Course: Financial Audit

Lecture 12: Audit Evidence and Audit Reports

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Lecture 11’s Overview

Audit Evidence

- Evidence encompasses any data or information that auditors use to assess if the information being audited aligns with established standards or criteria. This evidence can vary significantly in its persuasiveness regarding whether financial statements are presented fairly.
- The concept of using evidence extends well beyond the auditing profession; scientists, lawyers, and historians also heavily rely on evidence. Similarly, auditors collect evidence as a key part of their work.

Audit Evidence

- Auditors make four primary decisions in evidence collection:
  - Selecting specific audit procedures to carry out
  - Determining the sample size for each procedure
  - Deciding which items from the overall population to include in the sample
  - Choosing the timing for conducting these procedures

Audit Evidence

- Audit procedures are specific, detailed instructions on the type of audit evidence to be collected during an audit. These procedures are usually described in enough detail that any auditor can follow them accurately throughout the audit process.
- After defining the audit procedure, auditors can adjust the sample size according to the scope of items in the population being tested. This sample size decision is tailored to each audit, considering factors like the client's automated controls and the level of certainty required by the audit.

Audit Evidence

- Once the sample size for a procedure is set, the auditor determines which items from the population to examine. For instance, in selecting 50 disbursements from 6,600 recorded transactions, the auditor might use several selection methods. These could include (1) examining the first 50 transactions in a selected week, (2) focusing on the 50 highest-value transactions, (3) randomly selecting items, or (4) selecting transactions that the auditor suspects may contain errors. Often, a combination of these approaches is employed to ensure a representative and thorough sample.
- Financial statement audits typically cover a set period, such as a fiscal year. The audit is usually completed several weeks or even months after the period ends. The timing of the audit procedures can vary, ranging from early in the fiscal period to well after its conclusion. Timing considerations are partly determined by the client's desired completion date.

Audit Evidence

- An audit program refers to the collection of audit procedures created for an audit area or an entire audit engagement. This program always lists the necessary audit procedures and typically includes sample sizes, the items to be selected, and the timing for each test.
- Audit standards stipulate that auditors must gather enough appropriate evidence to support the opinion they express in the audit report. Given the inherent limitations of audit evidence and the cost of extensive auditing, it’s rare for auditors to be absolutely certain that their opinion is entirely correct.

Audit Evidence

- Appropriateness refers to the quality of evidence, particularly its relevance and reliability in meeting audit objectives for transactions, account balances, and disclosures. When evidence is highly appropriate, it strengthens the auditor's confidence in the fairness of the financial statements. Importantly, appropriateness pertains solely to the chosen audit procedures and cannot be enhanced by increasing the sample size or choosing different items from the population.

- For evidence to be deemed appropriate, it must be directly related to the specific audit objective that the auditor is testing.

- For instance, if an auditor suspects that a client may not be billing customers for certain shipments (related to the completeness objective), a relevant approach would be to trace a simple of shipping documents to corresponding sales invoices.

Audit Evidence

- Reliability refers to the credibility or trustworthiness of the evidence. Just as relevance enhances the persuasiveness of evidence, so does reliability in helping the auditor assess the fairness of financial statements.
- Six key factors influence the reliability of evidence:
  - Independence of provider
  - Effectiveness of client's internal controls
  - Auditor's direct knowledge
  - Qualifications of the provider
  - Degree of objectivity
  - Timeliness

Audit Evidence

- The sufficiency of audit evidence is largely influenced by the quantity gathered. For some audit objectives, sufficiency is measured primarily by the sample size selected by the auditor; generally, a sample of 100 items offers more sufficient evidence than a sample of 50.
- The persuasiveness of audit evidence can be assessed only by considering both its appropriateness and sufficiency, including all factors that affect these two aspects. Evidence from a large sample provided by an independent source lacks persuasiveness if it is irrelevant to the audit objective being tested. Similarly, evidence that is highly relevant but lacks objectivity is also not persuasive. A small sample of highly appropriate evidence alone may not be sufficiently persuasive.

