliability. Decision makers can then use the audited information on the assumption that it is reasonably complete, accurate, and unbiased. They value the auditor's assurance because of the auditor's integrity, independence, expertise, and knowledge of financial statement reporting matters. As a result, in order for the audit to be effective, the interests

of external users must be protected throughout the engagement. Figure 1 illustrates the relationships among the auditor, client, and financial statement users.

Figure 1: Accountability relationships among auditor, client, and external users



Nature of Auditing

Auditing is the accumulation and evaluation of evidence regarding assertions about information to determine the degree of correspondence between the assertions and established criteria and to report the results to interested users. Auditing should be done by a competent, independent person. The definition includes several key words and phrases which we'll discuss in more details.

1) Information and Established Criteria

To do an audit, there must be information in *a verifiable* form and some standards (criteria) by which the auditor can evaluate the information. **Information** can and does take many forms.

- Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns.
- Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited.

- In the audit of historical financial statements by CPA firms, the criteria may be Egyptian generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS).
- For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Boeing's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.
- For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of

specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

2) <u>Accumulation and Evaluation of Evidence</u>

Evidence is any information used by the auditor to assess whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including:

- Electronic and documentary evidence about transactions
- Oral testimony of the auditee (client)
- Written and electronic communication from outsiders
- Observations by the auditor

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and volume of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria.

3) <u>Competent, Independent Person</u>

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate to reach the proper conclusion after examining the evidence. The auditor must also have *an independent mental attitude.* The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

Auditors strive to maintain a high level of independence in order to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are *independent auditors.* Even though such auditors are paid a fee by a company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even internal auditors-those employed by the companies they audit-usually report directly to top management and the

board of directors, keeping auditors independent of the operating units they audit.

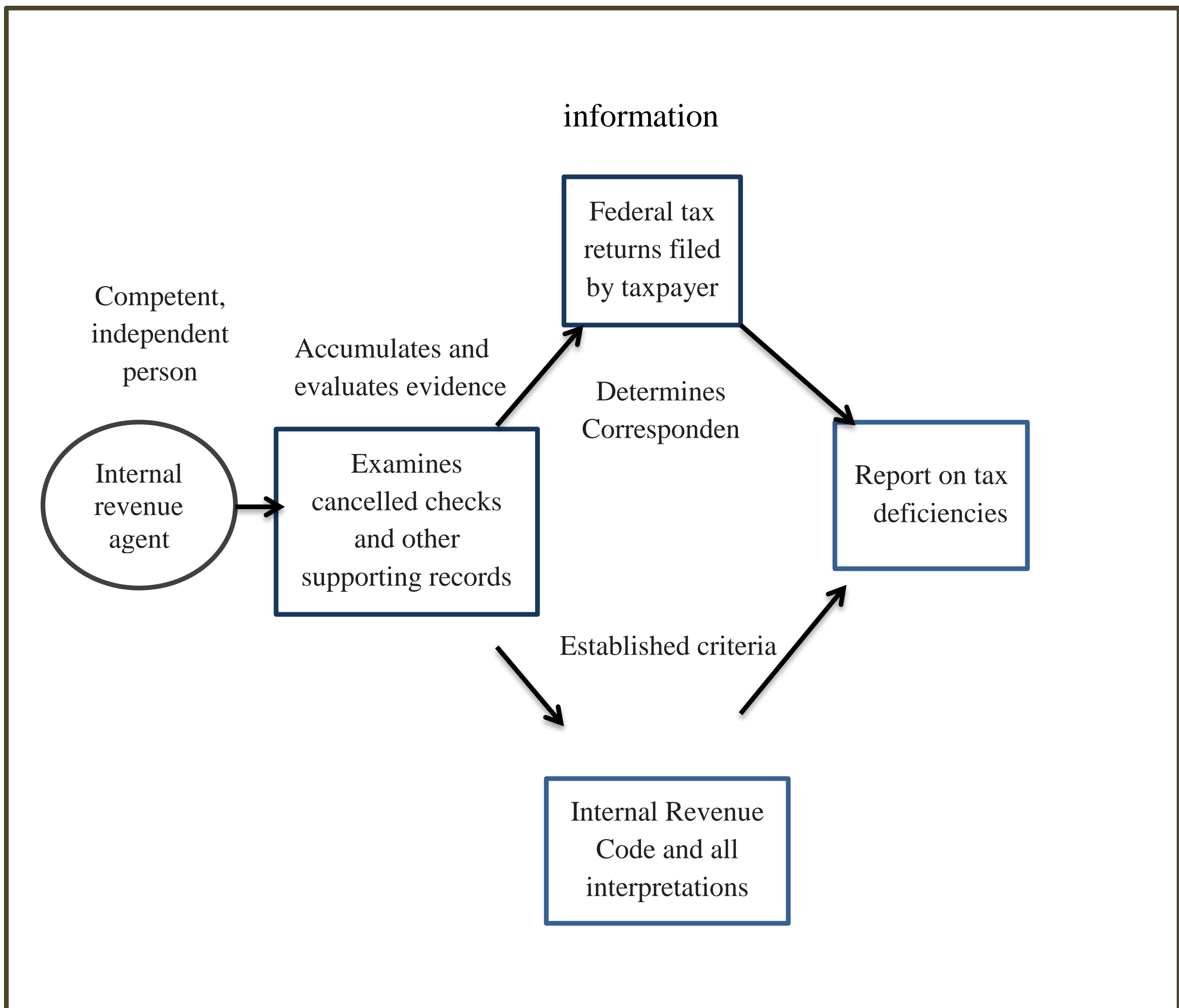
4) <u>Reporting</u>

The final stage in the auditing process is preparing the audit report, which communicates the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department's effectiveness.

An Illustration of the Definition of Auditing

The key parts in the description of auditing are illustrated in Figure (2) using the audit of a large corporate tax return by a team of Revenue Agency auditors. To determine whether the tax return was prepared in a manner consistent with the requirements of the tax law, the agent examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer. After completing the audit, the internal revenue agent issues a report to the taxpayer assessing additional taxes, advising that a refund is due, or stating that there is no change in the status of the tax return.

Figure 2: audit of a tax return



<u>Distinction between Auditing and Accounting</u>

Many financial statement users and members of the general public confuse auditing and accounting. The confusion occurs because most auditing is concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title "certified public accountant" many individuals who perform audits.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. The function of accounting is to provide relevant information that management and others can use to make decisions. Accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, the concern lies in evaluating whether recorded information reasonably reflects the economic events that occurred during the accounting period. Because international accounting standards provide the criteria for evaluating whether the accounting information is properly recorded, auditors must thoroughly understand those accounting standards.

In addition to understanding accounting, the auditor must also possess expertise in the accumulation and interpretation of audit evidence. It is this expertise that distinguishes financial statement auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are unique to the auditor.

Common Types of Audits

There are many different types of audits depending upon the subject matter under consideration. Table 1-1 summarizes the type of information, criteria, and evidence used in three common types of audits-the financial statement audit, the compliance audit, and the operational audit.

1) **A financial statement audit** is conducted to determine whether the financial statements (the information verified) are stated in accordance with specified criteria (the applicable accounting framework). Normally, the criteria are applicable local or international accounting standards, although auditors may conduct audits of financial statements prepared using the cash basis or some other basis of accounting appropriate for the organization.

2) **A compliance audit** is conducted to determine whether the auditee is following specific procedures, rules, or regulations set by some higher authority. Following are examples of compliance audits for a private business:

- Determine whether accounting personnel are following the procedures prescribed by the company controller.
- Review wage rates for compliance with minimum wage laws.
- Examine contractual agreements with bankers and other lenders to be sure the company is complying with legal requirements.
- Determine whether a supplier is in compliance with the organization's supplier code of conduct or child labor laws.

Governmental units, such as school districts, are subject to considerable compliance auditing because of extensive regulation, while many private and not-for-profit organizations have prescribed policies, contractual arrangements, and legal requirements that may require compliance auditing.

Results of compliance audits performed for private companies are typically reported to management, rather than outside users, because management is the primary group concerned with prescribed procedures and regulations. Therefore, a significant portion of work of this type is often done by auditors employed by the organizational units.

3) **<u>An operational audit or a performance audit</u>** evaluates the *efficiency* and *effectiveness* of any part of an organization's operating procedures and methods. At the completion of an operational audit, management normally expects recommendations for improving operations. For example, auditors might evaluate the efficiency and accuracy of processing payroll transactions in a newly installed computer system. Another example, where most accountants feel less qualified, is evaluating the efficiency, accuracy, and customer satisfaction in processing the distribution of letters and packages by a company such as Federal Express.

Because of the many different areas in which operational effectiveness can be evaluated, it is impossible to characterize the conduct of a typical operational audit. In one organization, the auditor might evaluate the relevancy and sufficiency of the information used by management in making decisions to acquire new fixed assets. In a different organization, the auditor might evaluate the efficiency of the information flow in processing sales.

Table 1-1 Examples of Three Types of Audits				
Type of Audit and Description	Example	Information	Established Criteria	Available Evidence
Financial statement audit:	Perform the annual audit to determine if the company financial statements are in conformity with IFRS.	annual financial statements	GAAP	Documents, records, inquiries, and outside sources of evidence
Compliance audit:	Determine if bank covenants for loan continuation have been met.	Company records	Loan agreement provisions	Financial statements And calculations by the auditor
Operational audit:	Evaluate whether the computerized payroll processing for subsidiary H is operating economically, efficiently, and effectively	Number of payroll records processed in a month, costs of the department, and error rate	Company standards for economy, efficiency, and effectiveness in payroll department	Error reports, payroll records, and payroll processing costs

Types of Auditors

Throughout our previous discussion, we have highlighted which auditors typically perform various types of audits. Here, we provide an overview of four types of auditors.

1. Certified Public Accounting (CPA) Firms

Certified public accounting firms are responsible for auditing the published historical financial statements of all publicly traded companies, most other reasonably large companies, and many smaller companies and noncommercial organizations. Because of the widespread use of audited financial statements in the global economy, as well as businesspersons' and other users' familiarity with these statements, it is common to use the terms *auditor and CPA firm* synonymously, even though several different types of auditors exist. The title certified public accounting firm reflects the fact that auditors who express audit opinions on financial statements must be licensed as CPAs. CPA firms are often called external auditors or independent auditors to distinguish them from internal auditors.

