Audit Evidence

(Relevant to AAT Examination Paper 8 – Auditing and Information Systems and PBE Paper III Auditing and Information Systems)
Raymond Wong, School of Accountancy, The Chinese University of Hong Kong
Dr. Helen Wong, Hong Kong Community College, Hong Kong Polytechnic University

Introduction

Hong Kong Standard on Auditing (HKSA) 500 “Audit Evidence” explains and defines the meaning of audit evidence. Auditors are required to obtain sufficient audit evidence to draw conclusions and express audit opinion. Auditors can carry out risk assessment and further audit procedures to obtain audit evidence. This article discusses audit procedures commonly used by auditors to collect audit evidence; one of the audit procedures (analytical procedures) is discussed in detail.

Inspection

Inspection involves the examination of records, documents and assets. Records and documents may be in the form of paper, electronic or other media both internally and externally. Auditors will be divided into groups. Some will examine the accounting records, invoices, electronic fund transfers, etc., while others will examine the existence of assets.

Observation

Auditors may observe the processes performed by clients. Auditors may look at the inventory count procedure performed by the internal auditors.

External confirmation

Auditors may obtain confirmation from a third party directly in the form of paper, electronic or other medium. The most common and frequent external confirmation is to verify account balances.

Recalculation

Auditors may recalculate the numbers manually or electronically to check the accuracy of the records.

Re-performance

Auditors may carry out procedures or controls that were presumed to be conducted by the entity’s personnel.

Inquiry

Auditors may seek information from the client formally (written inquiries) or informally (oral inquiries). However, sometimes it is difficult to obtain information about management intent as this information may be very limited.

Analytical procedures

Auditors may apply t analytical procedures (normally referred to as ratio analysis) to analyse the financial and non-financial data, and to determine whether the accounting records agree to the financial statements.

Financial data

Auditors may apply financial ratio analysis (liquidity ratio, solvency ratio and profitability ratio) to compare the information with that of prior periods, the entity's expected results and compare it with competitors in the same or similar industries.

Liquidity

Liquidity ratios provide information about an entity's short-term (usually one year or less than one year) ability to meet its obligation. The current ratio, acid-test (quick) ratio, receivable turnover ratio and inventory turnover ratio are employed to measure the entity's ability to pay its short-term obligations.

- Current ratio measures the entity's short term debt-paying ability.
- Current ratio = current assets / current liabilities
- Acid-test ratio measures the entity's immediate short term liquidity.
- Acid-test ratio = (cash + short term investments + receivables) / current liabilities
- Receivable turnover ratio measures the liquidity of receivables.
- Receivable turnover ratio = net credit sales / average net receivables
- Inventory turnover ratio measures the liquidity of inventory.
- Inventory turnover ratio = cost of goods sold / average inventory

Solvency

Solvency ratios provide information about an entity's long-term (usually more than one year) ability to meet its obligation. Long-term creditors and shareholders are interested in looking at the entity's debt to total assets ratio and times interest earned ratio as these ratios reflect the entity's ability to repay the debt and interest.

- Debt to total assets ratio measures the percentage of total assets provided by creditors.
  Debt to total assets ratio = total debt / total assets
- Times interest earned ratio measures the entity's ability to meet the interest payments when they come due.
  Times interest earned ratio = income before income taxes and interest expense / interest expense

Profitability

Profitability ratios provide information about an entity's ability to generate earnings. Profit margin on sales, gross profit margin, asset turnover ratio, return on assets ratio, return on common stockholders' equity ratio, earnings per share, price earnings ratio

and payout ratio are employed to measure the profit or the performance success of the entity.

- Profit margin on sales measures the net income generated by each dollar of sales.
  Profit margin on sales = net income / net sales
- Gross profit margin measures the gross profit generated by each dollar of sales.
  Gross profit margin = gross profit / net sales
- Asset turnover ratio measures how efficiently assets are used to generate sales.
  Asset turnover ratio = net sales / total assets less current liability
- Return on assets ratio measures the overall profitability of total assets.
  Return on assets ratio = net income / average total assets
- Return on common stockholders' equity ratio measures the profit earned for each dollar invested by the stockholders.
  Return on common stockholders' equity ratio = (net income – preferred dividends) / average common stockholders' equity
- Earnings per share measures the net income earned on each share of common stock.
  Earnings per share = (net income – preferred dividends) / weighted average number of common stocks outstanding
- Price earnings ratio measures the ratio of market price to earnings.
  Price earnings ratio = market price per share of stock / earnings per share
- Payout ratio measure the percentage of earnings distributed as cash dividends.
  Payout ratio = cash dividends / net income

Non-financial data

Auditors not only look at the financial data but also the non-financial data such as, leadership and number of employees, as these indicators may give insights to auditors to identify risk.

Auditors may also take into consideration matters such as discontinued operations, extraordinary items, changes in accounting principles, differences in accounting regulations across countries, and different fiscal years when they apply their analytical procedures.

With these analyses (financial and non-financial), auditors may then compare the current year's results with prior periods or expected results to identify fluctuations or significant variations, if any. Auditors should investigate any unexplained variations as these may indicate a misstatement. The auditor should devote time, effort and resources to looking at these variations at the planning stage, testing stage and completion stage of the audit.

Conclusion

Auditors can use inspection, observation, external confirmation, recalculation, re-performance, inquiry and analytical procedures to collect audit evidence. Although

ratio analysis and trend analysis are relatively easy tasks, these analyses require a good understanding of the client's business and industry. Thus, these analyses should preferably handled by the senior of the audit team.

Reference

Hong Kong Institute of CPAs, HKSA 500 "Audit Evidence"