



CHAPTER 10

AUDIT EVIDENCE AND WORKING PAPERS

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Review Questions

1. Professional skepticism means that internal auditors take nothing for granted; they continuously question what they hear and see and critically assess audit evidence.
2. Reasonable assurance means that internal auditors strive to obtain sufficient appropriate evidence to provide a reasonable basis for formulating their conclusions and advice. Internal auditors are rarely, if ever, in a position to provide absolute assurance regarding the truthfulness of management's assertions regarding the system of internal controls and performance. Even experienced internal auditors are rarely convinced beyond all doubt. This is due to the nature and extent of evidence they gather and the types of decisions they make. Frequently, internal auditors must rely on evidence that is persuasive rather than absolutely convincing, and audit decisions are rarely black and white. Moreover, internal auditors' conclusions and advice must be formed at a reasonable cost within a reasonable length of time to add economic value.
3. The defining characteristics of persuasive evidence are relevance, reliability, and sufficiency.
4. Audit objectives specify what the engagement is intended to achieve. Audit procedures are the specific tasks performed by the internal auditor to gather the evidence required to achieve the prescribed audit objectives.
5. The nature of audit procedures relates to the types of tests the internal auditor performs to achieve his or her objectives. The extent of audit procedures pertains to how much audit evidence the internal auditor must obtain to achieve his or her objectives. The timing of audit procedures pertains to when the tests are conducted and the period of time covered by the tests.
6. Characteristics among effective interviewers include:
 - Professionalism (for example, prepared, respectful, courteous, on time).
 - Outstanding interpersonal and oral communication skills, including listening skills.
 - The capacity to display confidence and command respect without being arrogant.
 - An innate curiosity.
 - Objectivity (that is, remain impartial and refrain from interjecting personal opinions).
7. *Vouching* refers to the tracking of information *backward* from one document or record to a previously prepared document or record, or to a tangible resource. Vouching is performed specifically to test the *validity* of documented or recorded information.

Tracing refers to the tracking of information *forward* from one document or record, or a tangible resource, to a subsequently prepared document or record. Tracing is performed specifically to test the *completeness* of documented or recorded information.
8. Common analytical procedures performed by internal auditors include analysis of common-size financial statements, ratio analysis, trend analysis, analysis of future-oriented information, external benchmarking, and internal benchmarking.
9. Common types of computer-assisted audit techniques (CAATs) include generalized audit software, utility software, test data, application software tracing and mapping, audit expert systems, and continuous auditing.



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10. The types of operations that internal auditors can perform with generalized audit software (GAS) include:
 - Examining files and records for validity, completeness, and accuracy.
 - Recalculating recorded values and calculating other values of audit interest.
 - Selecting and printing samples and calculating sample results.
 - Comparing information in separate files.
 - Summarizing, resequencing, and reformatting data.
 - Creating pivot tables for multidimensional analysis.
 - Searching for anomalies in data that may indicate errors or fraud.
 - Preparing and printing reports.
 - Automatically generating a historical log of data analyses performed.
11. The two most widely used commercially available audit software programs are ACL (Audit Command Language) and IDEA (originally an acronym for Interactive Data Extraction and Analysis).
12. Working papers:
 - Aid in planning and performing the engagement.
 - Facilitate supervision of the engagement and review of the work completed.
 - Indicate whether engagement objectives were achieved.
 - Provide the principal support for the internal auditors' communications to the auditee, senior management, the board of directors, and appropriate third parties.
 - Serve as a basis for evaluating the internal audit function's quality assurance program.
 - Contribute to the professional development of the internal audit staff.
 - Demonstrate the internal audit function's compliance with The Institute of Internal Auditors' (IIA's) *International Standards for the Professional Practice of Internal Auditing (Standards)*.
13. Key characteristics of well-prepared working papers include:
 - Working paper formats should be standardized as appropriate to streamline the audit process, facilitate consistent high-quality work across engagements, and simplify review of the working papers, but not overly standardized so that they inhibit internal auditor ingenuity and creativity.
 - Working paper files should be complete and well organized.
 - At the end of an engagement, the files should contain only the final versions of the working papers completed during the engagement.
 - Each individual working paper should stand on its own merits.

Multiple-choice Questions

1. **C** is the best answer. *Professional skepticism* means that internal auditors take nothing for granted; they continuously question what they hear and see and critically assess audit evidence. They do not assume by default that auditee personnel are either honest or dishonest. Applying professional skepticism throughout the engagement helps internal auditors remain unbiased and maintain an open mind to form judgments based on the preponderance of evidence gained during an engagement, and not just individual pieces of information.