2. Government Accountability Office (GAO) Auditors

A government accountability office auditor is an auditor working for the U.S. Government Accountability Office (GAO), a nonpartisan agency in the legislative branch of the federal government. Headed by the Comptroller General, the GAO reports to and is responsible solely to Congress.

The GAO's primary responsibility is to perform the audit function for Congress, and it has many of the same audit responsibilities as a CPA firm. The GAO audits much of the financial information prepared by various federal government agencies before it is submitted to Congress. Because the authority for expenditures and receipts of governmental agencies is defined by law, there is considerable emphasis on compliance in these audits.

An increasing portion of the GAO's audit efforts are devoted to evaluating the operational efficiency and effectiveness of various federal programs. Also, because of the immense size of many federal agencies and the similarity of their operations, the GAO has made significant advances in developing better methods of auditing through the widespread use of highly sophisticated statistical sampling and computer risk assessment techniques.

In many states, experience as a GAO auditor fulfills the experience requirement for becoming a CPA. In those states, if an individual passes the CPA examination and fulfills the experience stipulations by becoming a GAO auditor, he or she may then obtain a CPA certificate.

As a result of their great responsibility for auditing the expenditures of the federal government, their use of advanced auditing concepts, their eligibility to be CPAs, and their opportunities for performing operational audits, GAO auditors are highly regarded in the auditing profession.

3. <u>Internal Revenue Agents (IRS)</u>

The IRS, under the direction of the Commissioner of Internal Revenue, is responsible for enforcing the federal tax laws as they have been defined by Congress and interpreted by the courts. A major responsibility of the IRS is to audit taxpayers' returns to determine whether they have complied with the tax laws. These audits are solely compliance audits. The auditors who perform these examinations are called internal revenue agents.

It might seem that the audit of returns for compliance with the federal tax laws is a simple and straightforward problem, but nothing is farther from the truth. Tax laws are highly complicated, and there are hundreds of volumes of interpretations. The tax returns being audited vary from the simple returns of individuals who work for only one employer and take the standard tax deduction to the highly complex returns of multinational corporations. Taxation problems may involve individual income taxes, gift taxes, estate taxes,

corporate taxes, trusts, and so on. An auditor involved in any of these areas must have considerable tax knowledge and auditing skills to conduct effective audits.

4. <u>Internal Auditors</u>

Internal auditors are employed by all types of organizations to audit for management, much as the GAO does for Congress. Internal auditors' responsibilities vary considerably, depending on the employer. Some internal audit staffs consist of only one or two employees doing routine compliance auditing. Other internal audit staffs may have more than 100 employees who have diverse responsibilities, including many outside the accounting area. Many internal auditors are involved in operational auditing or have expertise in evaluating computer systems.

To maintain independence from other business functions, the internal audit group typically reports directly to the president, another high executive officer, or the audit committee of the board of directors. However, internal auditors cannot be entirely independent of the entity as long as an employer–employee relationship exists. Users from outside the entity are unlikely to want to rely on information verified solely by internal auditors because of their lack of independence. This lack of independence is the major difference between internal auditors and CPA firms.

Assurance Services

The General Characteristics of an Assurance Services

An assurance service is an independent professional service that improves the quality of information for decision makers. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information used as the basis for their decisions.

Assurance services can be done by CPAs or by a variety of other professionals. For example, Consumers Union, a nonprofit organization, tests a wide variety of products used by consumers and reports their evaluations of the quality of the products tested in Consumer Reports. The organization provides the information to help consumers make intelligent decisions about the products they buy. Many consumers consider the information in Consumer Reports more reliable than information provided by the product manufacturers because Consumers Union is independent of the manufacturers.

The need for assurance is not new. CPAs have provided many assurance services for years, particularly assurances about historical financial statement information. More recently, CPAs have expanded the types of assurance services they perform to include forward-looking and other types of information, such as company financial forecasts and Web site controls. For example, businesses and consumers using the Internet to conduct business need independent assurances about the reliability and security of electronic information. The demand for assurance services continues to grow as the demand increases for real-time electronic information.

A. Attestation services

One category of assurance services provided by CPAs is attestation services. An **attestation service** is a type of assurance service in which the CPA firm issues a report about a subject matter or assertion that is made by another party. Primary categories of attestation services include:

1. Audit of historical financial statements

The most well-known example of assurance services is the financial statement audit. In an audit of historical financial statements, management asserts that the statements are fairly stated in accordance with applicable Egyptian or U.S. or international accounting standards. An audit of these statements is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are fairly stated in accordance with the applicable accounting standards. These audits are the most common assurance service provided by CPA firms.

Audits are designed to provide reasonable assurance that the financial statements are free of materials misstatements. Reasonable assurance is a high, but not absolute level of assurance. This level of assurance is usually sufficient to meet the information needs of financial statements users.

Most public companies' audited financial statements can be accessed over the Internet from the Securities and Exchange Commission (SEC) database or directly from each company's Web site. Many privately held companies also have their annual financial statements audited to obtain financing from banks and other financial institutions. Government and not-for-profit entities often have audits to meet the requirements of lenders or funding sources.

2. <u>Review of historical financial statements</u>

As in the case of an audit, management asserts that the financial statements are fairly stated in accordance with accounting standards, the same as for audits. The CPA provides a lower level of assurance for reviews of financial statements compared to a high level for audits, therefore less evidence is needed. A review is often adequate to meet financial statement users' needs.

Many nonpublic companies use this attestation option to provide limited assurance on their financial statements without incurring the cost of an audit.

3. <u>Other attestation services that may be applied to a broad range of subject matter</u>

CPAs provide numerous other attestation services. Many of these services are natural extensions of the audit of historical financial statements, as users seek independent assurances about other types of information.

For example, when a bank loans money to company, the loan agreement may require the company to engage a CPA to provide assurance about the company's compliance with the financial provisions of the loan. The company requesting the loan must assert the loan provisions to be attested to before the CPA can accumulate the evidence needed to issue the attestation report.

Certified Public Accountant

Use of the title certified public accountant (CPA) is regulated by state law through the licensing departments of each state. Within any state, the regulations usually differ for becoming a CPA and retaining a license to practice after the designation has been initially achieved. To become a CPA, three requirements must be met. These are summarized in Figure 3.

For a person planning to become a CPA, it is essential to know the requirements in the state where he or she plans to obtain and maintain the CPA designation. The best source of that information is the State Board of Accountancy for the state in which the person plans to be certified. It is possible to transfer the CPA designation from one state to another, but additional requirements often must be met for formal education, practice experience, or continuing education.

Figure 3: Three Requirements for Becoming a CPA

Educational Requirement

Normally, an undergraduate or graduate degree with a major in accounting, including a minimum number of accounting credits. Most states now require 150 semester credit hours (225 quarter credits) for licensure as a CPA. Some states require fewer credits before taking the examination but require 150 semester credits before receiving the CPA certificate

Uniform CPA Examination Requirement

Computer-based examination offered at various testing centers. Examination sections are as follows:
- Auditing and Attestation 4 hours
- Financial Accounting and Reporting4 hours
- Regulation 3 hours
- Business Environment and Concepts3 hours

Some states also require a separate ethics examination.

Experience Requirement

Varies widely from no experience to 2 years, including auditing. Some states include experience working for governmental units or in internal auditing.

Questions

Multiple Choice Questions: Choose the best response

1- Which of the following best describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?

a- It is difficult to prepare financial statements that fairly present a company's financial position, operations, and cash flows without the expertise of an independent auditor.

b- It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial statements.

c- The opinion of an independent party is needed because a company may not be objective with respect to its own financial statements.

d- It is a customary courtesy that all stockholders of a company receive an independent report on management's stewardship of the affairs of the business.

2- Independent auditing can best be described as

- a- A branch of accounting.
- b- A discipline that attests to the results of accounting and other functional operations and data.
- c- A professional activity that measures and communicates financial and business data.
- d- A regulatory function that prevents the issuance of improper financial information.

3- Which of the following attributes is likely to be unique to the audit work of CPAs as compared to the work performed by practitioners of other professions?
   a- Due professional care.
   b- Competence.
   c- Independence.
   d- Complex body of knowledge.

4- Compliance auditing often extends beyond audits leading to the expression of opinions on the fairness of financial presentation and includes audits of efficiency, economy, effectiveness, as well as
   a- Accuracy.
   b- Evaluation.
   c- Adherence to specific rules or procedures.
   d- Internal control.

5- In a financial statement audit, the auditor obtains a reasonable level of assurance about whether the financial statements are free of materials misstatement in order to express an opinion. In order to obtain reasonable assurance, the auditor must
   a- Have prior experience in the industry in which the audit client operates.
   b- Examine all documents available that support the financial statements.
   c- Obtain sufficient audit evidence
   d- Test controls around significant transaction cycles.

True or False Questions

1. The criteria by which an auditor evaluates the information under audit may vary with the information being audited.

2. The criteria used by an external auditor to evaluate published financial statements are known as generally accepted auditing standards.

3. CPA firms are never allowed to provide bookkeeping services for clients.

4. Most public companies' audited financial statements are available on the SEC's EDGAR database.

5. The primary purpose of a compliance audit is to determine whether the financial statements are prepared in compliance with generally accepted accounting principles

6. Results of compliance audit are typically reported to someone within the organizational unit being audited rather than to a broad spectrum of outside users.

7. An auditor must be competent and have an independent mental attitude.

Chapter 2
Audit Reports

Chapter 2: Audit Reports

Learning Objectives

After studying this chapter, you should be able to

- ✓ Describe the parts of the standard unqualified audit report.
- ✓ Specify the conditions required to issue the standard unqualified audit report.
- ✓ Understand reporting on financial statements and internal control over financial reporting under Section 404 of the Sarbanes–Oxley Act.
- ✓ Describe the five circumstances when an unqualified report with an explanatory paragraph or modified wording is appropriate.
- ✓ Identify the types of audit reports that can be issued when an unqualified opinion is not justified.
- ✓ Explain how materiality affects audit reporting decisions.
- ✓ Draft appropriately modified audit reports under a variety of circumstances.
- ✓ Determine the appropriate audit report for a given audit situation.
- ✓ Understand proposed use of international accounting and auditing standards

Introduction

Reports are essential to audit and assurance engagements because they communicate the auditor's findings. Users of financial statements rely on the auditor's report to provide assurance on the company's financial statements. The auditor will likely be held responsible if an incorrect audit report is issued.

