Chapter 7
Audit Evidence

Review Questions

7-1 In both a legal case and in an audit of financial statements, evidence is used by an unbiased person to draw conclusions. In addition, the consequences of an incorrect decision in both situations can be equally undesirable. For example, if a guilty person is set free, society may be in danger if the person repeats his or her illegal act. Similarly, if investors rely on materially misstated financial statements, they could lose significant amounts of money. Finally, the guilt of a defendant in a legal case must be proven beyond a reasonable doubt. This is similar to the concept of sufficient appropriate evidence in an audit situation. As with a judge or jury, an auditor cannot be completely convinced that his or her opinion is correct, but rather must obtain a high level of assurance.

The nature of evidence in a legal case and in an audit of financial statements differs because a legal case relies heavily on testimony by witnesses and other parties involved. While inquiry is a form of evidence used by auditors, other more reliable types of evidence such as confirmation with third parties, physical examination, and documentation are also used extensively. A legal case also differs from an audit because of the nature of the conclusions made. In a legal case, a judge or jury decides the guilt or innocence of the defendant. In an audit, the auditor issues one of several audit opinions after evaluating the evidence.

7-2 The four major audit evidence decisions that must be made on every audit are:

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 procedure.

7-3 An audit procedure is the detailed instruction for the collection of a type of audit evidence that is to be obtained. Because audit procedures are the instructions to be followed in accumulating evidence, they must be worded carefully to make sure the instructions are clear.

7-4 An audit program for accounts receivable is a list of audit procedures that will be used to audit accounts receivable for a given client. The audit procedures, sample size, items to select, and timing should be included in the audit program.
7-5 The auditor must obtain sufficient appropriate evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. There are three major phrases of the standard.

<table>
<thead>
<tr>
<th>PHRASE</th>
<th>MEANING OF PHRASE</th>
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</thead>
<tbody>
<tr>
<td>Obtain sufficient appropriate evidence</td>
<td>The auditor must obtain evidence that is reliable and there must be a reasonable quantity of that evidence.</td>
</tr>
<tr>
<td>By performing audit procedures</td>
<td>The auditor performs audit procedures to meet audit objectives using the eight types of evidence.</td>
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<tr>
<td>To afford a reasonable basis for an opinion regarding the financial statements</td>
<td>The auditor cannot expect to be completely certain that the financial statements are fairly presented but there must be persuasive evidence. The collection of evidence gathered by the auditor provides the basis for the auditor’s opinion.</td>
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</table>

7-6 There are two primary reasons why the auditor can only be persuaded with a reasonable level of assurance, rather than be convinced that the financial statements are correct:

1. The cost of accumulating evidence. It would be extremely costly for the auditor to gather enough evidence to be completely convinced.
2. Evidence is normally not sufficiently reliable to enable the auditor to be completely convinced. For example, confirmations from customers may come back with erroneous information, which is the fault of the customer rather than the client.

7-7 The two determinants of the persuasiveness of evidence are appropriateness and sufficiency. Appropriateness refers to the relevance and reliability of evidence, or the degree to which evidence can be considered believable or worthy of trust. Appropriateness relates to the audit procedures selected, including the timing of when those procedures are performed. Sufficiency refers to the quantity of evidence and it is related to sample size and items to select.
Following are six characteristics that determine reliability and an example of each.

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<thead>
<tr>
<th>FACTOR DETERMINING RELIABILITY</th>
<th>EXAMPLE OF RELIABLE EVIDENCE</th>
</tr>
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<tbody>
<tr>
<td>Independence of provider</td>
<td>Confirmation of a bank balance</td>
</tr>
<tr>
<td>Effectiveness of client's internal controls</td>
<td>Use of duplicate sales invoices for a large well-run company</td>
</tr>
<tr>
<td>Auditor's direct knowledge</td>
<td>Physical examination of inventory by the auditor</td>
</tr>
<tr>
<td>Qualifications of provider</td>
<td>Letter from an attorney dealing with the client's affairs</td>
</tr>
<tr>
<td>Degree of objectivity</td>
<td>Count of cash on hand by auditor</td>
</tr>
<tr>
<td>Timeliness</td>
<td>Observe inventory on the last day of the fiscal year</td>
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**TYPES OF AUDIT EVIDENCE**

<table>
<thead>
<tr>
<th>TYPES OF AUDIT EVIDENCE</th>
<th>EXAMPLES</th>
</tr>
</thead>
</table>
| 1. Physical examination | ▪ Count petty cash on hand  
                       | ▪ Examine fixed asset additions                                                                                                          |
| 2. Confirmation         | ▪ Confirm accounts receivable balances of a sample of client customers  
                       | ▪ Confirm client's cash balance with bank                                                                                               |
| 3. Documentation        | ▪ Examine cancelled checks returned with cutoff bank statement  
                       | ▪ Examine vendors’ invoices supporting a sample of cash disbursement transactions throughout the year                                           |
| 4. Analytical procedures | ▪ Evaluate reasonableness of receivables by calculating and comparing ratios  
                       | ▪ Compare expenses as a percentage of net sales with prior year’s percentages                                                                 |
| 5. Inquiries of the client | ▪ Inquire of management whether there is obsolete inventory  
                       | ▪ Inquire of management regarding the collectibility of large accounts receivable balances                                                  |
7-9 (continued)