Audit Evidence

- When deciding on audit evidence, auditors must consider both the persuasiveness of the evidence and the associated costs. Often, there is more than one type of evidence available to verify information.
- Auditors can choose from eight broad categories of evidence, known as types of evidence, for gathering information. Each audit procedure involves one or more of the following evidence types:

1. Physical examination
2. Confirmation
3. Inspection
4. Analytical procedures
5. Inquiries of the client
6. Recalculation
7. Reperformance
8. Observation

Audit Evidence

- Physical examination refers to the auditor’s direct inspection or counting of a tangible asset. This type of evidence is commonly applied to items like inventory and cash but also extends to verifying securities, notes receivable, and physical fixed assets.
- Confirmation involves obtaining a direct written response from a third party to verify information requested by the auditor. This response can arrive in various forms. The auditor requests the client to have the third party send a response directly to the auditor.

Audit Evidence

- Inspection involves the auditor's examination of the client's documents and records to confirm information that should appear in the financial statements.
- Documents fall into two primary categories (internal and external). Internal documents originate within the client's organization and are retained without ever leaving the company. External documents, on the other hand, involve a third party in the transaction.
- The reliability of documentary evidence largely depends on whether the document is internal or external, and if internal, whether it was created and processed under strong internal controls.

Audit Evidence

- External documents, having passed through both the client and a third party, provide some assurance that both parties agree on the information and conditions stated within.
- When auditors use documentation to support recorded transactions or amounts, the process is known as vouching.

Audit Evidence

- Auditing standards define analytical procedures as assessments of financial information through the examination of reasonable relationships between financial and non-financial data.
- As part of audit planning, auditors must become familiar with the client’s industry and business operations. Conducting analytical procedures that compare the current year's unaudited data with prior years’ audited information or with industry averages enables auditors to identify notable changes.
- Analytical procedures also help auditors evaluate whether a company faces financial challenges.

Audit Evidence

- Significant, unexpected differences between current unaudited financial data and comparative figures are known as unusual fluctuations. These discrepancies can occur when an unexpected difference is present or when an anticipated difference is absent.
- When a predictable relationship exists between data points and the analytical procedure relies on dependable inputs, it can provide substantive evidence to support recorded balances.
- Inquiries involve gathering written or verbal information from the client through auditor-posed questions. While inquiry is commonly used for evidence collection, it is often insufficient on its own since responses are not from an independent party and may reflect the client's bias.

Audit Evidence

- Recalculation involves verifying the mathematical accuracy of figures provided by the client. It includes recalculating totals for sales invoices, inventory, journals, and subsidiary records, and validating computations for depreciation and prepaid expenses.
- Reperformance is the auditor’s independent testing of specific client accounting procedures or controls, which were part of the client’s internal control system. While recalculation checks numerical accuracy, reperformance evaluates procedural accuracy.
- Observation entails watching processes or procedures performed by others. Auditors might tour facilities for an overview or observe accounting staff to ensure task adherence.

Audit Evidence

- Physical examination and confirmation are the most costly evidence types due to the need for auditor presence (as with asset counts on the balance sheet date) and the complexity of confirmation processes, especially when managing responses and follow-up for nonresponses.
- The least expensive forms of evidence include observation, client inquiries, and recalculation. Observation usually occurs alongside other procedures, as when auditors observe inventory counting while also physically examining sample items. Inquiries are routine and low-cost, although some inquiries may incur higher expenses, such as when formal client statements are required. Recalculation is generally inexpensive, often aided by software for efficient completion of calculations and tracing.

Audit Reports

- Audit and assurance engagement reports are vital as they communicate the auditor's findings and conclusions. These reports give financial statement users confidence in the accuracy and reliability of the company’s financial information.
- The audit report represents the final step in the auditing process. Understanding its structure early on enhances comprehension of audit evidence, as the evidence gathered directly impacts the report’s form and content.
- To ensure clarity and consistency, AICPA auditing standards specify standardized language for audit reports. The PCAOB and AICPA recently introduced new standards to make audit reports more informative by detailing management and auditor responsibilities, especially for high-risk areas that require substantial judgment.