The audit report is the final step in the entire audit process. The reason for studying it now is to permit reference to different audit reports as we study the accumulation of audit evidence throughout this text. These evidence concepts are more meaningful after you understand the form and content of the final

product of the audit. We begin by describing the content of the standard auditor's report.

This chapter introduces audit reports, as well as describes the parts of the standard unqualified audit report, specify the conditions required to issue the standard unqualified audit report, and identify the types of audit reports that can be issued when an unqualified opinion is not justified.

Parts of Standard Unqualified Audit Report

To allow users to understand audit reports, the American Institute of Certified Public Accountants (AICPA) professional standard provide uniform wording for the auditor's report, as illustrated in the auditor's standard unqualified audit report in Figure 1.

The auditor's standard unqualified audit report contains seven distinct parts, and these are labeled in bold letters in the margin beside Figure 1.

1. **Report title**. Auditing standards require that the report be titled and that the title include the word independent. For example, appropriate titles include "independent auditor's report," "report of independent auditor," or "independent accountant's opinion." The requirement that the title include the word independent conveys to users that the audit was unbiased in all aspects.

2. **Audit report address**. The report is usually addressed to the company, its stockholders, or the board of directors. In recent years, it has become customary to address the report to the board of directors and stockholders to indicate that the auditor is independent of the company.

3. **<u>Introductory paragraph</u>**. The first paragraph of the report does three things:

   First: it makes the simple statement that the CPA firm has done an audit. This is intended to distinguish the report from a compilation or review report. The scope paragraph (see part 4) clarifies what is meant by an audit.

   Second: it lists the financial statements that were audited, including the balance sheet dates and the accounting periods for the income statement and statement of cash flows. The wording of the financial statements in the report should be identical to those used by management on the financial statements. Notice that the report in Figure 1 is on comparative financial statements. Therefore, a report on both years' statements is needed.

   Third: the introductory paragraph states that the statements are the responsibility of management and that the auditor's responsibility is to express an opinion on the statements based on an audit.

   The purpose of these statements is to communicate that management is responsible for selecting the appropriate accounting principles and making the measurement decisions and disclosures in applying those principles and to clarify the respective roles of management and the auditor.

4. **<u>Scope paragraph</u>**. The scope paragraph is a factual statement about what the auditor did in the audit. This paragraph first states that the auditor followed Egyptian Standards on Auditing (ESA).

   The scope paragraph states that the audit is designed to obtain **reasonable assurance** about whether the statements are free of **material misstatement**. The inclusion of the word *material* conveys that auditors are responsible only to search for significant misstatements, not minor misstatements that do not affect users' decisions. The use of the term *reasonable assurance* is intended to indicate that an audit cannot be expected to completely eliminate the possibility

that a material misstatement will exist in the financial statements. In other words, an audit provides a high level of assurance, but it is not a guarantee.

The remainder of the scope paragraph discusses the audit evidence accumulated and states that the auditor believes that the evidence accumulated was appropriate for the circumstances to express the opinion presented. The words *test basis* indicates that sampling was used rather than an audit of every transaction and amount on the statements.

Whereas the introductory paragraph of the report states that management is responsible for the preparation and content of the financial statements, the scope paragraph states that the auditor evaluates the appropriateness of those accounting principles, estimates, and financial statement disclosures and presentations given.

5. **Opinion paragraph.** The final paragraph in the standard report states the auditor’s conclusions based on the results of the audit. This part of the report is so important that often the entire audit report is referred to simply as the auditor’s opinion. The opinion paragraph is stated as an opinion rather than as a statement of absolute fact or a guarantee. The intent is to indicate that the conclusions are based on professional judgment. The phrase in our opinion indicates that there may be some information risk associated with the financial statements, even though the statements have been audited.

The opinion paragraph is directly related to the first and fourth generally accepted auditing reporting standards. The auditor is required to state an opinion about the financial statements taken as a whole, including a conclusion about whether the company followed Egyptian generally accepted accounting principles or the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

One of the controversial parts of the auditor's report is the meaning of the term *present fairly*. Does this mean that if generally accepted accounting principles are followed, the financial statements are presented fairly, or something more?. Occasionally, the courts have concluded that auditors are responsible for looking beyond generally accepted accounting principles to determine whether users might be misled, even if those principles are followed. Most auditors believe that financial statements are "presented fairly" when the statements are in accordance with generally accepted accounting principles, but that it is also necessary to examine the substance of trans - actions and balances for possible misinformation

6. **<u>Name of CPA firm</u>**. The name identifies the CPA firm or practitioner who performed the audit. Typically, the firm's name is used because the entire CPA firm has the legal and professional responsibility to ensure that the quality of the audit meets professional standards.

7. **<u>Audit report date</u>.** The appropriate date for the report is the one on which the auditor completed the auditing procedures in the field.

   This date is important to users because it indicates the last day of the auditor's responsibility for the review of significant events that occurred after the date of the financial statements. In the audit report in Figure 1, the balance sheet is dated December 31, 2018, and the audit report is dated February 15, 2019. This indicates that the auditor has searched for material unrecorded transactions and events that occurred up to February 15, 2019.

Figure 1: Standard Unqualified Opinion Audit Report on Comparative Statements for a Public Company

ANDERSON and ZINDER, P.C. Certified Public Accountants Suite 100, Park Plaza East, Denver, Colorado 80110 303/359-0800	
Independent Auditor's Report	**Report Title**
To the Board of Directors & Stockholders General Ring Corporation	**Audit Report Address**
We have audited the accompanying balance sheets of General Ring Corporation as of December 31, 2018, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.	**Introductory Paragraph (Factual Statement)**
We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.	**Scope Paragraph (Factual Statement)**
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of General Ring Corporation as of December 31, 2018, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America	**Opinion Paragraph (Conclusions)**
ANDERSON AND ZINDER, P.C., CPAs	**Name of CPA Firm**
February 15, 2019	**Audit Report Date (Date Audit Field Work Is Completed)**

Conditions for Standard Unqualified Audit Report

The standard unqualified audit report is issued when the following conditions have been met:

1. All financial statements balance sheet, income statement, statement of retained earnings, and statement of cash flows are included in the financial statements.
2. The three general standards have been followed in all respects on the engagement (see table 1 about auditing standards).
3. Sufficient appropriate evidence has been accumulated, and the auditor has conducted the engagement in a manner that enables him or her to conclude that the three standards of field work have been met.
4. The financial statements are presented in accordance with Egyptian Accounting Standards (EAS). This also means that adequate disclosures have been included in the footnotes and other parts of the financial statements.
5. There are no circumstances requiring the addition of an explanatory paragraph or modification of the wording of the report.

When these conditions are met, the standard unqualified audit report, as shown in Figure 1, is issued. The standard unqualified audit report is sometimes called a clean opinion because there are no circumstances requiring a qualification or modification of the auditor's opinion. The standard unqualified report is the most common audit opinion. Sometimes circumstances beyond the client's or auditor's control prevent the issuance of a clean opinion. However, in most cases, companies make the appropriate changes to their accounting records to avoid a qualification or modification by the auditor.

If any of the five requirements for the standard unqualified audit report are not met, the standard unqualified report cannot be issued. Figure 2 indicates the categories of audit reports that can be issued by the auditor. The departures from a standard unqualified report are considered increasingly severe as one move

down the figure. Financial statement users are normally much more concerned about a disclaimer or adverse opinion than an unqualified report with an explanatory paragraph. These other categories of audit reports are discussed in following sections.

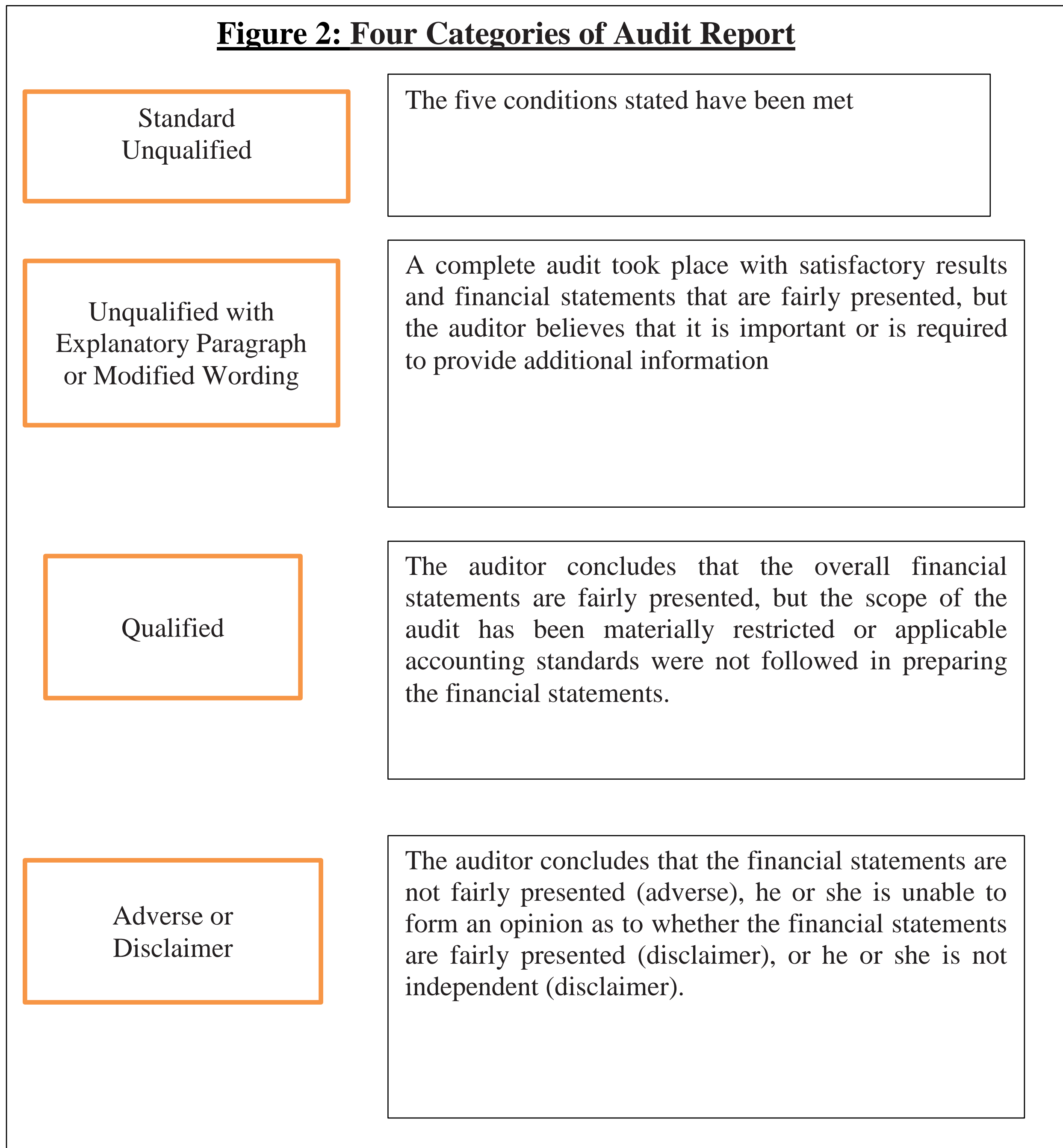


Table 1: Generally Accepted Auditing Standards

General Standards

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

Unqualified Audit Report with Explanatory Paragraph or Modified Wording:

The objective of this section is to describe the five circumstances when an unqualified report with an explanatory paragraph or modified wording is appropriate.