<table>
<thead>
<tr>
<th>TYPES OF AUDIT EVIDENCE</th>
<th>EXAMPLES</th>
</tr>
</thead>
</table>
| 6. Recalculation        | - Recompute invoice total by multiplying item price times quantity sold  
                           - Foot the sales journal for a one-month period and compare all totals to the general ledger |
| 7. Reperformance        | - Agree sales invoice price to approved price list  
                           - Match quantity on purchase invoice to receiving report |
| 8. Observation          | - Observe client employees in the process of counting inventory  
                           - Observe whether employees are restricted from access to the check signing machine |

7-10 The four characteristics of the definition of a confirmation are:

1. Receipt
2. Written or oral response
3. From independent third party
4. Requested by the auditor

A confirmation is prepared specifically for the auditor and comes from an external source. External documentation is in the hands of the client at the time of the audit and was prepared for the client's use in the day-to-day operation of the business.

7-11 *Internal documentation* is prepared and used within the client's organization without ever going to an outside party, such as a customer or vendor.

Examples:
- check request form
- receiving report
- payroll time card
- adjusting journal entry

*External documentation* either originated with an outside party or was an internal document that went to an outside party and is now either in the hands of the client or is readily accessible.

Examples:
- vendor's invoice
- cancelled check
- cancelled note
- validated deposit slip
Analytical procedures are useful for indicating account balances that may be distorted by unusual or significant transactions and that should be intensively investigated. They are also useful in reviewing accounts or transactions for reasonableness to corroborate tentative conclusions reached on the basis of other evidence.

The most important reasons for performing analytical procedures are the following:

1. Understanding the client’s industry and business
2. Assessment of the entity’s ability to continue as a going concern
3. Indication of the presence of possible misstatements in the financial statements
4. Reduction of detailed audit tests

The decrease of the current ratio indicates a liquidity problem for Harper Company since the ratio has dropped to a level close to the requirements of the bond indenture. Special care should be exercised by the auditor to determine that the 2.05 ratio is proper since management would be motivated to hide any lower ratio. The auditor should expand procedures to test all current assets for proper cutoff and possible overstatement and to test all current liabilities for proper cutoff and possible understatement.

Attention directing analytical procedures occur when significant, unexpected differences are found between current year’s unaudited financial data and other data used in comparisons. If an unusual difference is large, the auditor must determine the reason for it, and satisfy himself or herself that the cause is a valid economic event and not an error or misstatement due to fraud.

When an analytical procedure reveals no unusual fluctuations, the implication is minimized. In that case, 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 substantive tests in connection with those accounts.

Frequently, the same analytical procedures can be used for attention directing and for reducing substantive tests, depending on the outcome of the tests. Simple procedures such as comparing the current year account balance to the prior year account balance is more attention directing (and provides less assurance) than more complex analytical procedures; i.e., those which rely on regression analysis. More sophisticated analytical procedures help the auditor examine relationships between several information variables simultaneously. The nature of these tests may provide greater assurance than simple procedures.
The purposes of audit documentation are as follows:

1. To provide a basis for planning the audit. The auditor may use reference information from the previous year in order to plan this year’s audit, such as the evaluation of internal control, the time budget, etc.

2. To provide a record of the evidence accumulated and the results of the tests. This is the primary means of documenting that an adequate audit was performed.

3. To provide data for deciding the proper type of audit report. Data are used in determining the scope of the audit and the fairness with which the financial statements are stated.

4. To provide a basis for review by supervisors and partners. These individuals use the audit documentation to evaluate whether sufficient appropriate evidence was accumulated to justify the audit report.

Audit documentation are used for several purposes, both during the audit and after the audit is completed. One of the uses is the review by more experienced personnel. A second is for planning the subsequent year audit. A third is to demonstrate that the auditor has accumulated sufficient appropriate evidence if there is a need to defend the audit at a later date. For these uses, it is important that the audit documentation provide sufficient information so that the person reviewing an audit schedule knows the name of the client, contents of the audit schedule, period covered, who prepared the audit schedule, when it was prepared, and how it ties into the rest of the audit files with an index code.

The two criteria used by auditors of public companies when determining whether memos, correspondence, and other documents must be maintained in the audit files are as follows:

1. The materials are created, sent, or received in connection with the audit or review.

2. The materials contain conclusions, opinions, analyses, or financial data related to the audit or review.

The Sarbanes-Oxley Act of 2002 requires auditors of public companies to prepare and maintain audit schedules and other information related to any audit report in sufficient detail to support the auditor’s conclusions, for a period of not less than 7 years.

Audit schedules should include the following:

*Name of the client* Enables the auditor to identify the appropriate file to include the audit schedule in if it is removed from the files.

*Period covered* Enables the auditor to identify the appropriate year to which an audit schedule for a client belongs if it is removed from the files.
7-19 (continued)

Description of the contents A list of the contents enables the reviewer to determine whether all important parts of the audit schedule have been included. The contents description is also used as a means of identifying audit files in the same manner that a table of contents is used.

