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Audit evidence – necessity to qualify a pertinent opinion

Stefan Zuca^{a*}

^aRomanian-American University, Expozitiei Boulevard, No.1B, Bucharest,021101, Romania

Abstract

International standards audit (ISA) requires the auditor to obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. Although a variety of information may have some impact on the auditor's decision process, both the quantity and quality of audit evidence must be evaluated.

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1. Concept of audit evidence

Audit evidence is defined as all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and can be classified as:

- The underlying accounting records maintained by management to support the preparation of the entity's financial statements, and
- Other information.

Accounting records generally consist of the original books of entry, such as the entity's general ledgers and related subsidiary ledgers and journal entries, which may be initiated, authorized, recorded, processed, and reported

* Corresponding author. Tel.: +4-0744-502-341.
E-mail address: stefanzuca@yahoo.com

in electronic form or manually. Accounting records includes documents outside the entity's books of entry that support the transactions entered in the books: contracts and leases, checks, bank and broker statements and advice, vendor invoices, customer purchase orders, and accounting manuals. Accounting records also may include other documents that support journal entries and disclosures, such as spreadsheets containing computations such as allocation valuation models, and other calculations and disclosure checklists prepared by management of the entity. Preparation of the accounting records may be manually or may be part of stand-alone accounting software packages or integrated information systems that support all aspects of the entity's operations.

The auditor can use *other information* as audit evidence to reach conclusions through valid reasoning, information which may consist of documentary evidence obtained from external sources, sources internal to the client, and other information developed by, or available to, the auditor.

The audit evidence obtained by the auditor through the performance of auditing procedures and from other sources, such as a firm's quality control procedures is related to determining whether to accept or continue a client relationship and work performed in previous audits.

Management is responsible for preparing the financial statements from the entity's accounting records. The auditor's responsibility is to obtain audit evidence through testing the accounting records underlying the financial statements prepared by management, as well as by obtaining other audit evidence. Generally, the accounting records should be tested through procedures, such as:

1. Retracing transactions through the accounting system,
2. Reperforming procedures executed by management in the financial reporting process,
3. Recomputing allocations,
4. Testing reconciliations, and
5. Performing other mathematical calculations contained within the accounting records.

Although such auditing procedures performed on the underlying accounting records may provide the auditor with evidence that the accounting records are internally consistent and reconcile to the financial statements, such procedures alone do not provide sufficient appropriate audit evidence to support the auditor's opinion on the financial statements. Therefore, the auditor should obtain audit evidence from other information besides the accounting records before an opinion on the financial statements can be expressed.

2. Sufficient appropriate audit evidence

International standards audit (ISA) defines sufficiency of audit evidence as the “measure of the quantity of audit evidence”. International standards audit (ISA) defines the appropriateness of audit evidence as the “measure of the quality of audit evidence, or in other words, its relevance and reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions”.

Determining the quantity (**sufficiency**) of audit evidence required is based on the auditor's assessment of the risk of material misstatement as well as the quality of the audit evidence obtained. The figure 1, shows that the quantity of audit evidence required will be greater, if the the risk of material misstatement increases related to an account balance, class of transaction or disclosure.



Fig.1 Relationship of Risk of Material Misstatement to Sufficiency (Quantity) of Audit Evidence Required
 Source: Lui M. Puncel, "Knowledge-based audit procedures", 2009

The figure 2 shows that the quantity of audit evidence required decreases, if the quality (appropriateness) of audit evidence obtained increases. Thus, the concepts of sufficiency and appropriateness of audit evidence are interrelated.

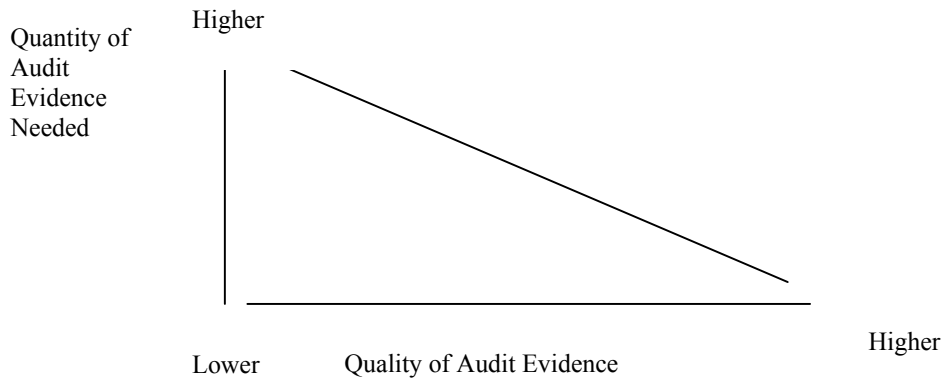


Fig.2 Relationship of Appropriateness (Quality) to Sufficiency (Quantity) of Audit Evidence Required
 Source: Lui M. Puncel, "Knowledge-based audit procedures", 2009

The two figures above are intended only to illustrate the general interrelationships between the quantity of evidence required and the risk of material misstatement and the quantity of evidence required and the quality of the evidence. As the figures shows, such relationships are not necessarily linear. For example, merely obtaining a greater quantity of lower quality audit evidence may not compensate for a lack of higher quality audit evidence. Therefore, is required to support the auditor's opinion requires judgment in order to determine the amount of audit evidence.

