

Chapter 7

Audit Evidence

■ Concept Checks

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1. Following are six characteristics that determine reliability of evidence and an example of each.

FACTOR DETERMINING RELIABILITY	EXAMPLE OF RELIABLE EVIDENCE
Independence of provider	Confirmation of a bank balance
Effectiveness of client's internal controls	Use of duplicate sales invoices for a large well-run company
Auditor's direct knowledge	Physical examination of inventory by the auditor
Qualifications of provider	Letter from an attorney dealing with the client's affairs
Degree of objectivity	Count of securities on hand by auditor
Timeliness	Observe inventory on the last day of the fiscal year

2. The eight types of evidence and examples of each are included in the table below.

TYPES OF AUDIT EVIDENCE	EXAMPLES
1. Physical examination	■ Count inventory in warehouse ■ Examine fixed asset additions
2. Confirmation	■ Confirm accounts receivable balances of a sample of client customers ■ Confirm client's cash balance with bank
3. Inspection	■ Examine copies of monthly bank statements ■ Examine vendors' invoices supporting a sample of cash disbursement transactions throughout the year

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TYPES OF AUDIT EVIDENCE	EXAMPLES
4. Analytical procedures	■ Evaluate reasonableness of receivables by calculating and comparing ratios ■ Compare expenses as a percentage of net sales with prior year's percentages
5. Inquiries of the client	■ Inquire of management whether there is obsolete inventory ■ Inquire of management regarding the collectibility of large accounts receivable balances
6. Recalculation	■ Recompute invoice total by multiplying item price times quantity sold ■ Foot the sales journal for a one-month period and compare all totals to the general ledger
7. Reperformance	■ Agree sales invoice price to approved price list ■ Match quantity on purchase invoice to receiving report
8. Observation	■ Observe client employees in the process of counting inventory ■ Observe whether employees are restricted from access to the check signing machine

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1. Analytical procedures are required during two phases of the audit: (1) during the planning phase to assist the auditor in determining the nature, extent, and timing of work to be performed and (2) during the completion phase, as a final review for material misstatements or financial problems. Analytical procedures are also often done during the testing phase of the audit as part of the auditor's further audit procedures, but they are not required in this phase.
2. The four categories of financial ratios and examples of ratios in each category are as follows:
 1. *Short-term debt-paying ability* – Cash ratio, quick ratio, and current ratio.
 2. *Liquidity activity* – Accounts receivable turnover, days to collect receivables, inventory turnover, and days to sell inventory.
 3. *Ability to meet long-term debt obligations* – Debt to equity and times interest earned.
 4. *Profitability* – Earnings per share, gross profit percent, profit margin, return on assets, and return on common equity

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1. The purposes of audit documentation are as follows:

- To provide a basis for planning the audit. The auditor may use reference information from the previous year in order to plan this year's audit, such as the evaluation of internal control, the time budget, etc.
- To provide a record of the evidence accumulated and the results of the tests. This is the primary means of documenting that an adequate audit was performed.
- To provide data for deciding the proper type of audit report. Data are used in determining the scope of the audit and the fairness with which the financial statements are stated.
- To provide a basis for review by supervisors and partners. These individuals use the audit documentation to evaluate whether sufficient appropriate evidence was accumulated to justify the audit report.

Audit documentation is used for several purposes, both during the audit and after the audit is completed. One of the uses is the review by more experienced personnel. A second is for planning the subsequent year audit. A third is to demonstrate that the auditor has accumulated sufficient appropriate evidence if there is a need to defend the audit at a later date. For these uses, it is important that the audit documentation provide sufficient information so that the person reviewing an audit schedule knows the name of the client, contents of the audit schedule, period covered, who prepared the audit schedule, when it was prepared, and how it ties into the rest of the audit files with an index code.

2. Audit schedules should include the following:

- *Name of the client.* Enables the auditor to identify the appropriate file to include the audit schedule in if it is removed from the files.
- *Period covered.* Enables the auditor to identify the appropriate year to which an audit schedule for a client belongs if it is removed from the files.
- *Description of the contents.* A list of the contents enables the reviewer to determine whether all important parts of the audit schedule have been included. The contents description is also used as a means of identifying audit files in the same manner that a table of contents is used.
- *Initials of the preparer.* Indicates who prepared the audit schedule in case there are questions by the reviewer or someone who wants information from the files at a later date. It also clearly identifies who is

responsible for preparing the audit documentation if the audit must be defended.