Initials of the preparer Indicates who prepared the audit schedule in case there are questions by the reviewer or someone who wants information from the files at a later date. It also clearly identifies who is responsible for preparing the audit documentation if the audit must be defended.

Date of preparation Helps the reviewer to determine the sequence of the preparation of the audit schedules. It is also useful for the subsequent year in planning the sequence of preparing audit schedules.

Indexing Helps in organizing and filing audit schedules. Indexing also facilitates in searching between related portions of the audit documentation.

7-20 The permanent file contains data of an historical and continuing nature pertinent to the current audit. Examples of items included in the file are:

1. Articles of incorporation
2. Bylaws, bond indentures, and contracts
3. Analysis of accounts that have continuing importance to the auditor
4. Information related to the understanding of internal control:
   a. flowcharts
   b. internal control questionnaires
5. Results of previous years' analytical procedures, such as various ratios and percentages compiled by the auditors

By separating this information from the current year's audit files, it becomes easily accessible for the following year's auditors to obtain permanent file data.

7-21 The purpose of an analysis is to show the activity in a general ledger account during the entire period under audit, tying together the beginning and ending balances. The trial balance includes the detailed make-up of an ending balance. It differs from an analysis in that it includes only those items comprising the end of the period balance. A test of reasonableness schedule contains information that enables the auditor to evaluate whether a certain account balance appears to be misstated. One example of a test of reasonableness schedule is a schedule that compares current year expenses to prior years' amounts. This type of schedule is intended to show which accounts need investigation due to significant variances.

7-22 Unanswered questions and exceptions may indicate the potential for significant errors or fraud in the financial statements. These should be investigated and resolved to make sure that financial statements are fairly presented.

The audit files can also be subpoenaed by courts as legal evidence. Unanswered questions and exceptions may indicate lack of due care by the auditor.
7-23 Tick marks are symbols adjacent to information in audit schedules for the purpose of indicating the work performed by the auditor. An explanation of the tick mark must be included at the bottom of the audit schedule to indicate what was done and who did it.

7-24 Audit files are owned by the auditor. They can be used by the client if the auditor wants to release them after a careful consideration of whether there might be confidential information in them. The audit files can be subpoenaed by a court and thereby become the property of the court. They can be released to another CPA firm without the client's permission if they are being reviewed as a part of a voluntary peer review program under AICPA, state CPA society, or state Board of Accountancy authorization. The audit files can be sold or released to other users if the auditor obtains permission from the client.

7-25 When evidence can be examined only in machine-readable form, auditors use computers to read and examine evidence. There are commercial audit software programs designed specifically for use by auditors, such as ACL Software and Interactive Data Extraction and Analysis (IDEA). Spreadsheet software packages can also be used by auditors to perform audit tests on data that is available only in machine-readable form.

7-26 The purposes of audit documentation software are to convert traditional paper-based documentation into electronic files and to organize the audit documentation. The benefits of audit documentation software, such as Automated Client Engagement (ACE), are as follows:

- The auditor can more efficiently prepare a trial balance, lead schedules, supporting audit documentation, financial statements, and ratio analysis using the computer rather than by hand.
- The effects of adjusting journal entries are automatically carried through to the trial balance and financial statements, making last-minute adjustments easier to make.
- Tick marks and review notes can be entered directly into computerized files.
- Data can be imported and exported to other applications. For example, a client’s general ledger can be downloaded into ACE and tax information can be downloaded into a commercial tax preparation package after the audit is completed.

**Multiple Choice Questions From CPA Examinations**

7-27 a. (2) b. (1) c. (4) d. (4)
7-28 a. (3) b. (3) c. (4) d. (4)
**Discussion Questions And Problems**

       5. Internal*  11. External  17. External  

* Even though these may be signed or initialed by employees, they are still internal documents.  
** Bills of lading are ordinarily signed by the freight company. That signature will be included on the top of the bill of lading, therefore, it is an external document.

b. External evidence is considered more reliable than internal evidence because external evidence has been in the hands of both the client and another party, implying agreement about the information and the conditions stated on the document.

7-30

1. (5) inquiry of client  
2. (8) observation  
3. (1) physical examination  
4. (2) confirmation  
5. (6) recalculation  
6. (2) confirmation  
7. (3) documentation  
8. (4) analytical procedures  
9. (5) inquiry of client  
10. (7) reperformance  
11. (8) observation  
12. (1) physical examination  
13. (4) analytical procedures  
14. (3) documentation  
15. (5) inquiry of client  
16. (4) analytical procedures  
17. (3) documentation  
18. (6) recalculation  
19. (1) physical examination  
20. (2) confirmation
Examples of audit evidence the auditor can use to support each of the functions are:

a. Examine invoice from vendor
   Direct confirmation with vendor
b. Physical examination
   Direct confirmation with custodian
c. Direct confirmation with customer
   Examine cash receipts journal and bank deposits for subsequent cash receipts
d. Examine title for ownership of asset
   Examine invoice from vendor
e. Direct confirmation with vendor
   Examine client's copy of vendor's statement
f. Physical examination
   Examine sales invoice of subsequent sale of goods showing marked down sale price
g. Count petty cash
   Direct confirmation with custodian

Confirmations are normally more reliable evidence than inquiries of the client because of the independence of the outside party confirming the information.