The remainder of this chapter deals with reports, other than standard unqualified reports, on the audit of financial statements. In certain situations, an unqualified audit report on the financial statements is issued, but the wording deviates from the standard unqualified report.

The **unqualified audit report with explanatory paragraph or modified wording** meets the criteria of a complete audit with satisfactory results and financial statements that are fairly presented, but the auditor believes it is important or is required to provide additional information. In a qualified, adverse, or disclaimer report, the auditor either has not performed a satisfactory audit, is not satisfied that the financial statements are fairly presented, or is not independent.

The following are the most important causes of the addition of an explanatory paragraph or a modification in the wording of the standard unqualified report:

1) Lack of consistent application of generally accepted accounting principles
2) Substantial doubt about going concern
3) Auditor agrees with a departure from promulgated accounting principles
4) Emphasis of a matter
5) Reports involving other auditors

The first four reports all require an explanatory paragraph. In each case, the three standard report paragraphs are included without modification, and a separate explanatory paragraph follows the opinion paragraph. Only reports involving the use of other auditors use a modified wording report. This report contains three paragraphs, and all three paragraphs are modified.

1) **<u>Lack of consistent application of GAAP</u>**

The second reporting standard requires the auditor to call attention to circumstances in which accounting principles have not been consistently observed in the current period in relation to the preceding period. Generally accepted accounting principles require that changes in accounting principles or their method of application be to a preferable principle and that the nature and impact of the change be adequately disclosed.

When a material change occurs, the auditor should modify the report by adding an explanatory paragraph after the opinion paragraph that discusses the nature of the change and points the reader to the footnote that discusses the change.

The materiality of a change is evaluated based on the current year effect of the change. An explanatory paragraph is required for both voluntary changes and required changes due to a new **accounting pronouncement**. Figure 3 presents such an explanatory paragraph.

Figure 3: **Explanatory Paragraph Because of Change in Accounting Principle**	
Fourth Paragraph Explanatory Paragraph	**Independent Auditor's Report** (Same introductory, scope, and opinion paragraphs as the standard report). As discussed in Note 5 to the financial statements, the Company changed its method of computing depreciation in 2018.

It is implicit in the explanatory paragraph in Figure 3 that the auditor concurs with the appropriateness of the change in accounting principles. If the auditor does not concur, the change is a violation of generally accepted accounting principles, and his or her opinion must be qualified.

Consistency versus Comparability

The auditor must be able to distinguish between changes that affect consistency and those that may affect comparability but do not affect consistency. The following are examples of changes that affect consistency and therefore require an explanatory paragraph if they are material:

1. Changes in accounting principles, such as a change from FIFO to LIFO inventory valuation
2. Changes in reporting entities, such as the inclusion of an additional company in combined financial statements
3. Corrections of errors involving principles, by changing from an accounting principle that is not generally acceptable to one that is generally acceptable, including correction of the resulting error.

Changes that affect comparability but not consistency and therefore need not be included in the audit report include the following:

1. Changes in an estimate, such as a decrease in the life of an asset for depreciation purposes
2. Error corrections not involving principles, such as a previous year's mathematical error
3. Variations in format and presentation of financial information
4. Changes because of substantially different transactions or events, such as new endeavors in research and development or the sale of a subsidiary.

Items that materially affect the comparability of financial statements generally require disclosure in the footnotes. A qualified audit report for inadequate disclosure may be required if the client refuses to properly disclose the items.

2) **Substantial Doubt about Going Concern**

Even though the purpose of an audit is not to evaluate the financial health of the business, the auditor has a responsibility under auditing standards to evaluate whether the company is likely to continue as a going concern. For example, the existence of one or more of the following factors causes uncertainty about the ability of a company to continue as a going concern:

1. Significant recurring operating losses or working capital deficiencies
2. Inability of the company to pay its obligations as they come due
3. Loss of major customers, the occurrence of uninsured catastrophes such as an earthquake or flood, or unusual labor difficulties.
4. Legal proceedings, legislation, or similar matters that have occurred that might jeopardize the entity's ability to operate.

The auditor's concern in such situations is the possibility that the client may not be able to continue its operations or meet its obligations for a reasonable period. For this purpose, a reasonable period is considered not to exceed 1 year from the date of the financial statements being audited.

When the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, an unqualified opinion with an explanatory paragraph is required, regardless of the disclosures in the financial statements. Figure 4 provides an example in which there is substantial doubt about going concern.

Figure 4: Explanatory Paragraph Because of Substantial Doubt About Going Concern	
Independent Auditor's Report (Same introductory, scope, and opinion paragraphs as the standard report) The accompanying financial statements have been prepared assuming that Fairfax Company will continue as a going concern. As discussed in Note 11 to the financial statements, Fairfax Company has suffered recurring losses from operations and has net capital deficiencies that raise substantial doubt about the company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 11. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.	**Fourth Paragraph Explanatory Paragraph**

Auditing standards permit but do not require a disclaimer of opinion when there is substantial doubt about going concern. The criteria for issuing a disclaimer of opinion instead of adding an explanatory paragraph are not stated in the standards, and this type of opinion is rarely issued in practice. An example for which a disclaimer might be issued is when a regulatory agency, such as the Environmental Protection Agency, is considering a severe sanction against a company and, if the proceedings result in an unfavorable outcome, the company will be forced to liquidate.

3) Auditor Agrees with a Departure from a Promulgated Principle:

To justify an unqualified opinion, the auditor must be satisfied and must state and explain, in a separate paragraph or paragraphs in the audit report, that adhering to the principle would produce a misleading result in that situation.

4) **Emphasis of a Matter**

Under certain circumstances, the CPA may want to emphasize specific matters regarding the financial statements, even though he or she intends to express an unqualified opinion. Normally, such explanatory information should be included in a separate paragraph in the report. Examples of explanatory information the auditor may report as an emphasis of a matter include the following:

- The existence of significant related party transactions
- Important events occurring subsequent to the balance sheet date
- The description of accounting matters affecting the comparability of the financial statements with those of the preceding year
- Material uncertainties disclosed in the footnotes.

5) **Reports Involving Other Auditors**

When the CPA relies on a different CPA firm to perform part of the audit, which is common when the client has several widespread branches or subdivisions, the principal CPA firm has three alternatives. Only the second is an unqualified report with modified wording.

(a) Make No Reference in the Audit Report: When no reference is made to the other auditor, a standard unqualified opinion is given unless other circumstances require a departure. This approach is typically followed when the other auditor audited an immaterial portion of the statements, the other auditor is well known or closely supervised by the principal auditor, or the principal auditor has thoroughly reviewed the other auditor's work. The other auditor is still responsible for his or her own report and work in the event of a lawsuit or SEC action.

(b) Make Reference in the Report (Modified Wording Report): This type of report is called a shared opinion or report. A shared unqualified report is appropriate when it is impractical to review the work of the other auditor or when the portion of the financial statements audited by the other CPA is material in relation to the whole. An example of an unqualified shared report is shown in Figure 5.

Notice that the report does not include a separate paragraph that discusses the shared responsibility, but does so in the introductory paragraph and refers to the other auditor in the scope and opinion paragraphs. The portions of the financial statements audited by the other auditor can be stated as percentages or absolute amounts.

(c) Qualify the Opinion: A qualified opinion or disclaimer, depending on materiality, is required if the principal auditor is not willing to assume any responsibility for the work of the other auditor. The principal auditor may also decide that a qualification is required in the overall report if the other auditor qualified his or her portion of the audit.

<table>
<tr><th colspan="2">Figure 5: Unqualified Shared Report</th></tr>
<tr><th colspan="2">Independent Auditor's Report</th></tr>
<tr><td colspan="2">Stockholders and Board of Directors, Washington Felp, Midland, Texas</td></tr>
<tr><td>Introductory Paragraph

Modified Wording</td><td>We have audited the accompanying consolidated balance sheets of Washington Felp as of July 31, 2011 and 2010, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Stewart Pane and Lighting, a consolidated subsidiary in which the Company had an equity interest of 84% as of July 31, 2011, which statements reflect total assets of $2,420,000 and $2,237,000 as of July 31, 2011 and 2010, respectively, and total revenues of $3,458,000 and $3,121,000 for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Stewart Pane and Lighting is based solely on the report of the other auditors.</td></tr>
<tr><td>Scope Paragraph

Modified Wording</td><td>We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.</td></tr>
<tr><td>Opinion Paragraph

Modified Wording</td><td>In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Washington Felp as of July 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.</td></tr>
<tr><td colspan="2">September 16, 2011
Farn, Ross, & Co.
Certified Public Accountants
Dallas, Texas</td></tr>
</table>

Departures from an Unqualified Audit Report:

It is essential that auditors and readers of audit reports understand the circumstances when an unqualified report is inappropriate and the type of audit report issued in each circumstance. In the study of audit reports that depart from an unqualified report, there are three closely related topics: the conditions requiring a departure from an unqualified opinion, the types of opinions other than unqualified, and materiality.

First, the three conditions requiring a departure are briefly summarized.