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- *Date of preparation.* Helps the reviewer to determine the sequence of the preparation of the audit schedules. It is also useful for the subsequent year in planning the sequence of preparing audit schedules.
- *Indexing.* Helps in organizing and filing audit schedules. Indexing also facilitates in searching between related portions of the audit documentation

■ Review Questions

7-1 In both a legal case and in an audit of financial statements, evidence is used by an unbiased person to draw conclusions. In addition, the consequences of an incorrect decision in both situations can be equally undesirable. For example, if a guilty person is set free, society may be in danger if the person repeats his or her illegal act. Similarly, if investors rely on materially misstated financial statements, they could lose significant amounts of money. Finally, the guilt of a defendant in a legal case must be proven beyond a reasonable doubt. This is similar to the concept of sufficient appropriate evidence in an audit situation. As with a judge or jury, an auditor cannot be completely convinced that his or her opinion is correct, but rather must obtain a high level of assurance.

The nature of evidence in a legal case and in an audit of financial statements differs because a legal case relies heavily on testimony by witnesses and other parties involved. While inquiry is a form of evidence used by auditors, other more reliable types of evidence such as confirmation with third parties, physical examination, and inspection are also used extensively. A legal case also differs from an audit because of the nature of the conclusions made. In a legal case, a judge or jury decides the guilt or innocence of the defendant. In an audit, the auditor issues one of several audit opinions after evaluating the evidence.

7-2 The four major audit evidence decisions that must be made on every audit are:

1. Which audit procedures to use.
2. What sample size to select for a given procedure.
3. Which items to select from the population.
4. When to perform the procedure.

7-3 An audit procedure is the detailed instruction for the collection of a type of audit evidence that is to be obtained. Because audit procedures are the instructions to be followed in accumulating evidence, they must be worded

carefully to make sure the instructions are clear.

7-4 An audit program for accounts receivable is a list of audit procedures that will be used to audit accounts receivable for a given client. The audit procedures, sample size, items to select, and timing should be included in the audit program.

7-5 There are two primary reasons why the auditor can only be persuaded with a reasonable level of assurance, rather than be convinced that the financial statements are correct:

1. The cost of accumulating evidence. It would be extremely costly for the auditor to gather enough evidence to be completely convinced.
2. Evidence is normally not sufficiently reliable to enable the auditor to be completely convinced. For example, confirmations from customers may come back with erroneous information, which is the fault of the customer rather than the client.

7-6 The two determinants of the persuasiveness of evidence are appropriateness and sufficiency. Appropriateness refers to the relevance and reliability of evidence, or the degree to which evidence can be considered believable or worthy of trust. Appropriateness relates to the audit procedures selected, including the timing of when those procedures are performed. Sufficiency refers to the quantity of evidence and it is related to sample size and items to select.

7-7 The characteristics of a confirmation are:

1. Receipt directly by auditor
2. Written or electronic response
3. From independent third party
4. Requested by the auditor

A confirmation is prepared specifically for the auditor and comes from an external source. External documentation is in the hands of the client at the time of the audit and was prepared by an external party for the client's use in the day-to-day operation of the business.

7-8 *Internal documentation* is prepared and used within the client's organization without ever going to an outside party, such as a customer or vendor.

Examples:

- check request form
- receiving report
- payroll time record
- adjusting journal entry

External documentation either originated with an outside party or was an internal document that went to an outside party and is now either in the hands of the client or is readily accessible.

7-8 (continued)

Examples:

- vendor's invoice
- cancelled check
- cancelled note
- validated deposit slip

7-9 The most important reasons for performing analytical procedures are the following:

1. Understanding the client's business and industry
2. Assessment of the entity's ability to continue as a going concern
3. Indication of the presence of possible misstatements in the financial statements
4. Reduction of detailed audit tests

7-10 Analytical procedures are required during two phases of the audit: (1) during the planning phase to assist the auditor in understanding the client's business and industry and to assist in determining the nature, extent, and timing of work to be performed, and (2) during the completion phase, as a final review for material misstatements or financial problems. Analytical procedures are also often done during the testing phase of the audit as part of the auditor's further audit procedures, but they are not required in this phase.

