Communicating Audit Evidence

George Iatridis

1. EVALUATING AUDIT EVIDENCE

The objective in evaluating audit evidence is to enable the auditor to form a reasonable basis, on which to set the audit opinion.

ISA 220 states:

"21. The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements..."

"26. Before the auditor’s report is issued, the engagement partner, through review of the audit documentation..., should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached..."

"38. An engagement quality control review should include an objective evaluation of:

(a) The significant judgments made by the engagement team; and
(b) The conclusions reached in formulating the auditor’s report."

ISA 320 states:

"12. ... the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material."

ISA 330 states:

"66. Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate."

"70. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk of material misstatement in the financial statements."
"72. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion."

ISA 520 states:

"13. The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor’s understanding of the entity."

ISA 540 states:

"24. The auditor should make a final assessment of the reasonableness of the entity’s accounting estimates based on the auditor’s understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit."

1.1 Evaluation of Audit Evidence and Objectives

In evaluating audit evidence, the auditor seeks to examine whether the assessment of the risks of material misstatement has been efficiently performed and also whether action has been taken to reduce the risks of material misstatement. For example, these risks may involve ignoring suspicious circumstances, over-generalizing the findings, and employing incorrect or biased assumptions when setting the audit procedures. An auditor should assess the possibility of fraud, the quality of internal control systems that are in place as well as whether further investigations should be carried out.

Items that should be considered when assessing quality of audit evidence include examining the materiality of misstatements and the related impact on the reported accounting numbers; the response of the company's management to audit findings and the company's identification of risk factors; prior experience; set-up of audit procedures and audit findings; reliability of audit input information; quality of audit evidence; etc. Exhibit 1 describes the considerations presented above in greater detail.
Exhibit 1 Evaluating the Sufficiency and Appropriateness of Audit Evidence

♦ Materiality of misstatements

How significant is a misstatement in the assertion being addressed and what is the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements?

♦ Management responses

How responsive is management to audit findings and how effective is the internal control in addressing risk factors?

♦ Previous experience

What has been the previous experience in performing similar procedures and were any misstatements identified?

♦ Results of performed audit procedures

Do the results of performed audit procedures support the objectives and is there any indication of fraud or error?

♦ Quality of information

Are the source and reliability of the available information appropriate for supporting the audit conclusions?

♦ Persuasiveness

How persuasive (convincing) is the audit evidence?

♦ Understanding the entity

Does the evidence obtained support or contradict the results of the risk assessment procedures (which were performed to obtain an understanding of the entity and its environment including internal control)?

Source: IFAC (2007), Exhibit 4.1-3, p. 308
1.2 Changes to the Original Assessment of Risk

An auditor should examine the possible differences between actual and anticipated financial results and how new information might affect the audit procedures. When a deviation is observed, the auditor might consider modifying the original assessment of risk. An auditor should therefore focus on the tests of controls and investigate whether managers influence the internal controls as well as whether possible weaknesses in the internal control systems are likely to lead to misstatements. Items that should be looked into include new risk factors, conflicting evidence, consistency in the application of accounting policies, association between financial and non-financial data, possible sources of fraud, patterns and omissions while performing tests, reliability of evidence, subjectivity in accounting estimates and fair value measurements, etc. A company must report any changes in the original assessment of risk together with any subsequent changes in the planned audit procedures. It is vital to note that the detection of fraud and irregularities would be aided by improving the coordination and communication between the audit-related parties. Examples of financial statement fraud are presented in Exhibit 2.

Exhibit 2 Fraudulent Financial Reporting

Source: IFAC (2007), Exhibit D-3, p. 373
1.3 Possible Sources and Correction of Misstatements

Misstatement may arise upon incorrect planning of specific audit procedures, inefficient projections of sample results, deviations from accounting estimates, including fair value estimates, misstatements in the opening balance of equity that have not been previously accounted for, incomplete or inaccurate accounting disclosures, aggregation of misstatements, including those relating to possible fraud or inaccurate accounting disclosures, which should be accounted for on an individual basis, etc.

The misstatements should be corrected by re-assessing certain areas of risk and subsequently correcting the respective accounting figures where appropriate; carrying out additional audit checks; identifying possible areas of misstatement; etc. The auditor should take into consideration the size of the misstatement, the possibility of not fully capturing the misstatement, the magnitude of materiality of the misstatement and the misstatement-related numbers, prior-period misstatements and unadjusted financial statements, and the effectiveness of internal controls.

2. COMMUNICATION OF AUDIT INFORMATION

ISA 260 states:

"11. The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance."

