

Solutions to Student Self Assessment Questions

Chapter 6

The search for evidence explained

Questions

6.1 Consider the truth or falsity of the following statements:

- (a) Sufficient evidence for the auditor means having enough to form a conclusion that an assertion made by management may be accepted.
- (b) Relevant evidence for the auditor would include the following:
 - (i) The dates that the chief accountant goes on holiday.
 - (ii) A file of recognized suppliers.
 - (iii) The place that the chief accountant chooses for his or her holiday.
 - (iv) Credit limits of customers buying on credit
- (c) Reliable evidence means evidence that has been vetted by the company's directors.
- (d) Written evidence from a bank manager is reliable evidence.
- (e) Written evidence from within the company is not reliable.
- (f) If differing types of evidence are consistent with each other, the auditor can reduce the amount of evidence collected and examined.
- (g) Physical inspection by the auditor of a non-current asset provides the auditor with reliable evidence as to its existence, but not as to its ownership, cost or value.

6.2 You are the auditor of Oakshaw Ltd and are searching for evidence to prove that the figures for purchases and related creditors are true and fair in the context of the accounts, taken as a whole. You have extracted the following information from the accounts at 31 December 2010:

Figures as on page 236, but change dates to 2010 and 2009 respectively and change stock (twice) to 'inventories'.

Your audit work has revealed the following:

- (i) Discussions with management and other tests show that selling prices have been increased by more than the cost of purchases with the result that gross profit has improved by 1 percentage point.
- (ii) The company maintains the following records:
 - *Purchase requisitions* from stores to the purchasing department (this is the request that goods be purchased).
 - *Purchase orders* made out by the purchasing department on the basis of purchase requisitions and files of information about suppliers (the purchase order is a request to a supplier of goods to deliver them).
 - *Goods received notes* made out by the goods receiving department when goods are received.
 - *File of purchase invoices* received from a supplier.
 - *Inventory records* showing quantities of receipts, issues and balances of inventory on hand.
 - *Purchase journal* in which all invoices are recorded.
 - *Purchase ledger* containing personal accounts for each supplier.
 - *General ledger accounts*, containing, among other things, purchase accounts and trade payables control account.
- (iii) As a result of your systems work you have concluded that each of the above records are held by different people and that they are carefully and properly controlled.

Required

- (a) In Figure 6.4 fill in the blanks to show the relationship between the above records and the purchases and trade payables figures in the accounts. You should refer to Figure 6.2 on page 227 while you are doing this.
- (b) Describe the kinds of evidence that can be used to upgrade the various documents and records.
- (c) Explain how the systems work and the review of the accounts may help you to accept the figure of 'purchases'.

Insert Figure 6.4 as on page 238

6.3 Below is a list of sources of audit evidence:

- (i) The chief accountant, who is a member of CIMA, explains why inventory levels are higher at the end than at the beginning of the year.
- (ii) A storeman in the main store explaining how the store control system operates.
- (iii) An invoice from a supplier of electricity.
- (iv) A trainee accountant, presently studying for professional accounting examinations, explaining the reason why telephone charges were lower this year than last.
- (v) A letter to the auditor from a lawyer confirming that, as far as he is aware, there are no legal matters of material significance.
- (vi) A confirmation from a credit customer agreeing that a balance in the books of the entity is correct.
- (vii) A calculation of tax charge and liability made by the auditor.
- (viii) Inventory count sheets, the count having been observed by the auditor.
- (ix) The company's order book, showing orders received from customers. This book is required for company planning purposes.
- (x) Estimates of useful life of newly acquired plant, made by the production director.

Required

- (a) Suggest which sources may be regarded as reliable, explaining why this is so.
- (b) Suggest how you might upgrade the evidence, if required.

6.4 Explain the meaning of the following terms:

- (i) Interim examination.
- (ii) Final examination.
- (iii) Inconsistent audit evidence.
- (iv) Systems-based evidence.
- (v) Third-party evidence.
- (vi) Persuasive evidence.

Solutions

6.1 a) *True*

The statement is true in itself, although it is incomplete. Auditors must clearly have enough evidence to form their conclusions. For instance, management might claim that the credit control department has checked all sales orders to ensure that the customer is likely to pay for goods and services ordered. Auditors may wish to satisfy themselves on this point and will test enough sales orders for evidence of credit control to ensure that the risk they have not been checked appears low. However, sufficiency of evidence is only one aspect. It is necessary also that it be relevant and reliable. It certainly appears to be relevant to ensuring within reason the credit worthiness of customers.

b) i) *True*

The dates that the chief accountant goes on holiday may well be relevant. For instance, if he or she exercises an important control function, care must be taken to ensure that, when on holiday, proper cover exists. The auditor might wish to test the holiday period in greater detail.

ii) *True*

The purchasing officer needs a file of recognised suppliers, when deciding who should supply goods and services to the company. As the list would need to be accurate for this purpose, the auditor would find it reliable in determining whether all liabilities have been reflected in the accounts. A typical audit question might be: 'I see that Runcorn Ltd is on your list of suppliers of Product X, but this company does not appear in the purchases record this year. Do you owe this company any money at the year-end?' Clearly, the list would be relevant as well as being reliable evidence.