b. Confirmation of bank balances is considered highly reliable whereas confirmation of a department store charge account is often not considered reliable. Banks are accustomed to confirmations from auditors and normally maintain excellent accounting records, whereas most customers of department stores have neither characteristic.

c. If an auditor is not qualified to distinguish between valuable inventory (e.g., diamonds) and worthless inventory (e.g., glass), the physical examination of inventory would not be considered to be reliable evidence.

d. Recalculation tests are highly reliable because the auditor is able to gain 100% assurance of the accuracy, but the tests only verify whether the recorded amounts are accurately totaled. These tests do not uncover omissions or fictitious amounts.

e. Relatively reliable documentation examples include: vendor statements, bank statements, and signed lease agreements. Relatively unreliable documentation examples may be: copies of customer invoices, internal memoranda and other communications, and a listing of fixed asset additions.

The difference between reliable and unreliable documentation examples above is whether they originate from outside or inside the client's organization. External information is considered more reliable than internal documentation.
7-32 (continued)

f. 1. Confirmation of accounts receivable - Corporation accustomed to confirmations compared to a member of the general public.
2. Examination of the corporate minutes - Experienced partner compared to a new assistant.
3. Physical observation of inventory - Auditor knowledgeable in the client's inventory compared to one who is not.
4. Attorney's letter - General counsel compared to an attorney involved only with patents.

g. Analytical procedures are evidence of the likelihood of misstatements in the financial statements, but they are rarely sufficient by themselves to conclude that the statements are misstated. Other supportive evidence is needed to determine whether apparent misstatements are actually material.

7-33

<table>
<thead>
<tr>
<th>ACCOUNT NAME</th>
<th>FROM WHOM CONFIRMED</th>
<th>INFORMATION TO BE CONFIRMED</th>
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</thead>
<tbody>
<tr>
<td>CASH IN BANK</td>
<td>All banks in which Star had deposits during the year including those which may have had an account that was closed out during the year.</td>
<td>■ Name and address of the bank. &lt;br&gt; ■ The amount on deposit for each account as of the balance sheet date plus the name of each account, the account number, whether or not the account is subject to withdrawal by check, and the interest rate if the account is interest bearing. &lt;br&gt; ■ The amount for which Star was directly liable to the bank for loans as of the balance sheet date plus the date of the loan, the due date, the interest rate, the date to which interest is paid, and description of the liability and collateral. &lt;br&gt; ■ If internal controls over cash are weak, the auditor may wish to request that the bank include a list of authorized signatures with the confirmation.</td>
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</table>
7-33 (continued)

