AUDITING (AUD)
CPALE Concept Notes

AUDIT EVIDENCE
Source: CPAR Lecture (Sir G. Roque), REO Live (Sir George) and Pre-Recorded (Sir Escala)

Topics Covered:

1. *Theory on Auditing and Attestation Services*
   - 1.4. *Audit Objectives, Procedures, Evidences, and Documentation*
     - 1.4.1. *Nature and significance*
     - 1.4.2. *Evidential matters*
     - 1.4.3. *Audit procedures/techniques*
2. *Auditing Practice*
   - 2.4. *Audit Communication and Reporting*
     - 2.4.2. *Evaluating audit evidence*

PSA 500 – Audit Evidence

Audit Procedures

- Primarily performed ***to gather evidence to support the audit opinion***
- Must *first set audit objectives* ***based on management assertions***, which *does not necessarily require a one-to-one relationship* with audit procedures
- ***Cost or difficulty*** is not a valid justification to omit certain required procedures:
  - Look for ***alternative procedures***
  - If none, ***perform the procedure regardless***

Risk Assessment Procedures
- *To obtain an **understanding** of the entity and its environment, including its internal control, to **assess ROMM***

Test of Controls
- *To test the **operating effectiveness of controls** in preventing or detecting and correcting material misstatements at the assertion level*

Substantive (Further Audit) Procedures
- *To **detect material misstatements** at the assertion level, including tests of details and analytical procedures*
- *Dependent on the level of detection risk*

Detection Risk	Substantive Tests
High	- Less effective procedures - Smaller sample size - At interim or several dates
Less than High	- More effective procedures - Larger sample size - Closer or nearer to year-end

a. *Test of Details*
- *Test of Transactions and Events*
  - *Items **causing the movement** of account balances*
  - *Income statement (I/S) accounts*
  - ***Small volume**, but **material amounts** of transactions*
  - *Most effective; Least efficient*
- *Test of Balances*
  - *Items comprising the **ending balance** of accounts*
  - *Balance sheet (B/S) accounts*
  - ***Large volume**, but **immaterial amounts** of transactions*
  - *Less effective; More efficient*

b. *Analytical Procedures*
- *Not required as substantive test; **Optional***
- *Upon identification of fluctuations or inconsistent relationships, the auditor shall inquire to the management and obtain appropriate evidence relevant to management response, and perform other procedures as necessary*
- *Least effective; Most efficient*

Applicable Audit Procedures in Each Stages

	RAP	TOC	ST / FAP
Inquiry	✓	✓	✓
Inspection	✓	✓	✓
Observation	✓	✓	✓
Analytical Procedures	✓	✗	✓ *(Optional)*
Reperformance	✗	✓	✗
Confirmation	✗	✗	✓
Recalculation	✗	✗	✓

- ***Inquiry** – Seeking financial and non-financial information from knowledgeable persons within or outside the entity*
- ***Inspection** – Physical examination of assets, or examining records or documents*
- ***Observation** – Looking at a process or procedures being performed by others*

AUDIT EVIDENCE
- Information used by the auditor ***to arrive at conclusions*** on which the opinion is based
- Includes information contained in the following:
  - ***Accounting Records*** *(Underlying the FS)*
    - Journals
    - Ledgers
    - Worksheets
    - Adjusting Journal Entries
    - Supporting Documents *(Cost Allocations, Computations, Reconciliations, Disclosures)*
    - Source Documents *(Invoices, Contracts, Checks, Records of Electronic Fund Transfers)*
  - ***Other Information*** *(Corroborating)*
    All others, including the following:
    - Minutes of meetings
    - Third-party confirmations
    - Analyst's reports
    - Comparable data about competitors *(benchmarking)*
    - Controls manuals
    - Those gathered by auditor by performing procedures

Attributes of Audit Evidence

A. SUFFICIENT
- ***Quantity***; being enough
- A matter of *professional judgment*, considering ROMM assessment and efficiency
- ***Directly related*** to the ROMM
- Not necessarily inversely related, but ***only interrelated with appropriateness or quality*** of evidence

Higher Quality Evidence	Less Quantity Needed
Lower Quality Evidence	***NOT Offset nor Compensated*** by More Quantity • Must look for other appropriate evidence

To be sufficient, it must be a ***combination of BOTH accounting records and other information***

More than Sufficient	May be ***inefficient***
Insufficient	May be ***ineffective***

Means of Gathering Evidence

I. 100% Testing
- Population consists a ***small number of large value items***
- ***Significant ROMM***, and other methods do not provide sufficient appropriate evidence *(including suspected fraud)*
- Process ***performed automatically*** by client's CIS or with CAATs