7-11 Attention-directing analytical procedures occur when significant, unexpected differences are found between current year's unaudited financial data and other data used in comparisons. If an unusual difference is large, the auditor must determine the reason for it, and satisfy himself or herself that the cause is a valid economic event and not an error or misstatement due to fraud. If the analytical procedure indicates an increased risk of misstatement, the auditor should consider the likely causes and evaluate the effect on the nature and extent of substantive tests.

Substantive analytical procedures are designed to reduce or eliminate detailed substantive tests. The effectiveness of an analytical procedure in providing substantive evidence depends on the predictability of the relationship and the reliability of underlying data used to support the analytical procedure calculations.

7-12 Roger Morris performs ratio and trend analysis at the end of every audit. By that time, the audit procedures are completed. If the analysis was done at an interim date, the scope of the audit could be adjusted to compensate for the findings, especially when the results suggest a greater likelihood of material misstatements. Analytical procedures must be performed in the planning phase of the audit and near the completion of the audit.

7-12 (continued)

The use of ratio and trend analysis appears to give Roger Morris an insight into his client's business and affords him an opportunity to provide excellent business advice to his client. It also helps provide a richer context for Roger to really understand his client's business, which should help Roger in assessing the risk of material misstatements.

7-13 Liquidity activity ratios, such as accounts receivable turnover, days to collect receivables, inventory turnover, and days to sell inventory, provide information about how long it takes a company to convert less-liquid current assets into cash. Auditors often use trends in these ratios from period-to-period to assess collectibility of receivables or potential obsolescence of inventory.

7-14 Audit files are owned by the auditor. They can be used by the client if the auditor wants to release them after a careful consideration of whether there might be confidential information in them. The audit files can be subpoenaed by a court and thereby become the property of the court. They can be released to another CPA firm without the client's permission if they are being reviewed as a part of a voluntary peer review program under AICPA, state CPA society, or state Board of Accountancy authorization. The audit files can be sold or released to other users *if* the auditor obtains permission from the client.

7-15 The Sarbanes–Oxley Act of 2002 requires auditors of public companies to prepare and maintain audit schedules and other information related to any audit report in sufficient detail to support the auditor's conclusions, for a period of not less than 7 years.

7-16 The permanent file contains data of an historical and continuing nature pertinent to the current audit. Examples of items included in the file are:

1. Articles of incorporation
2. Bylaws, bond indentures, and contracts
3. Analysis of accounts that have continuing importance to the auditor
4. Information related to the understanding of internal control:
 - a. flowcharts
 - b. internal control questionnaires
5. Results of previous years' analytical procedures, such as various ratios and percentages compiled by the auditors

By separating this information from the current year's audit files, it becomes easily accessible for the following year's auditors to obtain permanent file data.

7-17 The purpose of an *analysis* is to show the activity in a general ledger account during the entire period under audit, tying together the beginning and ending balances. The *trial balance* includes the detailed makeup of an ending balance. It differs from an analysis in that it includes only those items comprising the end of the period balance. A *substantive analytical procedure* involves comparison of the expectation of the account balance developed by the auditor to the recorded amount that enables the auditor to evaluate whether a certain account balance appears to be misstated.

7-18 Unanswered questions and exceptions may indicate the potential for significant errors or fraud in the financial statements. These should be investigated and resolved to make sure that financial statements are fairly presented.

The audit files can also be subpoenaed by courts as legal evidence. Unanswered questions and exceptions may indicate lack of due care by the auditor.

7-19 Tick marks are symbols adjacent to information in audit schedules for the purpose of indicating the work performed by the auditor. An explanation of the tick mark must be included at the bottom of the audit schedule to indicate what was done and by whom.

7-20 The purposes of audit engagement management software are to convert traditional paper-based documentation into electronic files and to organize the audit documentation, and help manage the engagement. The benefits of engagement management software are as follows:

- The software facilitates tracking audit progress by indicating the performance and review status of each audit area.
- The auditor can more efficiently prepare a trial balance, lead schedules, supporting audit documentation, financial statements, and ratio analysis using the computer rather than by hand.
- The effects of adjusting journal entries are automatically carried through to the trial balance and financial statements, making last-minute adjustments easier to make.
- Tick marks and review notes can be entered directly into computerized files, and the audit progress can be easily monitored.
- Data can be imported and exported to other applications. For example, a client's general ledger can be downloaded and tax information can be downloaded into a commercial tax preparation package after the audit is completed.