The concept of sufficient audit evidence does not contemplate the auditor examining all evidence that exists. The auditor is not free to collect unlimited amounts of evidence, because must work within economic limits. The auditor may consider the relationship between the cost of a procedure and the quality and reliability of the audit evidence obtained from performing the procedure. However, the difficulty or cost of performing an audit procedure is not a valid reason for omitting the procedure if there is no appropriate alternative. Conclusions can ordinarily be reached by using audit sampling and other methods of selecting items to test. Nevertheless, recognizing that important exceptions exist, reliable evidence usually has the following characteristics:

- Audit evidence is more reliable if it is obtained from a knowledgeable, independent source outside the entity;
- Audit evidence generated internally is more reliable if the entity's related internal controls are more effective;
- Evidence obtained directly by the auditor through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly or by inference. For example, the auditor's calculation of the gross profit percentage and comparison with prior years provides more reliable evidence than if the auditor relied on the client's calculations. Another example is that observation of the performance of a control is more reliable than inquiry about how the control is performed;
- Audit evidence in documentary form, whether paper or electronic, is more reliable than evidence obtained orally. For example, written documentation prepared by the company of the performance of a control is more reliable than evidence obtained through subsequent oral representations by the individual who performed the control;
- Original documents provide more reliable audit evidence than photocopies or facsimiles.

When the auditor utilizes photocopies, facsimiles, or filmed, digitized, or other electronic documents as audit evidence, International standards audit (ISA) notes that the auditor should consider their reliability, including relevant controls over their preparation and maintenance. However, International standards audit (ISA) also recognizes that auditing rarely involves the authentication of documentation, and the auditor is not trained or expected to be an expert in this area.

When using information produced by the entity to perform further audit procedures, for example, performing analytical review procedures or a recalculation of expected account balances or transactions to compare to the company's balances, the auditor should obtain audit evidence about the reliability (accuracy and completeness) of the information used in performing such procedures. Audit evidence about the completeness and accuracy of the information produced by the entity's information system might be derived by testing the entity's applicable controls over the production and maintenance of such data. Alternatively, the auditor might obtain audit evidence by directly testing the completeness and accuracy of the underlying data while simultaneously performing the primary procedure that is relying on such data.

Depending on the risk of material misstatement and the corresponding quantity and quality of audit evidence required, the auditor should consider the need to corroborate audit evidence by obtaining additional evidence from multiple sources, such as from sources external to the entity to corroborate a representation from management. Usually more assurance is obtained by the auditor through obtaining additional consistent audit evidence from different sources or of a different type rather than from only one source. In the situation, when the auditor obtains evidence from one source that is inconsistent with evidence obtained from a different source, the auditor should determine what additional audit procedures to perform to resolve the inconsistency.

3. Audit evidence in electronic form

In response to the increases in the technology, many entities process significant information electronically. For example, the client may be using Electronic Data Interchange with customers and suppliers to process transactions involving billing, purchasing, shipping, cash receipts, and cash disbursements or conduct electronic commerce over the Internet. In addition, transactional documents may be available only in electronic form or the original documents may be available only at certain points in time, because the entity scanned the documents into document imaging systems and did not retain the original source documents. Accordingly, it may be difficult, or impossible, for the auditor to access certain information for inspection or confirmation without using information technology, or the auditor may not be able to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions in these situations.

For example, the potential for improper initiation or alteration of information to occur and not be detected may

be greater if information is produced, maintained, or accessed in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter in order to support an assessed level of control risk below the maximum for affected assertions.

Purpose of electronic evidence is no different from traditional forms of evidence. Power electronic evidence in general depends on the effectiveness of internal controls over its validity. There is a question that the auditor needs to address, related to the credibility of the electronic evidence obtained. The client may not have physical documents for the auditor to examine. Therefore, the auditor may not recognize that the electronic evidence lacks credibility, unless the auditor tests the internal controls relevant to the electronic evidence,

4. Conclusions

Auditors must document and collect evidence concerning important issues both in preparing the report and supporting the opinion expressed and all other evidence to prove that the audit was conducted in accordance with International Standards on Auditing.

In other words, audit documentation may be perceived as a mission "story", that should allow any user to understand more easily its risks, assertion tested procedures, how they obtained the evidence and concluded that the statements through financial report and pertinent audit opinion.

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