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2. **B** is the best answer. Internal auditors are rarely, if ever, in a position to provide absolute assurance regarding the truthfulness of management's assertions regarding the system of internal controls and performance. Even experienced internal auditors are rarely convinced beyond all doubt. This is due to the nature and extent of evidence they gather and the types of decisions they make. Frequently, internal auditors must rely on evidence that is persuasive rather than absolutely convincing, and audit decisions are rarely black and white. Moreover, internal auditors' conclusions and advice must be formed at a reasonable cost within a reasonable length of time to add economic value. Accordingly, internal auditors strive to obtain sufficient appropriate evidence to provide reasonable, rather than absolute, assurance.
3. **B** is the best answer. An internal auditor performing assurance services must obtain sufficient appropriate evidence to support well-founded conclusions. Evidence is appropriate if it provides relevant and reliable support for the internal auditor's judgments. Appropriate evidence is sufficient when the internal auditor has obtained enough of it to support valid conclusions.
4. **A** is the best answer. The reliability of documentary evidence depends to a large extent on its origin and the route it follows before being examined by the internal auditor. A vendor's invoice comes from an outside third-party source. Credit memoranda, receiving reports, and copies of sales invoices are created internally and are not validated by a third party before being examined by the internal auditor.
5. **C** is the best answer. Observation does provide evidence about whether operating activities are aligned with prescribed policies. It is used, for example, to test segregation of duties. Individuals may, however, behave differently than they would otherwise when they know they are being observed. Observation generally is used to test existence and occurrence, not completeness.
6. **C** is the best answer. Net accounts receivable as a percentage of total assets increased over the three-year period. During this period, accounts receivable turnover decreased. Overstating sales returned for credit would cause both net sales and average accounts receivable to be understated, thus causing accounts receivable turnover to increase. Recording fictitious sales would cause both net sales and average accounts receivable to be overstated, thus causing accounts receivable turnover to decrease. Deteriorating credit and collection procedures would slow down the collection of accounts receivable, thus causing accounts receivable turnover to decrease. Understating the allowance for bad debts would cause net accounts receivable to increase, thus causing accounts receivable turnover to decrease.
7. **A** is the best answer. Vouching involves the tracking of information backward from one document or record to a previously prepared document or record and is performed specifically to test the validity of documented or recorded information. In this case, the approved purchase requisitions serve as the authorization to prepare the purchase orders that will be sent to vendors of office supplies. Tracing purchase requisitions forward to purchase orders would not uncover instances of missing purchase requisitions.
8. **C** is the best answer. Recorded purchases of raw materials would be increasing without a corresponding increase in cost of goods produced. Vouching cash disbursements to receiving reports and invoices would be ineffective because the manager falsified receiving reports and approved the invoices for payment. Confirmations from vendors would indicate that the raw materials had been purchased and shipped. Observing the receiving dock and counting the materials received would be ineffective since the materials in question never reached the receiving dock.



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9. **C** is the best answer. The purpose of the audit test is to determine the validity of cash disbursements, or more specifically, the validity of the vendors to which the payments are going. All expenditures, regardless of amount, should be supported by documentation indicating that goods or services were purchased and received. Lack of supporting documentation would be an indicator of fictitious vendors. Responses to confirmations sent to fictitious vendors are likely to indicate that the payments they received are for goods or services they provided.
10. **C** is the best answer. The working papers should identify the audit objectives, that is, what the engagement team expects to achieve, the procedures the team used to achieve its objectives, and the conclusions reached by the team based on its test results. The working papers also should contain the engagement team's observations, or "pertinent statements of fact" that "emerge by a process of comparing what should be with what is" and the team's recommendations, which are based on its conclusions and observations.

Discussion Questions

1.
 - a. The first audit objective involves validity. Recording sales transactions based on invalidly prepared sales invoices (that is, sales invoices not supported by an actual shipment of goods) results in sales being overstated. The second audit objective involves completeness. Failure to record sales transactions, because invoices were not prepared for shipments that occurred, results in sales being understated.
 - b. The audit procedure used to achieve the first objective is vouching sales invoices to shipping documents to determine whether the shipments upon which the invoices are based actually occurred. The audit procedure used to achieve the second objective is tracing shipping documents to sales invoices to ensure that an invoice has been prepared for each shipment that has occurred.
 - c. Choosing the proper document as the starting point and testing in the proper direction are important because failure to do so results in gathering evidence that is not relevant to the specified audit objective. Conclusions based on irrelevant audit evidence are invalid.
2.
 - a. The procedures an internal auditor might use to gain an understanding of how the computers were acquired, used, and accounted for include:
 - Inquiries of personnel directly involved in acquiring, using, and accounting for the computers.
 - Observing personnel using the computers.
 - Inspecting the accounting records and supporting source documents.
 - b.
 1. Vouch the purchase orders for the computers to approved purchase requisitions.
 2. Inquire about and observe the functional division of duties among the personnel responsible for authorizing the purchases, making the purchases, accounting for the purchases, and using the computers.
 3. Observe whether computer locks and tie-down cables are being used. Observe whether doors are locked during non-operating hours. Reperform login procedures using invalid login IDs and passwords.
 4. Inquire about the policies and procedures for installing software on the computers. Inspect the software loaded on the computers.
 5. Vouch the recorded computers from the accounting records to the actual computers.
 6. Trace the actual computers to the accounting records.