1. The Scope of the Audit Has Been Restricted (Scope Limitation)

When the auditor has not accumulated sufficient appropriate evidence to conclude whether financial statements are stated in accordance with GAAP, a scope restriction exists. There are two major causes of scope restrictions: restrictions imposed by the client and those caused by circumstances beyond either the client's or auditor's control. An example of a client restriction is management's refusal to permit the auditor to confirm material receivables or to physically examine inventory. An example of a restriction caused by circumstances is when the auditor is not appointed until after the client's year-end. It may not be possible to physically observe inventories, confirm receivables, or perform other important procedures after the balance sheet date.

2. The Financial Statements Have Not Been Prepared in Accordance with Generally Accepted Accounting Principles (GAAP Departure)

For example, if the client insists on using replacement costs for fixed assets or values inventory at selling price rather than historical cost as required by generally accepted accounting principles, a departure from the unqualified report is required. When U.S. generally accepted accounting principles or international financial reporting standards are referred to in this context, consideration of the adequacy of all informative disclosures, including footnotes, is especially important.

3. The Auditor Is Not Independent

Independence ordinarily is determined by the rules of the Code of Professional Conduct.

When any of the three conditions requiring a departure from an unqualified report exists and is material, a report other than an unqualified report must be issued. Three main types of audit reports are issued under these conditions: qualified opinion, adverse opinion, and disclaimer of opinion.

A. Qualified Opinion

A **qualified opinion** report can result from a limitation on the scope of the audit or failure to follow generally accepted accounting principles. A qualified opinion report can be used *only when the auditor concludes that the overall financial statements are fairly stated*. A disclaimer or an adverse report must be used if the auditor believes that the condition being reported on is highly material. Therefore, the qualified opinion is considered the least severe type of departure from an unqualified report.

A qualified report can take the form of *a qualification of both the scope and the opinion or of the opinion alone*. A scope and opinion qualification can be issued only when the auditor has been unable to accumulate all of the evidence required by generally accepted auditing standards. Therefore, this type of qualification is used when the auditor's scope has been restricted by the client or when circumstances exist that prevents the auditor from conducting a complete audit. The use of a qualification of the opinion alone is restricted to situations in which the financial statements are not stated in accordance with GAAP.

When an auditor issues a qualified report, he or she must use the term except for in the opinion paragraph. The implication is that the auditor is satisfied that the overall financial statements are correctly stated "except for" a specific aspect of them. It is unacceptable to use the phrase except for with any other type of audit opinion.

B. Adverse Opinion

An **adverse opinion** is used only when the auditor believes that the overall financial statements are so materially misstated or misleading that they do not present fairly the financial position or results of operations and cash flows in conformity with GAAP. The adverse opinion report can arise only when the auditor has knowledge, after an adequate investigation, of the absence of conformity. This is uncommon and thus the adverse opinion is rarely used.

C. Disclaimer of Opinion

A **disclaimer of opinion** is issued when the auditor has been unable to satisfy himself or herself that the overall financial statements are fairly presented. The necessity for disclaiming an opinion may arise because of a severe limitation on the scope of the audit or a non-independent relationship under the Code of Professional Conduct between the auditor and the client. Either of these situations prevents the auditor from expressing an opinion on the financial statements as a whole. The auditor also has the option to issue a disclaimer of opinion for a going concern problem.

The disclaimer is distinguished from an adverse opinion in that it can arise only from *a lack of knowledge* by the auditor, whereas to express an adverse opinion, the auditor must have knowledge that the financial statements are not fairly stated. Both disclaimers and adverse opinions are used only when the condition is highly material.

Materiality

The present section explains how materiality affects audit reporting decisions**.** **Materiality** is an essential consideration in determining the appropriate type of report for a given set of circumstances. For example, if a misstatement is immaterial relative to the financial statements of the entity for the current period, it is appropriate to issue an unqualified report. A common instance is the immediate expensing of office supplies rather than carrying the unused portion in inventory because the amount is insignificant.

The situation is totally different when the amounts are of such significance that the financial statements are materially affected as a whole. In these circumstances, it is necessary to issue a disclaimer of opinion or an adverse opinion, depending on whether a scope limitation or GAAP departure is involved. In situations of lesser materiality, a qualified opinion is appropriate.

The common definition of materiality as it applies to accounting and therefore to audit reporting is as follows:

A misstatement in the financial statements can be considered material if knowledge of the misstatement will affect a decision of a reasonable user of the statements.

In applying this definition, three levels of materiality are used for determining the type of opinion to issue.

Levels of Materiality

In applying this definition, three levels of materiality are used for determining the type of opinion to issue.

1. Amounts Are Immaterial

When a misstatement in the financial statements exists but is unlikely to affect the decisions of a reasonable user, it is considered to be immaterial. An unqualified opinion is therefore appropriate.

For example, assume that management recorded prepaid insurance as an asset in the previous year and decides to expense it in the current year to reduce record-keeping costs. Management has failed to follow GAAP, but if the amounts are small, the misstatement is immaterial and a standard unqualified audit report is appropriate.

2. Amounts Are Material but Do Not Overshadow the Financial Statements as a Whole

The second level of materiality exists when a misstatement in the financial statements would affect a user's decision, but the overall statements are still fairly stated and therefore useful.

For example, knowledge of a large misstatement in fixed assets might affect a user's willingness to loan money to a company if the assets were the collateral. A misstatement of inventory does not mean that cash, accounts receivable, and other elements of the financial statements, or the financial statements as a whole, are materially incorrect.

To make materiality decisions when a condition requiring a departure from an unqualified report exists, the auditor must evaluate all effects on the financial statements. Assume that the auditor is unable to satisfy himself or herself whether inventory is fairly stated in deciding on the appropriate type of opinion. Because of the effect of a misstatement in inventory on other accounts and on totals in the statements, the auditor needs to consider the materiality of the

combined effect on inventory, total current assets, total working capital, total assets, income taxes, income taxes payable, total current liabilities, cost of goods sold, net income before taxes, and net income after taxes.

When the auditor concludes that a misstatement is material but does not overshadow the financial statements as a whole, a qualified opinion (using "except for") is appropriate.

3. Amounts Are So Material or So Pervasive That Overall Fairness of the Statements Is in Question

The highest level of materiality exists when users are likely to make incorrect decisions if they rely on the overall financial statements. To return to the previous example, if inventory is the largest balance on the financial statements, a large misstatement would probably be so material that the auditor's report should indicate the financial statements taken as a whole cannot be considered fairly stated. When the highest level of materiality exists, the auditor must issue either a disclaimer of opinion or an adverse opinion, depending on which conditions exist.

When determining whether an exception is highly material, the extent to which the exception affects different parts of the financial statements must be considered. This is called pervasiveness. A misclassification between cash and accounts receivable affects only those two accounts and is therefore not pervasive.

On the other hand, failure to record a material sale is highly pervasive because it affects sales, accounts receivable, income tax expense, accrued income taxes, and retained earnings, which in turn affect current assets, total assets, current liabilities, total liabilities, owners' equity, gross margin, and operating income.

As misstatements become more pervasive, the likelihood of issuing an adverse opinion rather than a qualified opinion increases. For example, suppose

the auditor decides a misclassification between cash and accounts receivable should result in a qualified opinion because it is material; the failure to record a sale of the same dollar amount may result in an adverse opinion because of pervasiveness.

Regardless of the amount involved, a disclaimer of opinion must be issued if the auditor is determined to lack independence under the rules of the *Code of Professional Conduct*. This strict requirement reflects the importance of independence to auditors.

Any deviation from the independence rule is therefore considered highly material. Table 2-1 summarizes the relationship between materiality and the type of opinion to be issued.

Table 2-1	**Relationship of Materiality to Type of Opinion**	
Materiality Level	**Significance in Terms of Reasonable Users' Decisions**	**Type of Opinion**
Immaterial	Users' decisions are unlikely to be affected	Unqualified
Material	Users' decisions are likely to be affected only if the information in question is important to the specific decisions being made. The overall financial statements are presented fairly.	Qualified
Highly material	Most or all users' decisions based on the financial statements are likely to be significantly affected	Disclaimer or Adverse

Note: Lack of independence requires a disclaimer regardless of materiality.

Materiality Decisions

In concept, the effect of materiality on the type of opinion to issue is straightforward. In application, deciding on actual materiality in a given situation is a difficult judgment. There are no simple, well-defined guidelines that enable auditors to decide when something is immaterial, material, or highly material.

The evaluation of materiality also depends on whether the situation involves a failure to follow GAAP or a scope limitation.

Materiality Decisions-Non-GAAP Condition

When a client has failed to follow GAAP, the audit report will be unqualified, qualified opinion only, or adverse, depending on the materiality of the departure. Several aspects of materiality must be considered.

i. Dollar Amounts Compared with a Base

The primary concern in measuring materiality when a client has failed to follow GAAP is usually the total dollar mis statement in the accounts involved, compared with some base. A $10,000 misstatement might be material for a small company but not for a larger one. Therefore, misstatements must be compared with some measurement base before a decision can be made about the materiality of the failure to follow GAAP. Common bases include net income, total assets, current assets, and working capital.

For example, assume that the auditor believes there is a $100,000 overstatement of inventory because of the client's failure to follow GAAP. Also assume recorded inventory of $1 million, current assets of $3 million, and net income before taxes of $2 million. In this case, the auditor must evaluate the materiality of a misstatement of inventory of 10 percent, current assets of 3.3 percent, and net income before taxes of 5 percent.

To evaluate overall materiality, the auditor must also combine all unadjusted misstatements and judge whether there may be individually immaterial misstatements that, when combined, significantly affect the statements. In the inventory example just given, assume the auditor believes there is also an overstatement of $150,000 in accounts receivable. The total effect on current assets is now 8.3 percent ($250,000 divided by $3,000,000) and 12.5 percent on net income before taxes ($250,000 divided by $2,000,000).

When comparing potential misstatements with a base, the auditor must carefully consider all accounts affected by a misstatement (pervasiveness). For

example, it is important not to overlook the effect of an understatement of inventory on cost of goods sold, income before taxes, income tax expense, and accrued income taxes payable.

ii. Measurability

The dollar amount of some misstatements cannot be accurately measured. For example, a client's unwillingness to disclose an existing lawsuit or the acquisition of a new company subsequent to the balance sheet date is difficult if not impossible to measure in terms of dollar amounts. The materiality question the auditor must evaluate in such situations is the effect on statement users of the failure to make the disclosure.

iii. Nature of the Item

The decision of a user may also be affected by the kind of misstatement. The following may affect a user's decision and therefore the auditor's opinion in a different way than most misstatements:

1. Transactions are illegal or fraudulent.
2. An item may materially affect some future period, even though it is immaterial when only the current period is considered.
3. An item has a "psychic" effect (for example, the item changes a small loss to a small profit, maintains a trend of increasing earnings, or allows earnings to exceed analysts' expectations).
4. An item may be important in terms of possible consequences arising from contractual obligations (for example, the effect of failure to comply with a debt restriction may result in a material loan being called).

