

examining evidence

relevant to Professional Scheme Papers 2.6 and 3.1
and new ACCA Qualification Papers F8 and P7

proof or procedure?

■ **Questions in auditing exams on audit procedures are very common. However, Question 3 in Paper 3.1 requires students to describe audit evidence, and many students lose relatively easy marks because they fail to understand the difference between the two. This article considers:**

- the requirements of Question 3, and the difference in perspective of Papers 2.6 and 3.1
- the difference between audit procedures and audit evidence
- techniques for deciding on relevant audit evidence in a variety of circumstances.

PAPER 3.1 VERSUS PAPER 2.6

Although the syllabuses of Papers 3.1 and 2.6 have many topics in common, the difference between them is one of perspective. Generally, Paper 2.6 questions are approached from the perspective of the audit junior or audit supervisor, whereas in Paper 3.1 it is usually assumed that the candidate is the audit manager or audit partner.

Tests of control and substantive procedures are typically performed by audit juniors and audit supervisors. Audit managers and partners would rarely do this type of work themselves, but instead would supervise the performance of members of the audit team and review the working papers after the work is complete.

The Paper 3.1 examiner, Kim Smith, wants to test students' application of auditing techniques to the additional accounting knowledge gained in Paper 2.5 but, as stated above, managers and partners rarely carry out substantive testing.

The examiner's solution is to ask candidates to place themselves in the position of the audit manager and ask them to state the audit evidence they would expect to see when they carry out their review of the working

papers and financial statements. In other words, the audit junior or audit supervisor has already done the work, and Paper 3.1 candidates are reviewing the work that has already been performed, and the evidence that has been obtained as a result of that work.

AUDIT PROCEDURES VERSUS AUDIT EVIDENCE

Audit procedures are actions that auditors carry out during the audit. Paper 2.6 questions typically ask candidates to describe audit procedures, also known as 'audit tests' or 'audit work'.

Audit evidence is obtained by the auditor as a result of the audit procedure. For example, 'performing a circularisation of receivables/debtors' is an audit procedure, whereas 'replies from customers' is audit evidence. It is very important to be aware of the difference. If a question asks for audit evidence and candidates state audit procedures, then the question hasn't been answered, and gains no marks.

Which of the following are procedures and which are evidence?

- 1 Inspecting non-current/fixed assets for signs of obsolescence
- 2 An item of inventory/stock that is present at the inventory/stock count
- 3 A bank statement
- 4 Counting petty cash
- 5 A working paper showing a re-calculation of depreciation
- 6 A sales invoice
- 7 Attending a wages pay out.

Answer

Items 1, 4 and 7 are procedures (because procedures are actions, notice the use of verbs such as 'inspecting', 'counting', and

'attending'). The other items are evidence, as they are the result of audit procedures.

However, note that the phrasing of Question 3 in Paper 3.1 is 'state the audit evidence that you should expect to find in undertaking your review of the audit working papers and financial statements'. Item 5 meets this criterion because it is a working paper, but items 3 and 6 are not necessarily included in audit working papers, so one would need to phrase the answer in such a way as to make this clear. For example, one could say 'a copy sales invoice' and 'a copy bank statement with the balance cross-referenced to the bank reconciliation'.

Item 2 is definitely not evidence normally seen in working papers, since it is an item of physical inventory/stock. This could be rephrased as 'a schedule showing items test-counted at the inventory/stock count' to make it into a correct answer.

IDENTIFYING APPROPRIATE AUDIT EVIDENCE

Substantive testing questions in Paper 3.1 can be quite tricky, as they can cover any of the accounting standards from Papers 1.1 and 2.5, and therefore are more varied than questions on topics such as inventory/stock, receivables/debtors, payables/creditors, or non-current/fixed assets that come up so frequently in Paper 2.6. There is a chance, therefore, that the specific issue covered in a Paper 3.1 question may not be something that has been covered before in a study session.

Candidates need to be able to think on their feet and develop a 'sensible answer' approach to a wide variety of questions, even if they have never considered the subject previously. One way to do this is to use the financial statement assertions as a starting point.

The financial statement assertions are those assertions that are implicit or implied when the directors make an explicit statement that the financial statements give a true and fair view. In other words, they are attributes of the financial statements that must be true if the financial statements are to give a true and fair view.

Assertions include completeness (all assets, liabilities, transactions, and events are included) and valuation (assets and liabilities are included at an appropriate carrying value). Auditors design their audit programmes to ensure – as far as possible – that each of these assertions are true, in order to gain evidence that proves that the financial statements give a true and fair view.

Using the assertions as a starting point to answer a question can be useful if the question is general – for example ‘describe how you would audit leases’. These general questions appear in other audit papers and sometimes in Paper 3.1 questions other than Question 3. Candidates could consider what assertions are relevant to leases and then describe audit tests and/or evidence (depending on the question) to prove each of these assertions.

Question 3 is phrased differently, however. It does not require candidates to describe audit work generally, but instead asks for a description of the evidence a candidate would expect to see in relation to a specific issue. Although the assertion approach could be used, other techniques may be more suitable. To illustrate a possible approach, consider the following example. Note that this is *not* a past exam question, but is written in the style and format of a typical Paper 3.1 Question 3.

EXAMPLE

You are the manager in charge of the audit of Yummy Mummy Co., a listed company with a European-wide chain of fashion stores for babies and expectant mothers. The audit for the year ended 30 September 2006 is nearing completion. The draft financial statements show a profit before tax of \$50.6m (2005: \$95.3m).