<table>
<thead>
<tr>
<th>ACCOUNT NAME</th>
<th>FROM WHOM CONFIRMED</th>
<th>INFORMATION TO BE CONFIRMED</th>
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</thead>
<tbody>
<tr>
<td>TRADE ACCOUNTS RECEIVABLE</td>
<td>A representative sample of debtors at a selected confirmation date which may be either at the balance sheet or an interim date. Confirmations should also be requested for the following types of accounts:</td>
<td>The confirmation can be either a positive or negative form of request. The positive form requests the debtor to directly notify the auditor whether the information is correct and if not correct, which items are considered incorrect. The negative form requests a reply only if the information is incorrect. In both cases the information should include:</td>
</tr>
<tr>
<td></td>
<td>Accounts with large balances; Past-due accounts; Accounts with zero or credit balances; Accounts written off during the current period; Accounts whose collection is considered questionable; Other accounts of an unusual nature.</td>
<td></td>
</tr>
<tr>
<td>NOTES RECEIVABLE</td>
<td>A selected sample of notes receivable outstanding at the balance sheet date. If a note receivable was written off during the year, the balance written off should be confirmed.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Name and address of the debtor. Date of the note. Due date. Unpaid balance at balance sheet date. Payment arrangements. Interest rate. Date of last interest payment. Collateral, if any, to secure the note.</td>
</tr>
<tr>
<td>INVENTORIES</td>
<td>Public warehouses or other outside custodians (if any).</td>
<td>Name and address of public warehouse or other outside custodian. The inventory date. Detailed lists of inventory stored. Under auditing standards, direct confirmation is acceptable provided supplemental inquiries are made that the inventory is the property of the company, unless the amount is a significant percent of current or total assets.</td>
</tr>
<tr>
<td>ACCOUNT NAME</td>
<td>FROM WHOM CONFIRMED</td>
<td>INFORMATION TO BE CONFIRMED</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-------------------------------------------------------------------------------------</td>
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</table>
| TRADE ACCOUNTS PAYABLE  | Suppliers from whom substantial purchases have been made during the year, regardless of the balances of their accounts at the balance sheet date. | ■ Name and address of the supplier.  
■ The amount due and the amount of any purchase commitments as of the balance sheet date. When internal controls are considered effective, the confirmation can be at an interim date; however, a thorough review must then be made of changes in the major accounts during the intervening period between the confirmation date and year-end. It should also be noted that with interim confirmation, the auditor loses a desirable audit procedure for disclosing unrecorded and contingent liabilities at the balance sheet date.  
As an alternative to confirmation letters, it is a common practice to ask the vendor to send, directly to the independent auditor, a statement of the vendor’s account with the client as of the balance sheet date rather than send an accounts payable confirmation. |
| MORTGAGES PAYABLE       | Mortgagee for each mortgage that has a balance at the balance sheet date.           | ■ Name and address of mortgagee.  
■ Original amount.  
■ Date of note.  
■ Maturity date.  
■ Balance due at balance sheet date.  
■ Payment arrangements.  
■ Interest rate.  
■ Interest payment dates.  
■ Date of last interest payment.  
■ Nature of defaults and if any events of default are known to mortgagee.  
■ Location of mortgaged property. |
| CAPITAL STOCK           | If Star uses an outside transfer agent and registrar, confirmations should be sent to both. | ■ Name and address of transfer agent and registrar.  
■ Number of shares of common stock authorized, issued, outstanding, and held as treasury shares for the company as of the balance sheet date. |
<table>
<thead>
<tr>
<th>ACCOUNT NAME</th>
<th>FROM WHOM CONFIRMED</th>
<th>INFORMATION TO BE CONFIRMED</th>
</tr>
</thead>
<tbody>
<tr>
<td>LEGAL FEES</td>
<td>All of Star’s major attorneys. Letters should also be sent to attorneys that the independent auditor knows the client has used extensively in prior years.</td>
<td>The auditor should request a letter from each attorney as to litigation being handled as of and subsequent to the balance sheet date. For each case, the attorney should give a description, report on its status as of the balance sheet date and as of the date of the letter, and give his or her opinion as to the ultimate liability. The attorney should also state Star’s indebtedness to him or her as of the balance sheet date.</td>
</tr>
<tr>
<td>SALES AND EXPENSE ACCOUNTS</td>
<td>Occasionally, confirmation may be requested from an outside party for individual transactions contributing to total expenses or sales. This may be true where a major item is based on a formal contract and the auditor wants independent confirmation of agreement on the significant term of the contract and that these terms have been satisfactorily completed.</td>
<td>Name and address of outside party. Other specific information would depend on the nature of the item and the reason the auditor feels it is necessary to confirm the item.</td>
</tr>
<tr>
<td>AUDIT PROCEDURE</td>
<td>a. TYPE OF AUDIT EVIDENCE</td>
<td>b. BALANCE-RELATED AUDIT OBJECTIVE</td>
</tr>
<tr>
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<td>----------------------------------</td>
</tr>
<tr>
<td>1. Test extend unit prices times quantity on the inventory list, test foot the list and compare the total to the general ledger.</td>
<td>Recalculation</td>
<td>Detail tie-in</td>
</tr>
<tr>
<td>2. Trace selected quantities from the inventory list to the physical inventory to make sure that it exists and the quantities are the same.</td>
<td>Physical examination</td>
<td>Existence and Accuracy</td>
</tr>
<tr>
<td>3. Question operating personnel about the possibility of obsolete or slow-moving inventory.</td>
<td>Inquiry of the client</td>
<td>Realizable value</td>
</tr>
<tr>
<td>4. Select a sample of quantities of inventory in the factory warehouse and trace each item to the inventory count sheets to determine if it has been included and if the quantity and description are correct.</td>
<td>Physical examination</td>
<td>Completeness and Accuracy</td>
</tr>
<tr>
<td>5. Compare the quantities on hand and unit prices on this year's inventory count sheets with those in the preceding year as a test for large differences.</td>
<td>Analytical procedures</td>
<td>Accuracy</td>
</tr>
<tr>
<td>6. Examine sales invoices and contracts with customers to determine whether any goods are out on consignment with customers. Examine vendors' invoices and contracts with vendors to determine if any goods on the inventory listing are owned by vendors.</td>
<td>Documentation</td>
<td>Rights</td>
</tr>
<tr>
<td>7. Send letters directly to third parties who hold the client's inventory and request they respond directly to us.</td>
<td>Confirmation</td>
<td>Existence, Completeness, and Accuracy</td>
</tr>
</tbody>
</table>
The six factors determining the reliability of evidence are:
1. Independence of provider
2. Effectiveness of client’s internal controls
3. Auditor’s direct knowledge
4. Qualifications of individuals providing the information
5. Degree of objectivity
6. Timeliness