Materiality Decisions-Scope Limitations Condition

When there is a scope limitation in an audit, the audit report will be unqualified, qualified scope and opinion, or disclaimer, depending on the materiality of the scope limitation. The auditor will consider the same three factors included in the previous discussion about materiality decisions for failure to follow GAAP, but they will be considered differently.

The size of potential misstatements, rather than known misstatements, is important in determining whether an unqualified report, a qualified report, or a disclaimer of opinion is appropriate for a scope limitation. For example, if recorded accounts payable of $400,000 was not audited, the auditor must evaluate the potential misstatement in accounts payable and decide how materially the financial statements could be affected. The pervasiveness of these potential misstatements must also be considered.

It is typically more difficult to evaluate the materiality of potential misstatements resulting from a scope limitation than for failure to follow GAAP. Misstatements resulting from failure to follow GAAP are known. Those resulting from scope limitations must usually be subjectively measured in terms of potential or likely misstatements. For example, a recorded accounts payable of $400,000 might be understated by more than $1 million, which may affect several totals, including gross margin, net earnings, and total assets.

Discussion of Conditions Requiring a Departure from an Unqualified Report:

You should now understand the relationships among the conditions requiring a departure from an unqualified report, the major types of reports other than unqualified, and the three levels of materiality. This part of the chapter examines the conditions requiring a departure from an unqualified report in greater detail and shows examples of reports.

1. *Auditor's Scope Has Been Restricted*

Two major categories of scope restrictions exist: those caused by a client and those caused by conditions beyond the control of either the client or the auditor. The effect on the auditor's report is the same for either, but the interpretation of materiality is likely to be different. When there is a scope restriction, the appropriate response is to issue an unqualified report, a qualification of scope and opinion, or a disclaimer of opinion, depending on materiality.

For client-imposed restrictions, the auditor should be concerned about the possibility that management is trying to prevent discovery of misstated information. In such cases, auditing standards encourage a disclaimer of opinion when materiality is in question. When restrictions result from conditions beyond the client's control, a qualification of scope and opinion is more likely.

Two restrictions occasionally imposed by clients on the auditor's scope relate to the observation of physical inventory and the confirmation of accounts receivable, but other restrictions may also occur. Reasons for client-imposed scope restrictions may be a desire to save audit fees and, in the case of confirming receivables, to prevent possible conflicts between the client and customer when amounts differ.

The most common case in which conditions beyond the client's and auditor's control cause a scope restriction is when the auditor is appointed after the client's balance sheet date. The confirmation of accounts receivable, physical examination of inventory, and other important procedures may be impossible under those circumstances. When the auditor cannot perform procedures he or she considers desirable but can be satisfied with alternative procedures that the information being verified is fairly stated, an unqualified report is appropriate. If alternative procedures cannot be performed, a qualified scope and opinion or disclaimer of opinion is necessary, depending on materiality.

A restriction on the scope of the auditor's examination requires a qualifying paragraph preceding the opinion to describe the restriction. In the case of a disclaimer, the entire scope paragraph is excluded from the report.

For example, the report in Figure 6 is appropriate for an audit in which the amounts were material but not pervasive and the auditor could not obtain audited financial statements supporting an investment in a foreign affiliate and could not satisfy himself or herself by alternate procedures.

When the amounts are so material that a disclaimer of opinion rather than a qualified opinion is required, the auditor uses only three paragraphs. The first (introductory) paragraph is modified slightly to say "We were engaged to audit …." The second paragraph is the same as the third paragraph in Figure 6. The scope paragraph is deleted, and the final (opinion) paragraph is changed to a disclaimer. The reason for deleting the scope paragraph is to avoid stating anything that might lead readers to believe that other parts of the financial statements were audited and therefore might be fairly stated. Figure 7 shows the audit report assuming the auditor had concluded that the facts in Figure 6 required a disclaimer rather than a qualified opinion.

Figure 6 Qualified Scope and Opinion Report Due to Scope Restriction	
Independent Auditor's Report (Same introductory paragraph as standard report)	
Scope Paragraph Qualified	Except as discussed in the following paragraph, we conducted our audit . . . (remainder is the same as the scope paragraph in the standard report).
Third Paragraph Added	We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $475,000 or its equity in earnings of that affiliate of $365,000, which is included in net income, as described in Note X to the financial statements. Because of the nature of the Company's records, we were unable to satisfy ourselves as to the carrying value of the investment or the equity in its earnings by means of other auditing procedures.
Opinion Paragraph Qualified	In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to above present fairly, in all material respects, the financial position of Laughlin Corporation as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Figure 7 Disclaimer of Opinion Due to Scope Restriction	
	Independent Auditor's Report
Introductory Paragraph **Modification of Standard Report**	We were engaged to audit . . . (remainder is the same as the introductory paragraph in the standard report)
Second Paragraph **Added**	(Same wording as that used for the third paragraph in figure 6)
Opinion Paragraph **Disclaimer**	Because we were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate and we were unable to satisfy ourselves as to the carrying value of the investment or the equity in its earnings by means of other auditing procedures, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

2. Statements Are Not in Conformity with GAAP

When the auditor knows that the financial statements may be misleading because they were not prepared in conformity with GAAP, and the client is unable or unwilling to correct the misstatement, he or she must issue a qualified or an adverse opinion, depending on the materiality of the item in question. The opinion must clearly state the nature of the departure from accepted principles and the amount of the misstatement, if it is known. Figure 8 shows an example of a qualified opinion when a client did not capitalize leases as required by GAAP.

<table>
<tr><th colspan="2">Figure 8 Qualified Opinion Report Due to Non-GAAP</th></tr>
<tr><th colspan="2">INDEPENDENT AUDITOR’S REPORT</th></tr>
<tr><td colspan="2">(Same introductory and scope paragraphs as the standard report)</td></tr>
<tr><td>The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations that, in our opinion, should be capitalized to conform with U.S. generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $4,600,000, long-term debt by $4,200,000, and retained earnings by $400,000 as of December 31, 2011, and net income and earnings per share would be increased by $400,000 and $1.75, respectively, for the year then ended</td><td>Third Paragraph Added</td></tr>
<tr><td>In our opinion, except for the effects of not capitalizing lease obligations, as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Ajax Company as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.</td><td>Opinion Paragraph Qualified</td></tr>
</table>

When the amounts are so material or pervasive that an adverse opinion is required, the scope is still unqualified and the qualifying paragraph can remain the same, but the opinion paragraph might be as shown in Figure 9.

Figure 9 Adverse Opinion Due to Non-GAAP	
INDEPENDENT AUDITOR'S REPORT	
(Same introductory and scope paragraphs as the standard report)	
(Same third paragraph as that used for the third paragraph in Figure 3-9)	**Third Paragraph Added**
In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Ajax Company as of December 31, 2011, or the results of its operations and its cash flows for the year then ended.	**Opinion Paragraph Adverse**

When the client fails to include information that is necessary for the fair presentation of financial statements in the body of the statements or in the related footnotes, it is the auditor's responsibility to present the information in the audit report and to issue a qualified or an adverse opinion. It is common to put this type of qualification in an added paragraph preceding the opinion (the scope paragraph will remain unqualified) and to refer to the added paragraph in the opinion paragraph. Figure 10 shows an example of an audit report in which the auditor considered the financial statement disclosure inadequate.

Figure 10 Qualified Opinion Due to Inadequate Disclosure	
	INDEPENDENT AUDITOR'S REPORT
	(Same introductory and scope paragraphs as the standard report)
Third Paragraph Added	On January 15, 2011, the company issued debentures in the amount of $3,600,000 for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 2011. In our opinion, disclosure of this information is required to conform with accounting principles generally accepted in the United States of America.
Opinion Paragraph Qualified	In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly . . . (remainder is the same as the opinion in the standard report).

Determining whether statements are in accordance with GAAP can be difficult. Rule 203 in the *Code of Professional Conduct* permits a departure from generally accepted accounting principles when the auditor believes that adherence to these would result in misleading financial statements.

When the auditor decides that adherence to GAAP would result in misleading statements, there should be a complete explanation in a third paragraph. The paragraph should fully explain the departure and why GAAP would result in misleading statements.

The opinion paragraph should then be unqualified except for the reference to the third paragraph. As discussed earlier in the chapter, this is called an unqualified audit report with an explanatory paragraph.

3. *Lack of Statement of Cash Flows*

The client's unwillingness to include a statement of cash flows is specifically addressed in auditing standards. When the statement is omitted, there must be a third paragraph stating the omission and an "except for" opinion qualification.

4. *Auditor is Not Independent*

If the auditor is not independent as specified by the Code of Professional Conduct, a disclaimer of opinion is required even though all the audit procedures considered necessary in the circumstances were performed. The wording in Figure 11 is recommended when the auditor is not independent.

Figure 11 Disclaimer Due to Lack of Independence
We are not independent with respect to Home Decors.com, Inc., and the accompanying balance sheet as of December 31, 2011, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us. Accordingly, we do not express an opinion on them.

Note: When the auditor lacks independence, no report title is included

The lack of independence overrides any other scope limitations. Therefore, no other reason for disclaiming an opinion should be cited. There should be no mention in the report of the performance of any audit procedures. As a result, it is a one paragraph audit report.

Auditor's Decision Process for Audit Reports:

Auditors use a well-defined process for deciding the appropriate audit report in a given set of circumstances. The auditor must first assess whether any conditions exist requiring a departure from a standard unqualified report. If any conditions exist, the auditor must then assess the materiality of the condition and determine the appropriate type of report. The four steps the auditor makes for audit reports are as follows:

1. Determine Whether Any Condition Exists Requiring a Departure from a Standard Unqualified Report

The most important of these conditions are identified in Table 2-2. Auditors identify these conditions as they perform the audit and include information about any condition in the audit files as discussion items for audit reporting. If none of these conditions exist, which is the case in most audits, the auditor issues a standard unqualified audit report.

