

## ISA (UK) 500 AUDIT EVIDENCE (LECTURE A637 – 11.47 MINUTES)

The most crucial aspect to any audit is audit evidence. Audit evidence is the basis on which the audit engagement partner (the senior statutory auditor) forms their opinion as to whether the financial statements give a true and fair view. It is also fair to say that a lack of audit evidence is one of the most frequently criticised areas of audit files during file reviews (see also Section 11 of these course notes which discuss the ICAEW's findings during their review of audit files in 2017).

ISA (UK) 500 *Audit Evidence* deals with the auditor's responsibilities in obtaining audit evidence on which they will form their opinion. ISA (UK) 500 clearly outlines its objective at paragraph 4 which says:

ISA (UK) 500 para 4

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

The key phrase used in this objective is *'... sufficient appropriate audit evidence'*. 'Sufficiency' is the measure of the quantity of audit evidence, whereas 'appropriateness' is the measure of the quality of audit evidence; that is its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Audit evidence is cumulative in nature and is generated primarily through audit procedures undertaken during the audit (for example substantive procedures and tests of control). Audit evidence can be obtained from prior year audits, but when considering the appropriateness of this evidence, the auditor must determine whether changes have occurred since the previous audit which may affect its relevance to the current audit.

### **1.1 Procedures for obtaining audit evidence**

Two of the UK planning ISAs directly link into audit evidence; ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and ISA (UK) 330 *The Auditor's Responses to Assessed Risks*. These two UK ISAs say that audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (a) risk assessment procedures; and
- (b) further audit procedures, which comprise:
  - (i) tests of controls, when required by the ISAs (UK) or when the auditor has chosen to do so; and
  - (ii) substantive procedures, including tests of details and substantive analytical procedures.

Audit evidence corroborates management's assertions made in the financial statements; however, some audit evidence obtained by the auditor during the

course of the audit fieldwork can also contradict management's assertions. Audit evidence from external sources is the most reliable form of evidence – however such evidence is also the most time-consuming and costly to obtain and therefore the auditor will apply other procedures to generate audit evidence, including:

- Inspection
- Observation
- Confirmation
- Recalculation
- Reperformance
- Analytical procedures

'Inquiry' is also another audit procedure which can be used (and is often used) in obtaining audit evidence. However, the problem with this source of evidence is that it is the weakest form of evidence and the UK ISA acknowledges that inquiry alone does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. As a result, inquiry should complement other forms of audit evidence.

### ***Inspection***

Inspection involves the examination of records or documents which can be both internal and external. In addition, inspection can also involve physically inspecting an asset for existence and any evidence of impairment.

Inspection tends to be the most commonly used procedure and involves substantiating amounts in the accounting records by reference to documentation. Revenue, for example, will be audited in part by agreement to related contracts and invoices, together with any proof of delivery of goods or services.

### **Example - Inspection**

The financial statements of a company show the addition of a large number of computers during the year amounting to £90,000 which is material to the financial statements. The audit senior has emailed the purchase ledger clerk and asked for a copy of the invoice to be scanned and sent to the audit firm so that they can verify the rights and obligations assertion relating to this equipment.

The invoice from the supplier could have been altered by the purchase ledger clerk. The audit senior should have inspected the original document whilst carrying out the detailed audit work at the company's premises as ISA (UK) 500 considers that original documents are more reliable than photocopies, scanned copies or copies transmitted by facsimile

### ***Observation***

Observation involves looking at a process or procedure being performed by others. The most common observation test is the attendance at the year-end

stock count. This type of procedure provides audit evidence concerning the performance of a process or procedure but it does have inherent limitations. For example, observation tests are of limited application because they are only valid at a point in time and in some situations there are no alternative procedures which can be carried out.

#### **Example - Observation**

The audit senior has attended the year-end stock count of a company and is observing a team of counters checking the quantities and pricing of stock. The counters are organised into teams of two, with one person counting and another person recording the quantities on the stock sheets.

While errors or omissions may not be made whilst the audit senior is in attendance at the stock count, the procedures adopted by management may not be followed in their entirety once the auditor has left the premises.

#### ***External confirmation***

External confirmation (see also Section 10 of these notes) represents audit evidence because it will ordinarily be a direct written response to the auditor from a third party. The most common type of external confirmation is a bank audit letter (or bank certificate). While in practice it is more common to obtain external confirmations which relate to certain account balances and their elements, external confirmations can also be obtained for non-account balances, such as confirming the terms of agreements or transactions which an entity has with third parties.

#### **Example – Confirmation letter**

As part of the normal audit process, the audit senior has undertaken a trade debtors circularisation to confirm the amounts owed by customers.

Trade debtors circularisations are a common type of audit procedure. However, they are limited in their reliability because while they may satisfy the existence assertion, they do not satisfy the valuation assertion (confirming a debt exists does not confirm that the debt will be recoverable) and hence other procedures will need to be adopted to confirm valuation, such as after-date cash testing.

#### ***Recalculation***

Recalculation consists of checking the mathematical accuracy of documents or records and this sort of procedure can be carried out manually or electronically.

#### **Example - Recalculation**

The accounting policy for the depreciation of assets of East Ltd (East) is to depreciate on a pro-rata basis only in the year of acquisition. East has a year-end of 31 March 2018 and on 1 July 2017 an item of machinery was purchased.

Recalculation will involve checking that the accounting policy in respect of depreciation has been correctly calculated by recalculating the depreciation charge on this asset based on 9/12 of a full year's depreciation charge. This type of test is also known as a 'proof in total' test or a 'reasonableness' test

### ***Reperformance***

Reperformance involves the auditor independently undertaking a procedure which has previously been carried out by the client.

#### **Example - Reperformance**

The audit senior wants to confirm that the PAYE and NIC liabilities of a client have been correctly paid over during the year and that the year-end liability is fairly stated. She decides to undertake a PAYE/NIC control account reperformance for the year-ended 31 July 2018.

Reperforming the PAYE/NIC control account for the year will help to identify any potential over- or under-payments of taxes during the year or at the year-end. It will also offer comfort to the auditor if her reperformance of the PAYE/NIC control account agrees to the year-end financial statements

### ***Analytical procedures***

Analytical procedures involve the analysis of the relationships between amounts included within the financial statements, either within the same period, or between comparable amounts from different periods, or in some circumstances through available industry statistics. In carrying out substantive analytical procedures, the auditors will develop their own estimate of the figures they expect to see, compare this estimate with the actual outcome, obtain an explanation for any differences and then corroborate this explanation by reference to other audit evidence or other information available from the entity. It should be noted that there is a separate ISA, namely ISA (UK) 520 *Analytical Procedures* which provides the requirements to auditors where such procedures are concerned and must be applied on all audits.

#### **Example – Analytical procedures**

The audit senior has undertaken an analytical review of West's profit and loss account. He has noticed that gross profit margins in 2018 were 40% and in 2017 were 55%.

The fluctuation in gross margins would need to be investigated by the audit senior to ensure they are, in fact, correct and no errors (such as cut-off errors) have been made. Ordinarily gross margins remain static from one period to the next and the variation in gross margins could indicate inappropriate revenue recognition policies or errors in stock valuations.

## **1.2 Concluding comments**

Audit evidence tends to be weak in certain areas of the audit. For example, when testing revenue for income completeness, often the starting point is the sales invoice. Such tests should start from outside of the accounting system, hence the 'source' transaction is often the customer order. Also, keep in mind that while inquiry is a valid audit procedure under ISA (UK) 500, it should not be used as sole audit evidence as it is a weak form of evidence.