ISA 320 states:

"17. If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260 “Communication of Audit Matters with Those Charged with Governance.”"

In order to obtain clarifications and explanations, where necessary, an auditor should discuss audit matters with the company's management, unless there are issues of management integrity. Information about the identification of misstatements should be cross-referenced and accompanied by audit evidence and documentation. Local regulations may impose confidentiality restrictions regarding auditors’ communications of audit information. In such cases, the auditor should take into consideration the respective regulations before the communication of any information.
Items that should be communicated include audit strategy, indicating any possible limitations, changes in main accounting policies and their impact on the company's accounts, previous communications with management, risks of material misstatement and uncertainties and the related effects on reported numbers, material disagreements with management about issues that might significantly affect firms' accounts, weaknesses in internal control systems, major transactions with related parties, fraud-related incidents, audit adjustments, uncorrected misstatements considered to have immaterial impact on financial statements, possible changes in the auditor’s report, and managerial estimates and judgments about the valuation and presentation of discretionary accruals.

3. THE AUDITOR’S REPORT

ISA 700 states:

"4. The auditor’s report should contain a clear expression of the auditor’s opinion on the financial statements."

"38. The auditor’s report should state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor’s opinion."

"39. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework."

"40. When expressing an unqualified opinion, the opinion paragraph of the auditor’s report should state the auditor’s opinion that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the applicable financial reporting framework..."

"52. The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements."

"65. ... the auditor’s report should refer to the audit ... only if the auditor’s report includes, at a minimum, each of the following elements:

..."
(d) A description of management’s responsibility for the preparation and fair presentation of the financial statements;

(e) A description of the auditor’s responsibility to express an opinion on the financial statements and the scope of the audit...

(f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements..."

ISA 710 states:

"2. The auditor should determine whether the comparatives comply in all material respects with the financial reporting framework applicable to the financial statements being audited."

"6. The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the applicable financial reporting framework."

"15. In such circumstances, the auditor should consider the guidance in ISA 560, “Subsequent Events” and:

(a) If the prior period financial statements have been revised and reissued with a new auditor’s report, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures agree with the revised financial statements."

"19. In situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, appropriately modify the report."

"25. When reporting on the prior period financial statements in connection with the current year’s audit, if the opinion on such prior period financial statements is different from the opinion previously expressed, the auditor should disclose the substantive reasons for the different opinion in an emphasis of matter paragraph."
3.1 Formulation of an Audit Opinion

After evaluating the audit evidence obtained, the auditor may prepare the audit report. An audit report is prepared in a standard manner to promote uniformity and comparability. The formulation of an opinion should take into account the following: a) evaluation of audit evidence and reduction of the risks of material misstatement; b) assessment of the impact of uncorrected misstatements and evaluation of the company's accounting policies; c) evaluation of the compliance level of financial statements with the financial reporting requirements that are in place. This would involve examination of accounting policies, accounting estimates, reported information relevance, disclosure quality, and reported balance sheet and income statement numbers; d) assessment of whether the information content and quality of the financial statements faithfully reflects the economic situation of the firm; and e) examination of the validity and accuracy of the audit analytical procedures.

3.2 Components of an Audit Report

The title of an audit report must be “Independent Auditor’s Report”, in order to emphasise the independence of the auditor. The first paragraph presents the name of the company, the period of the audit as well as the accounting statements, policies and explanatory notes that have been audited. The report then comments on the responsibility of the management regarding the preparation of the financial statements, and specifically on whether they have used appropriate accounting policies, implemented proper internal controls and presented faithful and free from error accounting information. The subsequent section of the audit report focuses on the auditor's responsibility and should indicate that the audit has been performed in line with the International Standards on Auditing. This section seeks to investigate whether the reported financial numbers have been prepared in compliance with the accounting regulation and are free from material misstatement. Here, it is vital to confirm that the audit evidence, which will form the basis for forming the audit opinion, is sufficient and reliable.

The audit opinion expresses whether the audited financial statements represent the true and fair view of the company's financial position and performance and are in accordance with the applicable (international or national, as appropriate) accounting standards. Should the auditor be required, and essentially permitted, to comment on additional matters, such as the performance of certain company procedures, s/he should address them in a separate section of the audit report following the audit opinion. The audit report concludes with the auditor’s signature and address accompanied by additional details as required by the regulation. The audit report should be prepared after having obtained all the necessary audit evidence, which should lead to the formulation of an audit opinion.
3.3 Discovery of a Misstatement after the Release of the Audit Report

In the case of a discovery of a misstatement in the financial statements after the release of the audit report, the auditor should first discuss the issue with the company's misstatement. Upon such discovery, the company should immediately issue a revised set of financial statements or report the appropriate revision in the financial statements of a later accounting period if that is coming up. The auditor should explain in the audit report that refers to the revised financial statements that the previous audit report is not valid anymore and that the financial statements have been revised. Issues of disagreement between the company and the auditor, such as whether a misstatement has occurred, should be resolved by the people in charge of governance. Alternatively, legal advice should be sought.