<table>
<tr><th colspan="4">Audit Report for Each Condition Requiring a Departure from a Standard Unqualified Report at Different Levels of Materiality</th></tr>
<tr><th colspan="2" rowspan="2">Condition Requiring an Unqualified Report with Modified Wording or Explanatory Paragraph</th><th colspan="2">Level of Materiality</th></tr>
<tr><th>Immaterial</th><th>Material</th></tr>
<tr><td colspan="2">Accounting principles not consistently applied[1]</td><td>Unqualified</td><td>Unqualified report, explanatory paragraph</td></tr>
<tr><td colspan="2">Substantial doubt about going concern[2]</td><td>Unqualified</td><td>Unqualified report, explanatory paragraph</td></tr>
<tr><td colspan="2">Justified departure from GAAP or other accounting principle</td><td>Unqualified</td><td>Unqualified report, explanatory paragraph</td></tr>
<tr><td colspan="2">Emphasis of a matter</td><td>Unqualified</td><td>Unqualified report, explanatory paragraph</td></tr>
<tr><td colspan="2">Use of another auditor</td><td>Unqualified</td><td>Unqualified report, modified wording</td></tr>
<tr><td colspan="2"></td><td colspan="2">Level of Materiality</td></tr>
<tr><th>Condition Requiring a Departure from Unqualified Report</th><th>immaterial</th><th>Material, But Does Not Pervasive to the Financial Statements as a Whole</th><th>So material that overall fairness is in question</th></tr>
<tr><td>Scope restricted by client or other conditions</td><td>Unqualified</td><td>additional paragraph, and qualified opinion (except for)</td><td>Disclaimer</td></tr>
<tr><td>Financial statements not prepared in accordance with GAAP[3]</td><td>Unqualified</td><td>Additional paragraph and qualified opinion (except for)</td><td>Adverse</td></tr>
<tr><td>The auditor is not independent</td><td></td><td>Disclaimer, regardless of materiality</td><td></td></tr>
</table>

[1] If the auditor does not concur with the appropriateness of the change, the condition is considered a violation of GAAP.

[2] The auditor has the option of issuing a disclaimer of opinion.

[3] If the auditor can demonstrate that GAAP would be misleading, an unqualified report with an explanatory paragraph is appropriate.

2. Decide the Materiality for Each Condition

When a condition requiring a departure from a standard unqualified opinion exists, the auditor evaluates the potential effect on the financial statements. For departures from GAAP or scope restrictions, the auditor must decide among immaterial, material, and highly material. All other conditions, except for lack of auditor independence, require only a distinction between immaterial and material.

The materiality decision is a difficult one, requiring considerable judgment. For example, assume that there is a scope limitation in auditing inventory. It is difficult to assess the potential misstatement of an account that the auditor does not audit.

3. Decide the Appropriate Type of Report for the Condition, Given the Materiality Level

After making the first two decisions, it is easy to decide the appropriate type of opinion by using a decision aid. An example of such an aid is Table 3-2. For example, assume that the auditor concludes that there is a departure from GAAP and it is material, but not highly material. Table 3-2 shows that the appropriate audit report is a qualified opinion with an additional paragraph discussing the departure. The introductory and scope paragraphs will be included using standard wording.

4. Write the Audit Report Most

CPA firms have computer templates that include precise wording for different circumstances to help the auditor write the audit report. Also, one or more partners in most CPA firms have special expertise in writing audit reports. These partners typically write or review all audit reports before they are issued.

- **More Than One Condition Requiring a Departure or Modification**

Auditors often encounter situations involving more than one of the conditions requiring a departure from an unqualified report or modification of the standard unqualified report. In these circumstances, the auditor should modify his or her opinion for each condition unless one has the effect of neutralizing the others. For example, if there is a scope limitation and a situation in which the auditor is not independent, the scope limitation should not be revealed. The following situations are examples when more than one modification should be included in the report:

1. The auditor is not independent and the auditor knows that the company has not followed generally accepted accounting principles.
2. There is a scope limitation and there is substantial doubt about the company's ability to continue as a going concern.
3. There is a substantial doubt about the company's ability to continue as a going concern and information about the causes of the uncertainties is not adequately disclosed in a footnote.
4. There is a deviation in the statements' preparation in accordance with GAAP and another accounting principle was applied on a basis that was not consistent with that of the preceding year.

- **Number of Paragraphs in the Report**

Many readers interpret the number of paragraphs in the report as an important "signal" as to whether the financial statements are correct. A three-paragraph report ordinarily indicates that there are no exceptions in the audit. However, three-paragraph reports are also issued when a disclaimer of opinion is issued due to a scope limitation or for an unqualified shared report involving other auditors. More than three paragraphs indicate some type of qualification or required explanation.

An additional paragraph is added before the opinion for a qualified opinion, an adverse opinion, and a disclaimer of opinion for a scope limitation. This results in a four-paragraph report, except for the disclaimer of opinion for a scope limitation. A disclaimer due to a scope limitation results in a three-paragraph report because the scope paragraph is omitted. A disclaimer due to a lack of independence is a one paragraph report.

When an unqualified opinion with explanatory paragraph is issued, an explanatory paragraph usually follows the opinion. No explanatory paragraph is required for an unqualified shared report involving other auditors, but the wording in all three paragraphs is modified.

Table 2-3 summarizes the types of reports issued for the audit of financial statements, the number of paragraphs for each type, the standard wording paragraphs modified, and the location of the additional paragraph. The table excludes a disclaimer for a lack of independence, which is a special, one-paragraph report.

Table 3-3 Number of Paragraphs, Standard Wording Paragraphs Modified, and Location of Additional Paragraph for Audit Reports

Type of Report	No. of paragraphs	**Standard Wording Paragraphs Modified**	added paragraph Location
Standard unqualified	3	None	None
Unqualified with explanatory paragraph	4	None	After opinion
Unqualified shared report with other auditors	3	All three paragraphs	None
Qualified-opinion only	4	Opinion only	Before opinion
Qualified-scope and opinion	4	Scope and opinion	Before opinion
Disclaimer-scope limitation	3	Introductory and opinion paragraphs modified; scope paragraph eliminated	Before opinion
Adverse	4	Opinion only	Before opinion

Questions

❖ **Multiple Choice Questions: Choose the best response**

A. The date of the CPA's opinion on the financial statements of the client should be the date of the

1. Closing of the client's books.
2. Finalization of the terms of the audit engagement.
3. Completion of all important audit procedures.
4. Submission of the report to the client.

B. If a principal auditor decides to refer in his or her report to the audit of another auditor, he or she is required to disclose the

1- Name of the other auditor.
2- Nature of the inquiry into the other auditor's professional standing and extent of the review of the other auditor's work.
3- Portion of the financial statements audited by the other auditor.
4- Reasons for being unwilling to assume responsibility for the other auditor's work.

C. When the financial statements are fairly stated but the auditor concludes there is substantial doubt whether the client can continue in existence, the auditor should issue a(an)

1. Adverse opinion.
2. Qualified opinion only.
3. Unqualified opinion.
4. Unqualified opinion with explanatory paragraph.

D. Under which of the following circumstances would a disclaimer of opinion not be appropriate?

1- The auditor is unable to determine the amounts associated with an employee fraud scheme.

2- Management does not provide reasonable justification for a change in accounting principles.

3- The client refuses the auditor permission to confirm certain accounts receivable or apply alternative procedures to verify their balances.

4- The CEO is unwilling to sign the management representation letter.

E. Which of the following statements about a combined report on the financial statements and internal control over financial reporting is correct?

1. The auditor's opinion on internal control is for the same period of time as the opinion on the financial statements.
2. The report includes additional paragraphs for the definition and limitations of internal control.
3. The introductory, scope, and opinion paragraphs are unchanged from a report for an audit of the financial statements only.
4. GAAP is the framework used to evaluate internal control.

F. An audit of historical financial statements most commonly includes the:

1. Balance sheet, statement of retained earnings, and the statement of cash flows.
2. Income statement, cash flows statement, and the statement of net working capital.
3. Statement of cash flows, balance sheet, and the statement of retained earnings.
4. Balance sheet, income statement, and the statement of cash flows.

G. Auditing standards require that the audit report must be titled and that the title must:

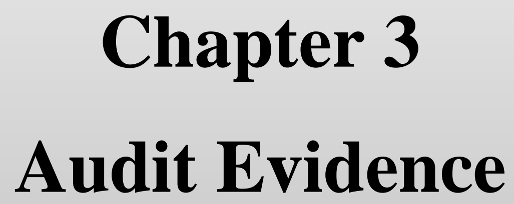
1. Include the word "independent."
2. Indicate if the auditor is a CPA.
3. Indicate if the auditor is a proprietorship, partnership, or incorporated.
4. Indicate the type of audit opinion issued.

H. The scope paragraph of the standard unqualified audit report states that the audit is designed to:

1. Discover all errors and/or irregularities.
2. Discover material errors and/or irregularities.
3. Conform to generally accepted accounting principles.
4. Obtain reasonable assurance whether the statements are free of material misstatement.

➢ **<u>True or false Questions</u>**

1. The financial statements most commonly audited by external auditors are the balance sheet, the income statement, and the statement of changes in retained earnings.
2. Users of the financial statements rely on the auditor's report because it provides absolute assurance the report provides.
3. AICPA professional standards provide uniform wording for the auditor's report to enable users of the financial statements understand the audit report.
4. The introductory paragraph of the auditor's report states that the auditor is responsible for the preparation, presentation and opinion on financial statements.
5. The audit report date is the date the auditor completed audit procedures in the field.
6. Audit reports issued for financial statements of a public company should refer to generally accepted auditing standards in the scope paragraph.
7. Audit reports issued for financial statements of a private company should refer to generally accepted auditing standards in the scope paragraph.
8. A modified unqualified auditor report arises when the auditor believes the financials are fairly stated but also believes additional information should be provided.
9. Items that materially affect the comparability of the financial statements generally require disclosure in the footnotes.



Chapter 3
Audit Evidence

Chapter (3): Audit Evidence

Learning objectives

- ✓ After studying this chapter, you should be able to Contrast audit evidence with evidence used by other professions.
- ✓ Identify the four audit evidence decisions that are needed to create an audit program.
- ✓ Specify the characteristics that determine the persuasiveness of evidence.
- ✓ Identify and apply the eight types of evidence used in auditing.
- ✓ Understand the purposes of audit documentation.
- ✓ Prepare organized audit documentation.
- ✓ Describe how technology affects audit evidence and audit documentation.