iii) *False*

We have suggested that the statement is false and to the extent that the chief accountant went on holiday to one seaside resort last year and to another this year, it would not be particularly relevant. If, on the other hand, the holiday was more expensive and the chief accountant's general standard of living higher than salary would appear to justify, the auditor might wish to consider whether he or she might be misappropriating funds from the company.

iv) *True*

Debtor's credit limits may be very relevant evidence. If limits are much exceeded, for instance, this might indicate that credit control is inadequate and that more work will be required to prove that the trade receivables are collectible.

c) *False*

While vetting by company directors may add to the reliability of evidence (for instance, directors' comments on a legal claim against the company), care should be taken in accepting it too readily. Evidence originating from directors or controlled by them is not as reliable as evidence obtained from independent third parties or created by the auditor himself. It may, of course, be substantiated by evidence from other sources.

d) *True*

The written evidence from the bank manager is good evidence and is reliable because it comes from an independent and professional source. However, the bank manager might not be aware of all bank accounts owned by the company if they had been made secret by putting them in the name of a specified individual.

e) *False*

While written evidence from within the company is not of itself reliable because it comes from a dependent source, it comes from a very well informed source and if it is derived from sound systems, it can also be very reliable.

f) *True*

Consistency is the basis for upgrading audit evidence, as evidence corroborated by other evidence is strengthened. For instance, the signature of an employee in a personnel record will provide evidence that a payroll entry bearing the same signature is accurate, each signature adding to the value of the other. This, of course, would be dependent on the personnel record being held by individuals other than those preparing the payroll. This is an example of synergy or a

situation where $2 + 2$ may equal 5. Conversely, inconsistent evidence may result in evidence previously collected not being accepted as of value. Thus, if the company's lawyer suggests that on the basis of previous case law, the company has a good chance of defending successfully a case brought against it, this apparently good evidence may be nullified if a second lawyer contradicts the first view. The auditor would then have to seek further evidence to confirm or refute either view.

g) *True*

If the auditor physically inspects the fixed asset, quite clearly this will prove that it exists. The question of ownership, cost and value can only be answered by looking for other kinds of evidence, such as original invoice for the asset, its entry in the fixed asset register and valuers' reports.

6.2.a) Figure 6.4 *Oakshow Ltd purchases and related trade payables* As on page 454 of the 1st edition

b) Figure 6.4 showing the Oakshaw purchases and trade payables audit trail indicates the upgrading process and you should study it carefully. Remember the various rules we discussed in the text, to which you should refer if you have any difficulty.

c) The brief answer to this question is that the auditor obtains satisfaction from a number of different sources. If the systems for controlling purchase transactions is proved to be sound, this will give some confidence that the purchases figure is valid. Similarly, if the review of the financial statements reveals nothing that is strange in relation to what the auditor knows about the company (that is, all the figures appear consistent with each other), this work can also support the purchases figure. Detailed matters of significance are as follows:

Systems: We are told that different people control the purchase and trade payables records. We shall see later in this book that this is a very important control feature. Also the auditor's work has revealed that the records are carefully and properly controlled. Both of these conclusions will help the auditor to conclude that the purchases figure is acceptable

Review of accounts: The gross profit percentage in 2007 is 30% compared with 29% in 2006 and the auditor would discuss this trend in the company with management to determine if demand for the company's products is inelastic enough to allow increases in selling prices unaccompanied by increases in costs. The auditor should supplement this work by comparing the company's margins with those of competitors. If the increase in margin appears to make sense in the light of this work, the auditor would be more inclined to accept the figure of purchases, although other more detailed tests on the purchases figure would be necessary.

6.3. a) i) The chief accountant is a well-informed officer of the company. For this reason, evidence emanating from him or her is good evidence. However, he or she is internal to the organisation and the auditor would seek corroborative evidence that the statement is acceptable. For instance, if the auditor finds that sales forecasts indicate a higher level of sales in the coming year than in the year just ended, this might help to prove the chief accountant's statement.

ii) The storeman is again internal to the organisation and his statements should perhaps be viewed with caution. However, such officials are frequently a very useful source of evidence as they may be very well informed about a small segment of the company's activities and may, indeed, be much better informed about them than the chief accountant. For instance, the chief accountant may believe that inventory control officials check physical

inventory against inventory records at regular intervals, whereas the storeman knows that this is not the case. On the other hand, it must be said that often people in organisations are not aware of the whole picture so that care must be taken in evaluating statements made by them. For instance, inventory control officials may carry out inventory counts at night when the storeman is not on duty. It would therefore be necessary to corroborate the statements made by the storeman.