■ Multiple Choice Questions From CPA Examinations

7-21 a. (2) b. (4) c. (4)

7-22 a. (1) b. (4) c. (2)

7-23 a. (3) b. (3) c. (4)

■ Multiple Choice Questions From Becker CPA Exam Review

7-24 a. (4) b. (2) c. (1)

■ Discussion Questions And Problems

7-25 a. 1. Internal 7. External 13. Internal
 2. Internal 8. External 14. Internal
 3. External 9. External 15. Internal*
 4. Internal 10. Internal 16. External
 5. External 11. Internal 17. External
 6. External 12. External 18. External**

* Even though these may be signed or initialed by employees, they are still internal documents.

** Bills of lading are ordinarily signed by the freight company. That signature will be included on the top of the bill of lading; therefore, it is an external document.

b. External evidence is considered more reliable than internal evidence because external evidence has been in the hands of both the client and another party, implying agreement about the information and the conditions stated on the document.

7-26

1. (4) analytical procedures
2. (5) inquiries of client
3. (3) inspection
4. (2) confirmation
5. (6) recalculation
6. (1) physical examination
7. (2) confirmation
8. (6) recalculation
9. (2) confirmation
10. (3) inspection
11. (4) analytical procedures
12. (5) inquiries of client
13. (7) reperformance
14. (8) observation
15. (1) physical examination
16. (3) inspection
17. (5) inquiries of client

18. (4) analytical procedures

7-27

ACCOUNT NAME	FROM WHOM CONFIRMED	INFORMATION TO BE CONFIRMED
CASH IN BANK	All banks in which Star had deposits during the year, including those which may have had an account that was closed out during the year.	■ Name and address of the bank. ■ The amount on deposit for each account as of the balance sheet date plus the name of each account, the account number, whether or not the account is subject to withdrawal by check, and the interest rate if the account is interest bearing. ■ The amount for which Star was directly liable to the bank for loans as of the balance sheet date plus the date of the loan, the due date, the interest rate, the date to which interest is paid, and description of the liability and collateral. ■ If internal controls over cash are deficient, the auditor may wish to request that the bank include a list of authorized signatures with the confirmation.
TRADE ACCOUNTS RECEIVABLE	A representative sample of debtors at a selected confirmation date which may be either at the balance sheet or an interim date. Confirmations should also be requested for the following types of accounts: ■ Accounts with large balances; ■ Past-due accounts; ■ Accounts with zero or credit balances; ■ Accounts written off during the current period; ■ Accounts whose collection is considered questionable; ■ Other accounts of an unusual nature.	The confirmation can be either a positive or negative form of request. The positive form requests the debtor to directly notify the auditor whether the information is correct and, if not correct, which items are considered incorrect. The negative form requests a reply only if the information is incorrect. In both cases the information should include: ■ Name and address of the debtor. ■ Account number (if applicable). ■ The confirmation "as of" date. ■ The aged account balance or individual invoices included in such balance (with invoice date).

7-27 (continued)

ACCOUNT NAME	FROM WHOM CONFIRMED	INFORMATION TO BE CONFIRMED
NOTES RECEIVABLE	A selected sample of notes receivable outstanding at the balance sheet date. If a note receivable was written off during the year, the balance written off should be confirmed.	■ Name and address of the debtor. ■ Date of the note. ■ Due date. ■ Unpaid balance at balance sheet date. ■ Payment arrangements. ■ Interest rate. ■ Date of last interest payment. ■ Collateral, if any, to secure the note.
INVENTORIES	Public warehouses or other outside custodians (if any).	■ Name and address of public warehouse or other outside custodian. ■ The inventory date. ■ Detailed lists of inventory stored. Under auditing standards, direct confirmation is acceptable provided supplemental inquiries are made that the inventory is the property of the company, unless the amount is a significant percent of current or total assets.