Introduction

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. This chapter deals with the types of audit evidence decisions auditors make, the evidence available to auditors, identify and apply the eight types of evidence used in auditing, and the use of that evidence in performing audits and documenting the results.

Nature of Evidence

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 presented or not.

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 3-1 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 3-1: 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 used

Audit Evidence Decisions

The main aim of this current section is to 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.

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
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.

Many auditors use electronic audit software packages to generate audit programs. These software programs help the auditor address risks and other audit planning considerations and select appropriate audit procedures.

Persuasiveness of Evidence

The aim of this section is 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.

Competence (appropriateness of evidence)

Competence 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.

1. 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.

2. 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:***

a. 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.

b. Effectiveness of client's internal controls.

When a client's internal controls are effective, evidence obtained is more reliable than when they are weak. 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.

c. 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.

d. 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 glass is not reliable evidence for the existence of diamonds.

e- 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 collectability 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.

f- 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 3-2. 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 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.

Table 3-2 **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

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.

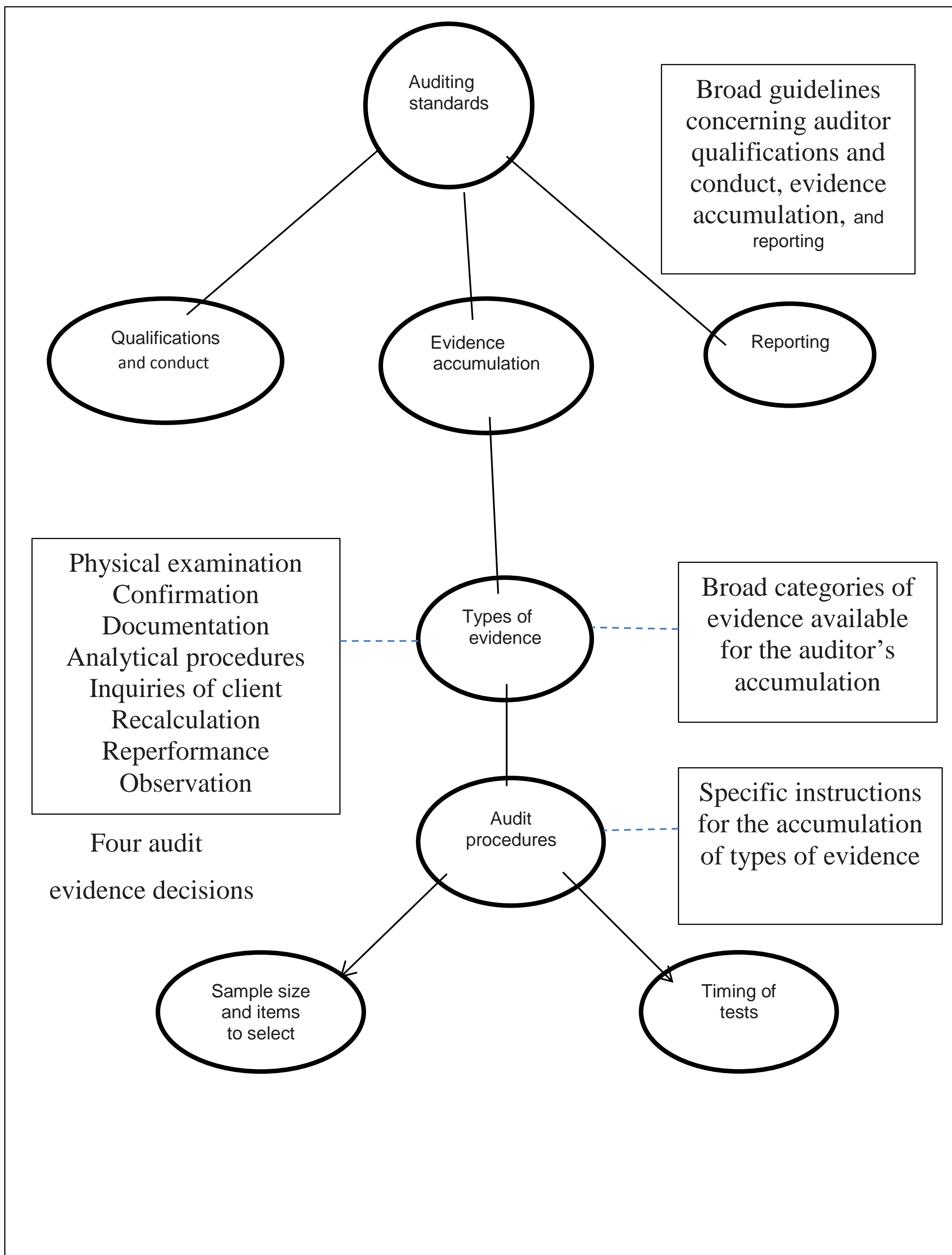
Types of Audit Evidence

The main objective of this section is to 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. Documentation
4. Analytical procedures
5. Inquiries of the client
6. Recalculation
7. Reperformance
8. Observation

Figure 3-1 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 3-1: 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 electronic or paper form. The request is made to the client, and the client asks the third party to respond directly to the auditor. Because confirmations come from sources independent 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 documentation 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.

Although confirmation is not required under U.S. GAAS 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 3-4.

Table 3-3 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

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 authenticate the identity of the confirmation respondent, especially for facsimile or electronic confirmation responses.

Documentation

Documentation is the auditor's inspection 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 are 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 weak 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 use comparisons and relationships to assess whether account balances or other data appear reasonable compared to the auditor's expectations. For example, an auditor may compare the gross margin percent in the current year with the preceding years. 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

1. 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.

2. 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 requires a report modification.

3. 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.

4. 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 documentation 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 is the use of the senses to assess client activities. Throughout the engagement with a client, auditors have many opportunities to use their senses—sight, hearing, touch, and smell to evaluate a wide range of items. 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 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 3-4 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 3-4.

Each of the 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 3-4.

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.

Table 3-4. Appropriateness of Types of Evidence

Type of Evidence	Independence of Providers	Effectiveness of Client's Internal Controls	Auditor's Direct Knowledge	Qualification of provider	Objectives of evidence
Physical examination	High (auditor does)	Varies	High	Normally high (auditor does)	High
Confirmation	High	Not applicable	Low	Varies- usually high	High
Documentation	Varies- external more independent than internal	Varies	Low	Varies	High
Analytical procedures	High/ low (auditor does/ client responds)	Varies	Low	Normally high (auditor does/ client responds	Varies-usually low
Inquiries of client	Low (client provides)	Not applicable	Low	Varies	Varies-low to high
Recalculation	High (auditor does)	Varies	High	High (auditor does)	High
Reperformance	High (auditor does)	Varies	High	High (auditor does)	High
Observation	High (auditor does)	Varies	High	Normally high (auditor does)	Medium

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.

Documentation, analytical procedures, and reperformance are moderately costly. If client personnel provide documents and electronic files for the auditor and organize them for convenient use, documentation usually has a fairly low cost. When auditors must find those documents themselves, however, documentation 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 3-5 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. 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

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 3-5. 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.

Table 3-5	**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 plus to client's counts	120 items	40 items dollar value, dollar value, plus 80 randomly selected	Balance sheet date
Documentation	Compare quantity on client's records to quantity on client's counts	70 items	30 items with large dollar value, plus 40 randomly selected	Balance sheet date

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.

Several terms commonly used to describe audit procedures are defined in Table 3-6. To illustrate each term, an audit procedure and associated type of evidence are also shown.

Audit Documentation

Auditing standards state that audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. 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, 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:

1. 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.

2. 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.

3. 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.

4. 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.

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.

Table 3-6	**Terms, Audit Procedures, and Types of Evidence**	
Term and Definition	**Illustrative Audit Procedure**	**Type of Evidence**
Examine—A reasonably detailed study of a document to determine specific facts about it.	*Examine* a sample of vendors' invoices to determine whether the goods or services received are reasonable	Documentation
Scan—A less-detailed examination of document 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.	Documentation
Compute—A calculation done by the auditor independent of the client.	*Compute* inventory turnover and compare those with 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	Recalculation

Foot—Addition of a column of numbers to determine whether the total are the same as the client's.	*Foot* the sales journal for a 1-month and compare the totals with the general ledger.	Recalculation
Trace—An instruction normally associated with documentation 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.	Documentation 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	Documentation
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	*Observe* whether the two inventory count	Observation

defined as observation.	teams independently count and record inventory counts.	
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.	Documentation

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.

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.

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

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.

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:

1. 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.
2. 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.
3. 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 weaknesses 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.

4. 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:

1. 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.

2. 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.

3. 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 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.

4. 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.

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.

5. *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 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.

- ***Reconciliation of amounts*.**

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.

- ***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 insert 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:

1. 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.
2. Audit documentation should be indexed and cross-referenced to aid in organizing and filing.
3. 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.

4. 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.
5. The conclusions that were reached about the segment of the audit under consideration should be plainly stated.

Effect of Technology on 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 group share software programs to access audit documentation simultaneously from remote locations.

Questions

☒ Multiple Choice Questions: 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. 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.

D. 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.

E. 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

F. 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.

G. 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.

❖ True or False Questions

1. Audit evidence to support an opinion about the fairness of a client's financial statements consists entirely of written information.
2. The relevance of audit evidence depends on the audit objective being tested.
3. Objective evidence is more reliable, and hence more persuasive, than subjective evidence.
4. Relevance of evidence can only be considered in terms of specific audit objectives.
5. Confirmations are among the most expensive type of evidence to obtain.

6. Whenever practical and reasonable, the confirmation of accounts receivable is required of CPAs.
7. Inquiries of clients and reperformance normally have a low cost associated with them
8. Auditor judgment is the primary determinant in determining the amount of evidence gathered.

☒ ***The following are examples of audit procedures:***

1. Review the accounts receivable with the credit manager to evaluate their collectability.
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.

- **Classify each of the preceding items according to the eight types of audit evidence:**
    a. physical examination,
    b. confirmation
    c. documentation
    d. analytical procedures
    e. inquiries of the client,
    f. recalculation,
    g. reperformance
    h. Observation.

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