Audit Reports

- The standard unmodified opinion audit report consists of eight main components:
  - Report title
  - Audit report address
  - Basis for opinion
  - Management’s responsibility
  - Auditor’s responsibility
  - Signature and address of CPA firm
  - Audit report date
- International auditing standards and PCAOB auditing standards require the communication of “key audit matters” (KAMs) or “critical audit matters” (CAMs) in the standard unmodified audit report.

Audit Reports

- The standard unmodified opinion audit report is issued when several conditions are met:
  - The financial statements, including the balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows, along with all required disclosures, are included in the financial statements.
  - Sufficient appropriate audit evidence has been gathered, and the auditor has conducted the audit in accordance with applicable auditing standards, ensuring that the audit was performed effectively.
  - The financial statements are presented fairly in all material respects in accordance with U.S. generally accepted accounting principles (GAAP) or other applicable accounting frameworks.
  - There are no circumstances that would require the addition of an emphasis-of-matter paragraph or any modification of the auditor's opinion or the report's wording.

Audit Reports

- The PCAOB reporting standard has recently been updated to provide more comprehensive information about the audit process. There are two notable differences in audit reporting for public companies compared to nonpublic companies.
- PCAOB standards refer to the standard unmodified opinion audit report as an "unqualified opinion" audit report.

Audit Reports

- PCAOB auditing standards define a critical audit matter as "any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment." Determining critical audit matters involves significant judgment by the auditor.

Audit Reports

- When determining whether a matter "involved especially challenging, subjective, or complex auditor judgment," the auditor would likely consider several factors:
  - The auditor's assessment of the risks of material misstatement, particularly significant risks that may affect the financial statements.
  - The extent of auditor judgment required in areas involving significant management estimation or judgment, such as areas with substantial measurement uncertainty in estimates.
  - The nature and timing of significant, unusual transactions, including the level of audit effort and judgment necessary to address these transactions.
  - The degree of subjectivity involved in the application of audit procedures to resolve the matter or in evaluating the results of those procedures.
  - The level of audit effort required to address the matter, including the need for specialized knowledge or skills, or consultations with experts outside the engagement team.
  - The type of audit evidence obtained in relation to the matter, including whether it required unique or more extensive procedures.

Audit Reports

- The PCAOB expects that in most audits, the auditor will identify at least one matter involving especially challenging, subjective, or complex judgment. If no critical audit matters (CAMs) are identified, this conclusion must be disclosed in the audit report. For each critical audit matter communicated, the auditor must:
  - Identify the matter as a critical audit matter.
  - Explain the principal considerations that led to the conclusion that the matter qualifies as a critical audit matter.
  - Describe how the critical audit matter was addressed in the audit process.
  - Reference the relevant financial statement accounts or disclosures that relate to the critical audit matter.

Audit Reports

- PCAOB auditing standards allow, but do not require, the disclosure of the audit engagement partner’s name in the audit report. Similarly, the names of other accounting firms that participated in the audit may also be disclosed.
- PCAOB auditing standards require the audit of internal control to be integrated with the audit of the financial statements. However, auditors may choose to issue separate reports, such as a separate report on internal control over financial reporting, or a combined report that covers both the financial statements and internal control.

Audit Reports

- While a combined report is allowed, the separate report on internal control is more common and typically includes the following elements:
  - The title includes the word “independent.”
  - The Opinion section, presented first, refers to the framework used to evaluate internal control and provides the auditor’s opinion on its effectiveness.
  - The next paragraph references the auditor’s separate report on the financial statements.
  - The Basis for Opinion section first highlights management’s responsibility and references the separate report containing management’s assessment of internal control.
  - A section after the Basis for Opinion paragraph defines internal control over financial reporting.
  - A concluding paragraph addresses the inherent limitations of internal control.