<table>
<thead>
<tr>
<th>SITUATION</th>
<th>TYPE OF EVIDENCE THAT IS MORE RELIABLE</th>
<th>FACTOR AFFECTING RELIABILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Confirmation with business organizations</td>
<td>Qualifications of provider</td>
</tr>
<tr>
<td>2</td>
<td>Physically examine three-inch steel plates</td>
<td>Qualifications of provider (in this case the auditor)</td>
</tr>
<tr>
<td>3</td>
<td>Examine documents when several competent people are checking each other’s work</td>
<td>Effectiveness of internal controls</td>
</tr>
<tr>
<td>4</td>
<td>Examine inventory of parts for the number of units on hand</td>
<td>Degree of objectivity</td>
</tr>
<tr>
<td>5</td>
<td>Discuss potential lawsuits with CPA firm’s legal counsel</td>
<td>Independence of provider</td>
</tr>
<tr>
<td>6</td>
<td>Confirm a bank balance</td>
<td>Degree of objectivity</td>
</tr>
<tr>
<td>7</td>
<td>Confirm a bank balance</td>
<td>Independence of provider</td>
</tr>
<tr>
<td>8</td>
<td>Physically count the client’s inventory</td>
<td>Auditor’s direct knowledge</td>
</tr>
<tr>
<td>9</td>
<td>Physically count the inventory</td>
<td>Independence of provider and auditor’s direct knowledge</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PROCEDURE</th>
<th>a. APPROPRIATE TERM</th>
<th>b. TYPE OF EVIDENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Observe (j)</td>
<td>Observation</td>
</tr>
<tr>
<td>2</td>
<td>Compute (d)</td>
<td>Analytical procedure</td>
</tr>
<tr>
<td>3</td>
<td>Foot (f), Trace (g)</td>
<td>Recalculation and reperformance</td>
</tr>
<tr>
<td>4</td>
<td>Scan (b)</td>
<td>Analytical procedure</td>
</tr>
<tr>
<td>5</td>
<td>Inquire (k)</td>
<td>Inquiry of client</td>
</tr>
<tr>
<td>6</td>
<td>Confirm (l)</td>
<td>Confirmation</td>
</tr>
<tr>
<td>7</td>
<td>Count (i)</td>
<td>Physical examination</td>
</tr>
<tr>
<td>8</td>
<td>Examine (a), Compare (h)</td>
<td>Documentation</td>
</tr>
<tr>
<td>9</td>
<td>Recompute (e)</td>
<td>Recalculation</td>
</tr>
<tr>
<td>10</td>
<td>Read (c)</td>
<td>Documentation</td>
</tr>
</tbody>
</table>
The purposes of analytical procedures are:

1. Understanding the client's industry and business.
2. Assessment of the entity's ability to continue as a going concern.
3. Indication of the presence of possible misstatements in the financial statements.
4. Reduction of detailed audit tests.

Analytical procedures are required in the planning and completion phases of the audit because of their importance in planning the audit, and as a final review for potential misstatements. Auditors use analytical procedures extensively because of their relatively low cost and effectiveness in identifying potential misstatements.

The extent to which the auditor will use the results of analytical procedures to reduce detailed tests depends on the effectiveness of the analytical procedure and whether it supports the correctness of the recorded account balance. The effectiveness of the analytical procedure is a function of the precision of the expectation developed by the auditor and whether it is based on objective data.

In general, the audit schedule is not set up in a logical manner to show what the auditor wants to accomplish. The primary objective of the audit schedule is to verify the ending balance in notes receivable and interest receivable. A secondary objective is to account for all interest income, cash received and cash disbursed for new notes, collateral as security, and other information about the notes for disclosure purposes.

Specific deficiencies of the audit schedule presented in the question are included below.

<table>
<thead>
<tr>
<th>DEFICIENCY</th>
<th>IMPROVEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Tick mark explanation &quot;tested&quot; does not indicate specifically what was done.</td>
<td>Should have separate tick marks meaning: Agreed to confirmation Footed Traced to cash receipts journal Recomputed, etc.</td>
</tr>
<tr>
<td>2. Explanation of some tick marks is not given.</td>
<td>Explain all tick marks on the same page of the audit schedule.</td>
</tr>
<tr>
<td>3. Classification of long-term portion indicates no verification.</td>
<td>Recompute portions of notes that are long-term. Column should say &quot;date paid to&quot; and this should be confirmed.</td>
</tr>
<tr>
<td>4. Paid-to-date row is confusing.</td>
<td>Include due dates on the audit schedule for these notes.</td>
</tr>
<tr>
<td>5. Due dates are missing for J.J. Co., P. Smith, and Tent Co.</td>
<td></td>
</tr>
</tbody>
</table>

In general, the audit schedule is not set up in a logical manner to show what the auditor wants to accomplish. The primary objective of the audit schedule is to verify the ending balance in notes receivable and interest receivable. A secondary objective is to account for all interest income, cash received and cash disbursed for new notes, collateral as security, and other information about the notes for disclosure purposes.

Specific deficiencies of the audit schedule presented in the question are included below.

a. and b.
c. Spreadsheet Solution

The purpose of using an Excel spreadsheet in this problem is to give the student some experience in preparing a simple audit schedule using an Excel spreadsheet. It should be explained to students that this type of audit schedule may or may not be prepared in actual practice, and that often templates are used to prepare more time-consuming audit schedules. Also, whether or not tick marks are computerized is a matter to be decided. The advantage is that the completed audit work can then be stored and reviewed electronically. On the other hand, it may be more efficient to indicate audit work manually as it is performed, and a contrast in the color of the tick marks through use of a colored pencil may be desirable.