II. Selecting Specific Items
May include:
- High value or key items
- All items over a certain amount
- Items to obtain certain information *(including to test control)*

- The results of audit procedures applied to selected items **cannot** be projected to the entire population *(Specific Conclusion only)*

III. Audit Sampling
- Less than 100% of items, but ***all items have a chance to be selected***
- Generalized conclusion can be applied *(Representative of the whole)*

B. APPROPRIATE

- **Quality or competence** of evidence
- **Relevance**
  - Audit procedures performed must be <u>based on the **assertions** and **audit objectives**</u>
- **Reliable** *(Persuasive, Validity, or Dependability)*
  - Does not need to be conclusive
  - Consider the source, nature, and individual circumstances under which the evidence is obtained

Generalizations about Reliability

- **External *(Independent)* Sources** over Internal *(Within)*
  - *If both are external, choose the one that is **<u>Purely External</u>**, meaning, obtained DIRECTLY by the auditor from the outsiders*
- **Effective Internal Controls** over Weak Internal Controls
- **Directly Obtained** over Obtained by Inference
- **Documentary Form *(Written)*** over Oral Representations
- **Original Documents** over Photocopies or Facsimiles

Substantive Tests

- *Dependent on Detection Risk*

ROMM *(IR x CR)*	***Detection Risk***	***Substantive Test***
High	Less than High	• More Effective Procedures • Larger Sample Size • Nearer to Year-End
Less than High	High	• Less Effective Procedures • Smaller Sample Size • At Interim or Several Dates

A. <u>TEST OF DETAILS</u>

1. ***Test of Transactions and Events***
   - Items causing the ***movement of account balances***
   - *<u>Income Statement</u>* accounts
   - Transactions of *<u>small volume, but material amounts</u>*
   - Most effective, but least efficient
2. ***Test of Balances***
   - Items comprising the ***ending balance of accounts***
   - *<u>Balance Sheet</u>* accounts
   - Transaction of *<u>large volume, but immaterial amounts</u>*
   - Less effective, more efficient

B. <u>ANALYTICAL PROCEDURES</u> (Optional, Not Required as ST)

- Evaluates the reasonableness of financial information and the ***plausibility of relationships***
- Upon identification of fluctuations or inconsistent relationships, the auditor must *<u>inquire to the management</u>* and *<u>obtain appropriate evidence</u>* relevant to the management's response, and perform other procedures as necessary
- Least effective, but most efficient

PSA 501 – Specific Considerations

Items for Specific Consideration	Auditor's Primary Concern
Inventory	Existence and Condition
Litigation and Claims	Completeness
Segment Information	Presentation and Disclosure

<u>INVENTORY</u>

The auditor must

- Perform audit procedures over final inventory records as to **accuracy** with the actual inventory count results
- Attend ***physical inventory count***
  - To evaluate management's instructions and procedures for recording and controlling results of physical count
  - To observe the performance of the count procedures
  - To inspect the inventory
  - To perform test counts *(as to possible overstatements)*

<u>XPN:</u> Unless impracticable

- Perform ***alternative audit*** procedures
  - If not possible to do so, issue a qualified or disclaimer of opinion

If unable to attend original schedule of count

- Request reschedule on an alternative date, and perform audit procedures on intervening transactions

Inventory under Third Party's Custody or Control

Auditor shall perform either of the following:

- ***Confirmation*** as to quantities and condition
- ***Inspection***, if practical, or other audit procedures appropriate

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<u>LITIGATION AND CLAIMS</u>

- *Primary **Source of Information** – Management*
- *Primary **Source of Corroborating Evidence** – Attorney Confirmations*

Audit Procedures:

- ***Inquiry*** of management, and in-house legal counsel if applicable
- Review ***minutes of meetings*** of TCWG and ***correspondence*** between the entity and its external legal counsel
- Review *<u>legal expense accounts</u>*
- Seek ***direct communication*** with entity's external legal counsel through a *<u>letter of general inquiry</u>*
  - ***Only if*** *auditor assessed a **ROMM regarding litigation and claims**, or audit procedures performed indicate that **other material litigation or claims may exist***
  - *Prepared by the management, but sent by the auditor*

Letter of Audit Inquiry

Letter of General Inquiry	Requests information to the entity's external counsel as to • Any litigation and claims he is aware of • ***Assessment of outcome*** of the litigation and claims • Estimate of the ***financial implications***, including costs involved
Letter of Specific Inquiry	If external legal counsel is ***unlikely to respond*** *Includes:* • List of litigation and claims • Management's assessment of outcome of each and its estimate of financial implications and costs • A request that external counsel ***confirm the reasonableness of management's assessment***, and provide auditor with further information if the list is incomplete or incorrect