3.4 Audit Procedures and Comparative Financial Statements

To ensure that the comparative financial statements comply with the applicable accounting regulation, the auditor should examine whether the prior period accounting policies are consistent with those of the current period and whether appropriate adjustments have been recorded. In the case where the prior period's financial statements have been audited by a different auditor, the previous auditor may reissue the audit report on the prior period, while the incoming auditor may report on the current period. The audit report that is prepared by the incoming auditor should describe the report that was issued by the previous auditor. In the case where, due to change in circumstances or events, the opinion that is expressed within the current year's audit on the prior period's financial statements differs from the opinion that was initially expressed, the auditor should refer to the different opinion in an emphasis of matter paragraph.

It may be that the auditor has identified a material misstatement in the prior period's financial statements, where an unmodified audit report has been issued. If, after consultation with management, the prior period's financial statements have been revised accordingly and a new audit report has been issued, the auditor should ensure that the audit evidence corresponds to the revised financial statements. If the previous auditor disagrees with the suggested restatement in the prior period's financial statements or the reissue of the audit report on the prior period's financial statements, the audit report may show that the previous auditor has reported on the prior period's non-restated financial statements.

If the prior period's financial statements are not audited, the auditor should explicitly show in the audit report that the particular figures have not been audited. In the case where the prior period's unaudited financial statements exhibit a material misstatement, the auditor should ask the company's management to revise the figures under
investigation. If the company does not agree to revise the corresponding figures, the audit report should be modified.

4. MODIFICATIONS TO THE AUDIT REPORT

ISA 701 states:

"6. The auditor should modify the auditor’s report by adding a paragraph to highlight a material matter regarding a going concern problem."

"7. The auditor should consider modifying the auditor’s report by adding a paragraph if there is a significant uncertainty ..., the resolution of which is dependent upon future events and which may affect the financial statements."

"12. A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being ‘except for’ the effects of the matter to which the qualification relates."

"13. A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements."

"14. An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements."

"15. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements."

"18. When there is a limitation on the scope of the auditor’s work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor’s report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed."
"20. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion."

4.1 Emphasis of a Matter without Qualification of Opinion

An emphasis of a matter paragraph would refer to a situation, where sorting an issue would depend on actions that are not under the direct control of the company. The issue referred to in the paragraph would be further discussed in a respective note in the financial statements. The emphasis of a matter paragraph does not affect the auditor’s opinion, and follows the auditor’s opinion paragraph. In the case where the audited financial statements differ materially from the actual financial statements, the auditor should ask the company to take the appropriate corrective action. If the company does not comply with the auditor’s request, the auditor could add an emphasis of matter paragraph to explain the material deviation. In cases of significant material inconsistencies and uncertainties, the auditor may issue a disclaimer of opinion.

4.2 Qualified Opinion, Disclaimer of Opinion and Adverse Opinion

A qualified opinion is expressed when the impact of a limitation on scope is not so material so as to call for an adverse opinion or a disclaimer of opinion to be issued. A disclaimer of opinion is issued when the impact of a limitation on scope is so material that has prevented the auditor from obtaining sufficient audit evidence and is subsequently unable to issue an opinion. An adverse opinion is expressed when the impact of a disagreement with the company's management is so material that the auditor considers that the expression of a qualified opinion would not sufficiently describe the misstatement of the financial statements.

4.3 Limitations on Scope

Limitations on the scope of an auditor’s work could relate to cases where the company's management does not agree with the execution of an audit procedure that is considered by the auditor to be essential. On the other hand, the auditor may not be able to carry out an audit procedure effectively because of factors, such as time constraints, procedures that commenced before the auditor’s appointment, lack of accurate or proper accounting records, limited access to key information sources, etc. To overcome such limitations, the auditor should employ alternative techniques in order to obtain proper audit evidence. If proper audit evidence cannot be obtained, the auditor should express a qualified opinion or a disclaimer of opinion, explaining the underlying limitations and presenting the
various adjustments to the company's accounts that would be necessary if there were no such limitations.

References