The audit senior has produced a schedule of ‘Points for the attention of the audit manager’ as follows:

- a Due to the falling birth rate, the performance of the stores in Italy has been worse than expected. An impairment review was performed on 15 October 2006, treating the Italian stores as a single cash-generating unit, which indicated that the recoverable amount of the assets (based on value in use) was \$23m lower than the carrying value. (6 marks)
- b The company self-manufactures many of its clothing lines, and has a factory in Manchester, UK. Research has shown that the company could achieve substantial cost savings by outsourcing to south east Asia, and the factory in Manchester is to be closed. A provision of \$3.2m to cover redundancy costs has been included in the 2006 draft financial statements. (7 marks)
- c The company is planning to open 20 new stores in south east Asia in the next year. To assist in financing the expansion, the company sold a number of its properties on 28 September 2006 for \$200m and leased them back under operating leases. (7 marks)

Required:

For each of the above points:

- i Comment on the matters that you should consider; and
- ii State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Yummy Mummy Co. (20 marks)

The mark allocation is shown against each of the three points.

Formulating an answer

Note the format of the question. There are three mini-case studies, and for each the candidate has to (i) comment on the matters that should be considered and (ii) state audit evidence. As this article is about audit evidence, we will only consider Part (ii) of the question. However, the examiner has given guidance on how she wants candidates to answer Part (i), and has said

that matters to consider will normally include risk, materiality, and accounting treatment. In many answers, there is also a requirement to comment on the type of audit report that would be needed if the company refuses to amend an erroneous treatment.

Deciding on audit evidence

For each scenario:

- 1 Think about how the accountant would have calculated the numbers in the financial statements, the source documents used and the systems followed, and then write about the documents etc, that one would expect to see.
- 2 Think about how to verify the other relevant facts in each case.
- 3 Consider the accounting/disclosure requirements of each scenario, and say how one can check if they are being met.

Remember, as the question is about evidence, not procedures, I would advise candidates to begin their answers to each part with the words ‘I would expect to see’, and then list out the evidence as bullet points. This should stop candidates talking about procedures.

Here is an example answer – the bracketed text in italics is *not* part of the answer, but simply explanation where required.

(a) (*Accounting issues in this scenario are subsequent events (adjusting) and impairment.*)

I would expect to see:

- extracts from the management accounts showing the performance of the Italian stores compared to budget, and the most recent budget for 2007
- a copy of the board minutes detailing management’s plans to improve performance or to sell the stores (*if performance continues to be poor it could affect going concern, if stores are to be sold they may need to be re-categorised as assets held for sale*)
- a schedule comparing the carrying value of the assets with the recoverable amount, annotated to show that carrying value has been agreed to the non-current/fixed assets register, and that any allocation of central assets and goodwill was reasonable

- a completed audit programme for non-current/fixes assets (*as the appropriateness of the value of the assets has already been checked during the audit of non-current/fixes assets, there is no need to check it again*)
- a calculation of value in use, annotated to show that the cash flows have been compared with budgets for 2007 and beyond, and with actual cash flows (*to see if they are reasonable*).

(b) (*The obvious accounting issue is provisions, but issues which are not mentioned – but which are potentially relevant – include assets held for sale and discontinued operations.*)

I would expect to see:

- a copy of the announcement of the restructuring (*has to be before the year end in order for a provision to be made*)
- a working paper detailing whether redundancy payments are being made in accordance with contractual, statutory, or constructive obligations, and how the constructive obligations, if any, have been derived (*in some countries, companies are required under statute to pay certain levels of compensation to redundant employees*)
- a schedule detailing the amount to be paid to each redundant employee. This schedule should be annotated to show that all relevant employees have been included and that the calculations have been checked for a sample of employees, including agreement of their pay/service to their contracts where relevant
- a point in the management representation letter as to any other costs to be provided for in closing the factory (eg penalties for cancellation of leases)
- a point in the management representation letter detailing whether the factory is to be sold or abandoned (*if a decision is made to sell, then assets are valued as assets held for sale, but not if it is to be abandoned*)
- a copy of the invitation to tender for the outsourcing contract, and notes of discussions with management as to how the manufacturer was selected and how quality is to be assured.

(c) (*Candidates need to focus on checking whether the leaseback is really an operating lease rather than a finance lease.*)

I would expect to see:

- a copy of the leasing contract
- a schedule comparing the present value of the minimum lease payments with the fair value of the leased assets
- a note comparing the length of the lease with the estimated useful life of the assets, and stating whether Yummy Mummy Co. is responsible for maintenance and insurance
- a schedule calculating the amounts that should appear in the financial statements, if the audit team believes this to be a finance lease
- an estimate of the carrying value of the assets at the date of sale, if the lease is an operating lease (*if selling price is not fair value, it affects how profit on sale is recognised*)
- a point in the management representation letter on the purchaser of these properties, and whether they are related to Yummy Mummy Co. and, if necessary, a draft of the related party disclosures that will appear in the financial statements.

This is just one possible answer – there are many other valid points that could be made. Notice that this sample answer reflects the three points mentioned above:

- 1 Evidence to show that the accountant has worked out the figures correctly (eg the calculation of the redundancy payment, the calculation of value in use).
- 2 Evidence to prove other relevant facts (eg performance in Italy, outsourcing contract, lease agreement).
- 3 Evidence to prove that accounting standards have been complied with (eg date of closure announcement, comparison of payments, fair value of leased assets).

Students should practise applying this approach to past Paper 3.1 questions. This will help students develop an answer to the exam question. ■

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