The following solution was prepared with Excel (Filename P738.xls). The formulas used are self-evident, so no listing is provided, although it is available on the Companion Website. Two items deserve comment:

1. An advantage of using a spreadsheet program for these types of analyses is that footing and crossfooting are done automatically.
2. When auditor tick marks are done by computer, a problem arises as to how to place them on the worksheet. One could use narrow columns inserted between the scheduled client data, or, as done here, the tick marks are placed in blank rows beneath the related data.
### Account #110 - Notes Receivable

<table>
<thead>
<tr>
<th>Maker</th>
<th>Date Made/ Due</th>
<th>Interest Rate/Date Paid to</th>
<th>Face Amount</th>
<th>Value of Security</th>
<th>Balance 12/31/09</th>
<th>Additions</th>
<th>Payments</th>
<th>Balance 12/31/09</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apex Co.</td>
<td>6/15/08 / 06/15/10</td>
<td>5% / None</td>
<td>5000</td>
<td>4000</td>
<td>0</td>
<td>1000</td>
<td>3000</td>
<td>104</td>
<td>175</td>
</tr>
<tr>
<td>Ajax, Inc.</td>
<td>11/21/08 / 12/31/09</td>
<td>5% / None</td>
<td>3591</td>
<td>3591</td>
<td>0</td>
<td>3591</td>
<td>0</td>
<td>24</td>
<td>102</td>
</tr>
<tr>
<td>J.J. Co.</td>
<td>11/1/08 / 12/31/09</td>
<td>5% / None</td>
<td>13180</td>
<td>12780</td>
<td>0</td>
<td>2400</td>
<td>10380</td>
<td>24</td>
<td>577</td>
</tr>
<tr>
<td>P. Smith</td>
<td>7/26/09 / 08/01/11</td>
<td>5% / None</td>
<td>25000</td>
<td>25000</td>
<td>0</td>
<td>25000</td>
<td>20000</td>
<td>0</td>
<td>468</td>
</tr>
<tr>
<td>Martin-Peterson</td>
<td>5/12/08 / 12/31/09</td>
<td>5% / None</td>
<td>2100</td>
<td>2100</td>
<td>0</td>
<td>2100</td>
<td>0</td>
<td>0</td>
<td>105</td>
</tr>
<tr>
<td>Tent Co.</td>
<td>9/3/09 / 11/30/09</td>
<td>6% / None</td>
<td>12000</td>
<td>12000</td>
<td>0</td>
<td>1600</td>
<td>10400</td>
<td>0</td>
<td>162</td>
</tr>
<tr>
<td></td>
<td>($200/Mo.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>($1000/Mo.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>($400/Mo.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

|                  |                  |                            |             |                    |                   |           |          |                  |          |
|                  |                  |                            |             |                    |                   |           |          |                  |          |
|                  |                  |                            |             |                    |                   |           |          |                  |          |
|                  |                  |                            |             |                    |                   |           |          |                  |          |

- **Legend of Auditor's Tick Marks**
  - *f* Footed
  - *cf* Crossfooted
  - **Tp** Traced to prior year audit files
  - **wtb** Traced total to working trial balance
  - **op** Traced total to operations audit schedule - OP6
  - * Examined note for payee, made and due dates, interest rate, face amount, and value of security. No exceptions noted.
  - *c* Received confirmation, including date interest paid to, interest rate, interest paid during 2009, note balance, and security. No exceptions noted.
  - *r* Traced to cash receipts records
  - < Recomputed for the year
Cases

7-39 The following are deficiencies in the sufficiency and appropriateness of the evidence in the audit of accounts payable for Grande Stores:

McClure Advertising Credits – An insufficient number of confirmations (four) were sent. The use of alternative procedures is probably acceptable. However, one credit was confirmed by telephone, rather than by written confirmation. Although the differences found were immaterial, the auditors should have determined the reason for the differences, and any errors should have been projected to the population.

Twenty additional credits were selected for testing. Whether this is a sufficient number is a matter of judgment, and depends on several factors. With a fairly small sample, it is critical that the items selected for testing adequately represent the population. The testing relied on internal documentation, which is insufficient to support the credits. The placing of the ad is insufficient evidence without supporting evidence from the vendor supporting the reduction in accounts payable.

Springbrook Credits – These credits were confirmed by telephone, and were not supported by a written confirmation. The staff auditor was suspicious of the client’s willingness to allow written confirmation of the amounts, as well as the client’s changing explanation of the nature of the credits, but did not perform additional testing to resolve any doubts about the validity of the credits.

Ridolfi Credits – The auditor obtained an oral confirmation that these credits were not valid. The client indicated that the auditor’s information was incorrect, but would not allow the auditor to obtain written confirmation for these credits. In addition, the credit memos had been altered, which should have further indicated to the auditor that the credits were not valid.

Accounts Payable Accrual – The auditors sent 50 accounts payable confirmations. Whether this is a sufficient number of confirmations is a matter of auditor judgment. However, the adequacy of the confirmations as evidence is significantly undermined by the knowledge that the client told suppliers how to respond. As a result, the auditor should have verified the confirmed balances using alternative procedures. There is no discussion of the performance of alternative procedures for nonresponses, or the resolution of the six responses that were not reconciled to Grande’s records.