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7. Vouch the recorded amounts to vendor invoices.
 8. Inquire about how the useful lives and salvage values of the computers were determined. Compare the estimated useful lives and salvage values of these computers with comparable computers used in other divisions or functional areas of the company.
 9. Inspect the formulas used to calculate depreciation expense. Recalculate depreciation expense.
3. a. Formulas:
- Gross profit percentage = $(\text{Net sales} - \text{Cost of goods sold}) \div \text{Net sales}$
 - Inventory turnover = $\text{Cost of goods sold} \div ([\text{Beginning inventory} + \text{Ending inventory}] \div 2)$
 - Cost of materials purchased to cost of finished goods produced = $\text{Materials purchased} \div (\text{Ending inventory} + \text{Cost of goods sold} - \text{Beginning inventory})$

Calculated values:

	2007	2006	2005	2004
Gross profit percentage	26.3%	22.6%	22.4%	22.4%
Inventory turnover	6.58	7.64	7.60	7.94
Cost of materials purchased to cost of finished goods produced	59.9%	51.8%	48.7%	51.1%

- b. The gross profit percentage increased. Both gross profit and net sales increased. Gross profit increased by a higher percentage than net sales. Possible reasons:
- Sales prices were increased without a corresponding increase in cost of goods sold.
 - The method of accounting for inventory was changed causing a higher ending inventory (more costs absorbed into inventory) and lower cost of goods sold.
 - Inventory cutoff was improper. Sales were recorded without the corresponding entry to cost of goods sold.
 - The product mix of the company changed. More high-markup items were sold.
 - Fictitious sales were recorded (fraud).

Inventory turnover decreased. Both finished goods inventory and cost of goods sold increased. Finished goods inventory increased by a higher percentage than cost of goods sold. Possible reasons:

- The increased selling prices, which caused the gross profit percentage to increase, reduced demand.
- The company is building its supply of inventory in anticipation of increased sales next year.
- A portion of the company's inventory has become obsolete.

The cost of materials purchased to cost of finished goods produced percentage increased. Both the cost of the materials purchased and the cost of finished goods produced increased. The cost of materials purchased increased by a higher percentage than the cost of finished goods produced.

Possible reasons:

- The company purchased an excessive amount of materials.
- The company purchased poorer quality materials causing more scrap/waste.
- Someone ordered excessive quantities of materials and diverted the shipments (fraud).
- The price of materials increased at a higher rate than other inventory costs.



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4. a. The internal auditor should identify shipping documents for shipments immediately before and after the year-end cutoff and trace them to sales invoices and the accounting records. The internal auditor also should identify sales recorded in the accounting records immediately before and after the year-end cutoff and vouch them to sales invoices and the accounting records.
- b. Invoice 8351: The goods were shipped in 2006 and the customer was billed in 2006. Assuming that the sale was recorded on the billing date per the company's policy, no adjusting entry is required.

Invoice 8352: The goods were shipped in 2006, but the customer was not billed until 2007. Sales for 2006 are understated. The following adjusting entries should be recorded:

Accounts Receivable	xxx	
Sales		xxx
Cost of Goods Sold	yyy	
Inventory		yyy

Invoice 8353: The goods were shipped in 2007, but the customer was billed in 2006. Sales for 2006 are overstated. The internal auditor should investigate this situation to determine why the customer was billed before the goods were shipped. The following adjusting entries should be recorded:

Sales	xxx	
Accounts Receivable		xxx
Inventory	yyy	
Cost of Goods Sold		yyy

Invoice 8354: The goods were shipped in 2007 and the customer was billed in 2007. Assuming that the sale was recorded on the billing date per the company's policy, no adjusting entry is required.

Cases

Case 1

The textbook authors recommend that instructors complete this case themselves before assigning it to their students. Working through the tutorial is straightforward.

Case 2

The textbook authors recommend that instructors complete this case themselves before assigning it to their students. Working through the tutorial is straightforward.