TRADE ACCOUNTS PAYABLE	Suppliers from whom substantial purchases have been made during the year, regardless of the balances of their accounts at the balance sheet date.	■ Name and address of the supplier. ■ The amount due and the amount of any purchase commitments as of the balance sheet date. When internal controls are considered effective, the confirmation can be at an interim date; however, a thorough review must then be made of changes in the major accounts during the intervening period between the confirmation date and year-end. It should also be noted that with interim confirmation, the auditor loses a desirable audit procedure for disclosing unrecorded and contingent liabilities at the balance sheet date. As an alternative to confirmation letters, it is a common practice to ask the vendor to send, directly to the independent auditor, a statement of the vendor's account with the client as of the balance sheet date rather than send an accounts payable confirmation.
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7-27 (continued)

ACCOUNT NAME	FROM WHOM CONFIRMED	INFORMATION TO BE CONFIRMED
MORTGAGES PAYABLE	Mortgagee for each mortgage that has a balance at the balance sheet date.	■ Name and address of mortgagee. ■ Original amount. ■ Date of note. ■ Maturity date. ■ Balance due at balance sheet date. ■ Payment arrangements. ■ Interest rate. ■ Interest payment dates. ■ Date of last interest payment. ■ Nature of defaults and if any events of default are known to mortgagee. ■ Location of mortgaged property.
CAPITAL STOCK	If Star uses an outside transfer agent and registrar, confirmations should be sent to both.	■ Name and address of transfer agent and registrar. ■ Number of shares of common stock authorized, issued, outstanding, and held as treasury shares for the company as of the balance sheet date.
LEGAL FEES	All of Star's major attorneys. Letters should also be sent to attorneys that the independent auditor knows the client has used extensively in prior years.	The auditor should request a letter from each attorney as to litigation being handled as of and subsequent to the balance sheet date. For each case, the attorney should give a description, report on its status as of the balance sheet date and as of the date of the letter, and give his or her opinion as to the ultimate liability. The attorney should also state Star's indebtedness to him or her as of the balance sheet date.
SALES AND EXPENSE ACCOUNTS	Occasionally, confirmation may be requested from an outside party for individual transactions. This may be true where a major item is based on a formal contract and the auditor wants independent confirmation of agreement on the significant term of the contract and that these terms have been satisfactorily completed.	■ Name and address of outside party. ■ Other specific information would depend on the nature of the item and the reason the auditor believes it is necessary to confirm the item.

7-28

AUDIT PROCEDURE	a. TYPE OF AUDIT EVIDENCE	b. TRANSACTION- RELATED AUDIT OBJECTIVE
1. Trace from receiving reports to vendors' invoices and entry in the acquisitions journal.	Inspection	Completeness
2. Add the sales journal for the month of July and trace amounts to the general ledger.	Recalculation	Posting and summarization
3. Examine expense voucher packages and related vendors' invoices for approval of expense account classification.	Inspection	Classification
4. Observe opening of cash receipts to determine that cash receipts are promptly deposited and recorded.	Observation	Timing and Completeness
5. Ask the accounts payable clerk about procedures for verifying prices, quantities, and extensions on vendors' invoices.	Inquiries of client	Accuracy
6. Vouch entries in sales journal to sales invoices and related shipping documents.	Inspection	Occurrence

7-29

AUDIT PROCEDURE	a. TYPE OF AUDIT EVIDENCE	b. BALANCE- RELATED AUDIT OBJECTIVE
1. Select a sample of inventory items in the factory warehouse and trace each item to the inventory count sheets to determine if it has been included and if the quantity and description are correct.	Physical examination	Completeness and Accuracy
2. Trace selected quantities from the inventory list to the physical inventory to make sure that it exists and the quantities are the same.	Physical examination	Existence and Accuracy
3. Compare the quantities on hand and unit prices on this year's inventory count sheets with those in the preceding year as a test for large differences.	Analytical procedures	Accuracy
4. Test the extension of unit prices times quantity on the inventory list for a sample of items, test foot the list, and compare the total to the general ledger.	Recalculation	Detail tie-in
5. Send letters directly to third parties who hold the client's inventory, and request they respond directly to the auditor.	Confirmation	Existence, Completeness, and Accuracy
6. Examine sales invoices and contracts with customers to determine whether any goods are out on consignment with customers. Examine vendors' invoices and contracts with vendors to determine if any goods on the inventory listing are owned by vendors.	Inspection	Rights

AUDIT PROCEDURE	a. TYPE OF AUDIT EVIDENCE	b. BALANCE- RELATED AUDIT OBJECTIVE
7. Question operating personnel about the possibility of obsolete or slow-moving inventory.	Inquiries of the client	Realizable value

- 7-30** a. The six factors determining the reliability of evidence are:
1. Independence of provider
 2. Effectiveness of client's internal controls
 3. Auditor's direct knowledge
 4. Qualifications of individuals providing the information
 5. Degree of objectivity
 6. Timeliness
- b.
and
c.

