

AUDIT EVIDENCE

1. Audit Evidence Defined

"Audit evidence includes any factual matter available to an auditor from which he may know or infer the relative truth or falsity of the assertions in financial statements." (Mautz)

2. Audit Evidence and the Theory of Knowledge

(a) Induction

- (i) From the particular to the general; based on observation/
description
 - in the standard setting context,
 - in the fieldwork context.
- (ii) Universal and statistical generalizations
 - degrees of credibility.
- (iii) The Utility of Induction
 - the "inductive leap".
- (iv) The Problems of Induction
 - the "fallacy of insufficient statistics"
 - degrees of credibility
 - the "is/ought" problem
 - problems of perception
 - "validation" by means of intersubjectivity
 - relationship to degrees of credibility
 - the "hardline empiricist"
 - the quest for certainty.

(b) Deduction

- (i) From the general to the particular; based on reason/logic.
- (ii) Truth and validity distinguished.
- (iii) The "sterility" of pure deduction.
- (iv) The need for the truth content of the deductive process to be "verified" empirically.

3. First Functional Postulate

There is sufficient competent and reliable evidence available to allow the auditor to give an opinion on the credibility of the accounting information in the company's financial statements, and the auditor can collect and evaluate the evidence within a reasonable time and at a reasonable cost.

4. The Duties of the Auditor Arise From Three Sources. What Relevance Do These Sources Have to the Concept of Audit Evidence?

(a) Statements by Professional Bodies (AUP 14, Audit Evidence)

Introduction

1. Statement of Auditing Standards AUS 1 (para. 21) states:

"21. The auditor "shall" obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information." (Prior to 1987 amendment).

The purpose of this Statement is to amplify the basic principle outlined above. In this Statement the term "financial information" encompasses financial statements.

Sufficient Appropriate Audit Evidence

3. Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency is the measure of the quantity of audit evidence obtained; appropriateness of audit evidence relates to its relevance and reliability. Normally the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. He may often seek evidence from different sources or of a different nature to support the same assertion (see paragraphs 6 and 7).

4. The audit evidence should, in total, enable the auditor to form an opinion on the financial information. In forming such an opinion, the auditor does not normally examine all of the information that is available to him because he can reach a conclusion about an account balance, class of transactions or a control by way of judgmental or statistical sampling procedures.

5. The auditor's judgment as to what is sufficient appropriate audit evidence is influenced by such factors as:

(a) the degree of risk of misstatement. This risk may be affected by:

- (i) the nature of the item;
- (ii) the adequacy of internal control;
- (iii) the nature of the business carried on by the entity;
- (iv) situations which may exert an unusual influence on management; and
- (v) the financial position of the entity.

(b) the materiality of the item in relation to the financial information taken as a whole;

(c) the experience gained during previous audits;

(d) the results of auditing procedures, including fraud or error which may have been found; and

(e) the type of information available.

6. In obtaining audit evidence from compliance procedures, the auditor is concerned with the following assertions:

- Existence - the control exists;
- Effectiveness - the control is operating effectively;
- Continuity - the control has so operated throughout the period of intended reliance.

7. In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

- Existence - an asset or a liability exists and pertains to the entity at a given date;
- Occurrence - a transaction or event took place which pertains to the entity;
- Completeness - there are no unrecorded assets, liabilities or transactions;
- Valuation - an asset or liability is recorded at an appropriate carrying value;
- Measurement - a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period;
- Presentation and Disclosure - an item is disclosed, classified, and described in accordance with acceptable accounting policies and, when applicable, legal requirements.

Obtaining evidence relevant to one assertion, for example, existence of inventory, will not compensate for failure to do so with respect to another, for example, its valuation. The extent and nature of substantive procedures to be performed will vary with respect to each of the above assertions.

8. The reliability of audit evidence is influenced by its source - internal or external, and by its nature - visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalizations may be useful in assessing the reliability of audit evidence:

- External evidence (e.g. confirmation received from a third party) is more reliable than internal evidence.
- Internal evidence is more reliable when related internal control is satisfactory.
- Evidence obtained by the auditor himself is more reliable than that obtained from the entity.
- Evidence in the form of documents and written representations is more reliable than oral representations.

9. The auditor may gain increased assurance when audit evidence obtained from different sources or of a different nature is consistent. In these circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, further procedures may have to be performed to resolve the inconsistency.
10. The auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation. In selecting procedures to obtain evidence, he should recognize the possibility that the financial information may be materially misstated.
11. There should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting a procedure.
12. When the auditor is in reasonable doubt as to any assertion of material significance, he should attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence, he should not express an unqualified opinion.

AUP 14 Audit Evidence
Paragraphs 1, 3-12.

(b) Statute

(c) Common Law

- re London and General Bank (1895)
- re The Kingston Cotton Mill Coy. Ltd. (1896)
- Pacific Acceptance Corp. Ltd. v Forsyth (1970)

5. The Characteristics of Audit Evidence

- Utility
- Scarcity
- Authority
- Technicality
- Expensiveness
- Conclusiveness
- Relevancy
- Objectivity

6. The Sources of Evidence/Evidential Matter

- Internal control
- Physical evidence
- Documentary evidence
- Ledgers and journals
- Comparisons and ratios
- Computations
- Oral evidence

7. Some Theoretical and Practical Difficulties

- Legal and Audit approaches to evidence
- Other issues

8. Conclusions

- the need to recognise the inductive context of auditing
- the audit court

Required Reading

1. Robertson, J.C., Auditing, Sixth Edition, B.P.I., Texas, 1990. Chapter 6.
2. American Accounting Association, Committee on Basic Auditing Concepts, A Statement of Basic Auditing Concepts, Studies in Accounting Research, No. 6, (A.A.A., Florida, 1973), pp. 18-41. (RNT, RC)
3. Mautz, R.K., "The Nature and Reliability of Audit Evidence" in Readings in Auditing, J.H. Brasseaux and J.D. Edwards, editors, (3rd Edition, South-Western, 1973), pp. 205-217. (RNT, RC)

TUTORIAL QUESTIONS

1. Critically evaluate the definition of "evidence" as postulated by Mautz.
2. What are the problems raised by the "First Functional Postulate"?
3. Critically evaluate the profession's contribution to the concept of audit evidence. Are user needs satisfied by the application of this concept of evidence?
4. What are the implications of judicial decision for the profession's approach to evidence? Describe the profession's reaction to judicial decision.
5. Describe the characteristics of audit evidence.
6. What is the objective of the auditor's accumulation of audit evidence? Can this objective be achieved using conventional approaches?
7. "The reliability of audit evidence will vary according to its source". Discuss.
8. Compare and contrast the legal and audit approaches to evidence. Which approach is superior? Why?
9. What do you understand by the concept "degree of credibility"? Explain the use of this concept in an inductive context. Can the use of "professional skill and judgment" provide an adequate degree of credibility?
10. "Both the auditor's study of internal control and the subsequent evaluation of internal control require the use of evidence". Discuss.
11. "The establishment of an 'audit court' may act as the catalyst in improving traditional approaches to audit evidence". Discuss.
12. Evaluate the approach to audit evidence as propounded by the American Accounting Association.