The auditors agreed to an adjustment of $260,000 when their cutoff tests indicated a potential liability of $500,000. It would be appropriate for the auditors to agree to a lower amount only if additional testing supported a lower accrued liability.
The audit schedule contains the following deficiencies:

1. There is no indication of follow-up on the identified error in the accrued interest payable computation.
2. There is no indication whether the confirmation exception was resolved.
3. The loan with an unwaived violation of a provision of the debt agreement is misclassified as long-term.
4. The liability activities of Lender's Capital Corp. and the audit schedule totals do not crossfoot.
5. There is no indication of cross-referencing of the stockholder loan to the related party transactions audit schedule.
6. There is no investigation of the payment on the stockholder loan that was reborrowed soon after year-end.
7. There is no consideration of the need to impute interest on the 0% stockholder loan.
8. There is no indication that the dates under "interest paid to" were audited.
9. There is no indication that the unusually high average interest rate ($281,333/$1,406,667 = 20%) was noted and investigated.
10. The audit schedule does not support the overall conclusions expressed.
11. The tick mark "R" is used but not explained in the tick mark legend.
12. There is no indication that the audit schedule was prepared by client personnel.

7-41 – ACL Problem Solution

a. There are 44 payroll transactions in the Payroll file. *(This is determined by reading the number at the bottom of the screen.)*

b. The largest and smallest gross pay amounts for September are $4,395.83 and $1,278.33, respectively. *(Use Quick Sort.)*

c. Total gross pay for September was $99,585.46. *(Use the Total command.)*

d. The report on the following page shows gross pay by department. *(Use the Summarize command on the Gross Pay column, save to a file, and print.)* Note that this screenshot was produced using the "Screen" option in the Output tab of the Summarize window. Students' hardcopy printouts will appear slightly different, but will contain the same departmental totals.
Report for requirement d:

<table>
<thead>
<tr>
<th>Work Dept</th>
<th>Gross Pay</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>A00</td>
<td>17,020.83</td>
<td>5</td>
</tr>
<tr>
<td>B01</td>
<td>3,437.50</td>
<td>1</td>
</tr>
<tr>
<td>C01</td>
<td>9,007.49</td>
<td>4</td>
</tr>
<tr>
<td>D11</td>
<td>23,051.69</td>
<td>11</td>
</tr>
<tr>
<td>D21</td>
<td>14,973.34</td>
<td>7</td>
</tr>
<tr>
<td>E01</td>
<td>3,347.92</td>
<td>1</td>
</tr>
<tr>
<td>E11</td>
<td>9,782.50</td>
<td>6</td>
</tr>
<tr>
<td>E21</td>
<td>16,401.69</td>
<td>8</td>
</tr>
<tr>
<td>E83</td>
<td>1,662.50</td>
<td>1</td>
</tr>
<tr>
<td>Totals</td>
<td>99,585.46</td>
<td>44</td>
</tr>
</tbody>
</table>

- There are no exceptions in the calculation of net pay for September. (Use the following Filter: Gross Pay – Taxes <> Net Pay.)
- There are no duplicate check numbers. (Use the Duplicates command on the check [cheque] number column). There are four missing checks (#12389 - #12392). The audit concern is that there may be unrecorded payroll transactions. (Use the Gaps command on the check [cheque] number column.)

**Internet Problem Solution: Use of Audit Software for Fraud Detection and Data Quality Assurance**

7-1 The use of audit software has increased dramatically in recent years. Software is now used to fulfill administrative functions in the audit environment, document audit work, and conduct data analysis. While some accounting firms use internally-developed software, other firms purchase software from vendors such as ACL and Audit Analytics. When technology is properly used auditors are
Internet Problem 7-1 (continued)

able to focus their efforts on understanding their client and the related accounting and auditing issues. Visit ACL’s website [http://www.acl.com/] to learn more about the various software tools available for use in the audit environment.

1. Read about ACL’s solution for data quality and fraud detection. How might an auditor use ACL’s data analytics software for these two purposes?

Answer:
Because companies generate very large amounts of data and use different information systems to generate that data, auditors must be able to overcome these potential constraints. ACL has the ability to handle huge volumes of data that are generated by various operating systems, database structures, and enterprise applications (e.g. ERP, CRM, SCM, and BI systems). After data are captured, ACL can be used to independently test, reconcile, and validate transactional data. If performed manually, these types of procedures can take extraordinary amounts of time. ACL can also be used for fraud detection purposes. ACL can identify trends, generate exception reports, and highlight potential areas of concern. Auditors can then use the information from the various analyses and conduct further audit procedures to determine whether a fraud has occurred.

2. How might ACL be used by a company to comply with the requirements related to internal control over financial reporting? Hint: Take a look at ACL’s Continuous Controls Monitoring (CCM) software.

Answer:
ACL’s CCM software provides an independent mechanism to automatically monitor internal controls effectiveness within key business processes. Also, CCM uses analytics and embedded audit "best practices" in business operations so that management receives timely notification of unusual patterns and control breaches. According to ACL, the benefits of CCM include:

- Independent testing of controls through transaction analysis at the source level
- Timely notification to management of controls breakdowns enabling control weaknesses to be fixed before they are reported externally
- Fraud reduction and improved risk management through identification of control gaps and weaknesses that can lead to error, abuse and fraud
Internet Problem 7-1 (continued)

- Improvements to operational efficiency and effectiveness
- Extensibility to multiple end-to-end business processes with independent assurance of controls effectiveness and transaction integrity across the enterprise

(Note: Internet problems address current issues using Internet sources. Because Internet sites are subject to change, Internet problems and solutions may change. Current information on Internet problems is available at www.pearsonhighered.com/arens.)