- iii) An invoice from a supplier of electricity is a document in the hands of the company emanating from a third party. It may be regarded as a particularly reliable document for the following reasons:
 - Electricity invoices are normally issued at regular intervals during the year and can be easily compared with previous electricity invoices, although there is a possibility that they may be forged.
 - The electricity usage will be metered and meter readings can easily be tested by the auditor.Electricity charges may be corroborated in general terms by assessing general levels of activity.
- iv) Invoices of the Telephone Company will support the telephone charges and these invoices are as reliable as the electricity invoice referred to above. The explanations for the charges being lower this year depends upon whether they appear reasonable in the light of what the auditor knows about the company. For instance, if company sales are much lower because of a downturn in economic activity, telephone charges may be lower if they are correlated to sales. Analytical review of activity levels could thus help to corroborate telephone charges. Your view of the trainee accountant's ability may also affect the credence given to his statements.
- v) The letter from the lawyer would be regarded as good evidence in itself because it comes from an independent professional person and has been sent direct to the auditor. The main problem for the auditor is identifying which legal advisors the company had used. In particularly difficult cases involving perhaps complex legal matters, the auditor might wish to corroborate the opinions of the company's legal advisor(s) by seeking a second opinion.
- vi) The letter from the debtor is also good evidence, coming as it does from an independent third party direct to the auditor. We would be inclined to regard it as less reliable than that from the lawyer, however, for the reasons outlined in the text. Confirmations from credit customers would not normally be the sole evidence sought by the auditor in confirming trade receivables balances and sales invoices. Other corroborative evidence would include all the supporting evidence detailed in Figure 6.2.
- vii) Most qualified auditors will have knowledge of taxation, although it is an area in which one may get rapidly out of date. Assuming that the auditor is a tax expert or has called upon expert help from within his firm, the computation of tax charge and liability would be reliable evidence for the auditor, especially if the computation is checked by others within the firm. Although the computation has been done by the auditor, it would be necessary to ensure that management was in agreement with it.
- viii) Inventory count sheets are prepared as a result of a physical count carried out by company staff. If the system that the company has established to control the inventory count is good and the auditor's observation has confirmed that the count has been properly carried out, the inventory count sheets may be regarded as good evidence, particularly if supported by the auditors own count sheets (that would serve to corroborate the company's figures). Remember that inventory count sheets prepared by the company are internal documents and may therefore be subject to manipulation.

- ix) The company requires the order book for its own planning purposes and in the normal course of business. Such evidence is better than evidence prepared on an ad hoc basis and may be used by the auditor for testing such matters as the saleability of inventory. Provided that the auditor can corroborate its accuracy by reference to correspondence from customers, salesmen's records etc., the order book may be good evidence.
- x) The estimate of useful life is a more difficult matter as it relates to the future and the future is notoriously cloudy. In itself the estimate by the production director is poor quality evidence, but it may be upgraded on the basis of past experience, manufacturer's specifications, experience of others in the industry and so on. Remember also that, within the company, the production director may be the best qualified to estimate the useful lives of production plant. The auditor should certainly discuss the matter with him or her.

- 6.4 i) The term '**interim examination**' is used for that part of the audit carried out prior to the year-end. Normally, the interim will be used to review and test the operation of systems and to test the accuracy and completeness of the recording of transactions. The results of this work and the conclusions drawn therefore will be used during the final examination in planning and in supporting conclusions on the final work. In the case of large assignments, there may be more than one interim examination, and indeed for very large engagements, auditors may be present in the company and its various locations throughout the year.
- ii) '**Final examination**' is the term given to the work on the financial statements after the year-end. Note that in the case of small assignments, the systems, transaction testing and work on the final financial statements are likely all to be carried out in the same period.
 - iii) '**Inconsistent audit evidence**' is evidence that does not support other evidence, thereby downgrading it and rendering it of less value. It may reveal that the auditor has initially formed a view that is not sustainable. For instance, let us assume that you are auditing a roofing company, which makes provision for customer claims on the basis of 3% of turnover per annum. The auditors may have satisfied themselves that 3% is adequate on the basis of past experience, but a recent article in the trade press has suggested that rate of claims is likely to rise because of problems in the use of new materials. In this case the reliability of evidence based on past experience would be reduced because it is inconsistent with more up-to-date evidence.
 - iv) '**Systems-based evidence**' is evidence that has been produced or influenced in some way by the accounting and control system in use by the company. For instance, a supplier's invoice which has been checked by company officials and stamped to indicate agreement with purchase order and goods received note has been checked by the system. A sound system of control tends to make such evidence more reliable.
 - v) '**Third party evidence**' is evidence emanating from persons or organisations external to the company and therefore possesses the important quality of independence. It is usual to distinguish between third party evidence coming from:
 - Professional people such as lawyers or other accountants
 - Non-professional people such as customers and suppliers
 - Third party evidence coming direct to the auditor such as a letter from a bank manager confirming a bank balance, and third party evidence in the hands of the company, such as the suppliers invoice referred to above.
 On the whole third party evidence is reliable as far as the auditor is concerned.
 - vi) The use of the term 'persuasive' in relation to audit evidence indicates that often (normally) the evidence collected by the auditor is not conclusive. For instance, if the auditor checks 10 items of inventory on hand with the inventory count sheets

and finds that the sheets are correct in each case, this may well persuade the auditor that the inventory count is being properly conducted and that the inventory sheets are reliable. Auditors would, however, be very unwise to draw the conclusion that the inventory count was 100% correct on the basis of their test. They may of course obtain sufficient confidence on the basis of the persuasiveness of the evidence in the context of tolerable error.