Audit Reports

- In certain situations, an unmodified opinion audit report may be issued, but it deviates from the standard wording. This occurs when the auditor believes it is important to draw attention to specific matters or is required to provide additional information.
- The main causes for the inclusion of an emphasis-of-matter paragraph or modification in the wording of a standard unmodified opinion audit report under both AICPA and PCAOB standards include:
  - Lack of consistent application of generally accepted accounting principles (GAAP).
  - Auditor agreement with a departure from established accounting principles.
  - Substantial doubt about the company’s ability to continue as a going concern.
  - Emphasis of other matters, which may include significant disclosures or issues.
  - Reports involving other auditors, where the work of other auditors is involved in the audit.

Audit Reports

- Auditing standards require the auditor to highlight situations where accounting principles have not been consistently applied between the current and preceding periods. Generally accepted accounting principles (GAAP) stipulate that changes in accounting principles or their methods must be to a preferable principle and that the nature and impact of the change must be fully disclosed.

Audit Reports

- In certain situations, a CPA may wish to emphasize specific matters related to the financial statements while still expressing an unmodified opinion. This type of explanatory information should generally be included in a separate paragraph within the audit report. Examples of matters the auditor may highlight include:
  - The existence of material related-party transactions
  - Significant events occurring after the balance sheet date
  - Descriptions of accounting matters that affect the comparability of the financial statements with those of the prior year
  - Material uncertainties disclosed in the footnotes, such as significant litigation or regulatory actions
  - A major catastrophe that has had, or continues to have, a substantial effect on the entity's financial position

Audit Reports

- CPAs often rely on other CPA firms to conduct parts of an audit when the client has extensive operations. Under PCAOB auditing standards, the primary auditor issuing the opinion on the financial statements is referred to as the principal auditor, while under AICPA auditing standards, this individual is called the group engagement partner.
- When a CPA firm depends on another firm to perform part of the audit, the primary auditor has three options, with only the second option leading to an unmodified opinion audit report with modified wording:
  - Make no reference in the audit report
  - Make reference in the report
  - Qualify the opinion

Audit Reports

- It is crucial for auditors and users of audit reports to understand when an unmodified opinion is inappropriate and what type of audit report should be issued in those situations.
- In cases where an audit report deviates from the unmodified opinion, three closely related issues arise: the conditions requiring a modification to the opinion, the types of opinions issued other than unmodified, and the concept of materiality.
  - Scope limitation
  - GAAP departure
  - Lack of independence

Audit Reports

- Materiality plays a key role in deciding the type of opinion to issue. If a misstatement is immaterial, meaning it does not affect the financial statements significantly, an unmodified opinion may be issued. For example, small misstatements like expensing office supplies rather than reporting them as inventory may be immaterial.
- On the other hand, when misstatements are significant enough to materially affect the financial statements as a whole, a qualified, adverse, or disclaimer opinion is required, depending on the nature of the issue (scope limitation or GAAP departure).

Audit Reports

- The common definition of materiality in accounting and audit reporting is: A misstatement is considered material if knowledge of the misstatement would influence a reasonable user's decision regarding the financial statements.
- In applying the concept of materiality, auditors use three levels to determine the type of opinion to issue:
  - Amounts are immaterial
  - Amounts are material but do not overshadows the financial statements as a whole
  - Amounts are so material or pervasive that overall fairness of the statements is in questions

Audit Reports

- Auditors follow a well-defined process for determining the appropriate audit report in any given set of circumstances.
- This process involves assessing whether any conditions require a departure from the standard unmodified opinion, evaluating the materiality and pervasiveness of the condition, and determining the type of report to issue:
  - Determine Whether Any Condition Exists Requiring a Departure From a Standard Unmodified Opinion
  - Decide the Materiality for Each Condition
  - Decide the Appropriate Type of Report for the Condition
  - Inclusion of Key Audit Matters or Critical Audit Matters

Audit Reports

- In some situations, multiple conditions may require departures from the standard unmodified opinion, or revisions to the report wording. In such cases, the auditor must modify their opinion for each condition unless one condition neutralizes the effect of another.
- For instance, if a scope limitation exists along with an independence issue, the auditor would generally not need to disclose the scope limitation if the independence issue renders the opinion qualified.

Conclusion & Closing

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Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014