- The auditor must consider the status of legal matters ***<u>up to the date of auditor's report</u>***
- ***Management's refusal to give permission*** to communicate with the entity's lawyer, and the ***lawyer's refusal to respond*** to a letter of audit inquiry constitutes a <u>scope limitation</u>, normally resulting to a ***qualified or adverse opinion***

<u>SEGMENT INFORMATION</u>

Audit Procedures

- Obtain understanding of ***methods*** used by management
- Evaluate the ***compliance*** to applicable frameworks of the method's results
- Test the ***application*** of such methods, where appropriate
- Perform analytical procedures and other appropriate audit procedures

PSA 505 – External Confirmations

EXTERNAL CONFIRMATION

- Direct written response to the auditor by a third party
- ***Prepared*** and signed by the client's appropriate level of ***management*** *(auditor may provide template)*
- Sent and ***received*** directly ***by the auditor***
- Verifies certain management assertions

Assets	Existence and Rights
Liabilities	Completeness and Obligations

Blank Confirmations

- Use of *blank forms*, wherein confirming party must indicate the exact amount
- Less efficient than positive confirmation, as it likely to result to ***more non-responses***

Positive and Negative Confirmation

	Positive Confirmation	Negative Confirmation
When Required to Respond?	Always *(Agree or Disagree)*	Only when Disagree
Instances Preferred or Applicable	• Few transactions, but with ***larger balances*** • Ineffective internal controls • ***High*** Control Risk • ***Low*** Detection Risk • ***High*** ROMM • Existence of specific ***fraud risk factors*** • Unlikely to respond • Substantial number of amounts may be in dispute • Information ***only available outside*** the entity	• Many transactions, but with ***small balances*** • Effective internal controls • ***Low*** Control Risk • ***High*** Detection Risk • ***Low*** ROMM • Ideal respondent profile and ***likely to respond*** • Small number of accounts may be in dispute • Information ***available within and outside*** the entity
Effectiveness or Efficiency	More ***Effective***	More ***Efficient***

Non-Response in a Positive Confirmation

- *First Option*: Send a ***second request***
- *Second Option*: Perform ***alternative procedures***

  In ***general***:
  - Examine **subsequent** receipts, collections, or payments *(applies to both receivables and payables)*
  - Examine supporting documents *(shipping documents, invoices)*

  If pertaining to ***cash-in-bank***:
  - (1) Inspect bank statement; (2) Audit bank reconciliation

  If pertaining to ***inventory with consignee***:
  - (1) Site visit; (2) Inspect remittance report

Search for Unrecorded ***Retirement*** *of Assets*	Start with the ***books (records)***, followed by touring the facilities
Search for Unrecorded ***Acquisition*** *of Assets*	Start with a ***tour of facilities***, followed by inspecting the books *(records)*

Non-Response in a Negative Confirmation

- *Conclude that confirming party is in agreement*
- *Perform alternative procedures only if necessary*

Client Refusal

Evaluate the reasonableness of refusal and perform alternative procedures

Alternative Procedures are ***Available***	Perform Procedures to Obtain Evidence
Alternative Procedures are ***Not Available***	Scope Limitation

Response with Exception or Difference

By maintaining a neutral assumption, investigate first the exceptions if indicative of misstatements or not (do not assume as misstatement already)

- **Response Deemed Unreliable**
  Obtain further audit evidence to resolve doubts about the reliability of the response

PSA 540 – Auditing Accounting Estimates

- ***Management*** is the one ***responsible*** for making accounting estimates
- When accounting estimates are involved, the ***ROMM is higher***
- Thus, the auditor shall obtain sufficient appropriate evidence that the accounting estimates are:
  - ***Reasonable***
    - *Objective and not susceptible to bias*
    - *Consistent with historical patterns (as to application)*
    - *Consistent with industry guidelines*
  - ***Properly Accounted for and Appropriately Disclosed***

    In line with such, the auditor should ***pay particular attention*** *to assumptions that are:*
    - *Subjective*
    - *Inconsistent with historical patterns and/or industry guidelines*
    - *Susceptible to material misstatement*

AUDIT PROCEDURES INVOLVED

Risk Assessment

- Understanding the entity and its control over estimates
- Perform ***retrospective review***
- Determine specialized skill or knowledge required
- Obtain ***knowledge*** about the *applicable financial reporting standards* related to the accounting estimate
- Identify and ***assess ROMM***

Evidence Gathering (FAP)

- Review and test ***how management made or developed the estimates***
- Develop ***auditor's point estimate or range***, and *compare with the management's point estimate*
- Obtain ***evidence from subsequent events*** and regarding related disclosures
- Evaluate the audit procedures, evidence, and request management written representations