SITUATION	b. TYPE OF EVIDENCE THAT IS MORE RELIABLE	c. FACTOR AFFECTING RELIABILITY
1	Confirmation with business organizations	Qualifications of provider
2	Physically examine three-inch steel plates	Qualifications of provider (in this case the auditor)
3	Examine documents when several competent people are checking each other's work	Effectiveness of internal controls
4	Examine inventory of parts for the number of units on hand	Degree of objectivity
5	Discuss potential lawsuits with CPA firm's legal counsel	Independence of provider
6	Confirm a bank balance	Degree of objectivity
7	Confirm a bank balance	Independence of provider
8	Physically count the client's inventory	Auditor's direct knowledge
9	Physically count the inventory	Independence of provider and auditor's direct knowledge

7-31

PROCEDURE	a. APPROPRIATE TERM	b. TYPE OF EVIDENCE
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1	Recompute (e)	Recalculation
2	Observe (j)	Observation
3	Compute (d)	Analytical procedure
4	Foot (f), Trace (g)	Recalculation and reperformance
5	Scan (b)	Analytical procedure
6	Inquire (k)	Inquiry of client
7	Count (i)	Physical examination
8	Confirm (l)	Confirmation
9	Examine (a), Compare (h)	Inspection
10	Read (c)	Inspection

- 7-32** a. The purposes of analytical procedures are:
1. Understanding the client's business and industry.
 2. Assessment of the entity's ability to continue as a going concern.
 3. Indication of the presence of possible misstatements in the financial statements.
 4. Reduction of detailed audit tests.
- b. Analytical procedures are required in the planning and completion phases of the audit because of their importance in planning the audit, and as a final review for potential misstatements. Auditors use analytical procedures extensively because of their relatively low cost and effectiveness in identifying potential misstatements.
- c. The extent to which the auditor will use the results of analytical procedures to reduce detailed tests depends on the effectiveness of the analytical procedure and whether it supports the correctness of the recorded account balance. The effectiveness of the analytical procedure is a function of the precision of the expectation developed by the auditor and whether it is based on objective data.

7-33

STATEMENT	RELATED STAGE OF AUDIT
1. Should focus on enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date.	a. Planning the audit
2. Should focus on identifying areas that may represent specific risks relevant to the audit.	a. Planning the audit
3. Require documentation in the working papers of the auditor's expectation of the ratio or account balance.	b. Substantive testing
4. Do not result in detection of misstatements.	d. Statement is not correct concerning analytical procedures
5. Designed to obtain evidential matter about particular assertions related to account balances or classes of transactions.	b. Substantive testing
6. Generally use data aggregated at a lower level than the other stages.	b. Substantive testing

7-33 (continued)

STATEMENT	RELATED STAGE OF AUDIT
7. Should include reading the financial statements and notes to consider the adequacy of evidence gathered.	c. Overall review
8. Not required during this stage.	b. Substantive testing
9. Involve reconciliation of confirmation replies with recorded book amounts.	d. Statement is not correct concerning analytical procedures
10. Use the preliminary or unadjusted working trial balance as a source of data.	a. Planning the audit

- 7-34** a. The company's financial position is deteriorating significantly. The company's ability to pay its bills is marginal (quick ratio = 0.97), and its ability to generate cash is weak (days to convert inventory to cash = 266.7 in 2016 versus 173.8 in 2012). The earnings per share figure is misleading because it appears stable while the ratio of net income to common equity has been halved in two years. The accounts receivable may contain a significant amount of uncollectible accounts (accounts receivable turnover reduced 25% in four years), and the inventory may have a significant amount of unsalable goods included therein (inventory turnover reduced 40% in four years). The company's burden for increased inventory and accounts receivable levels has required additional borrowings. The company may experience problems in paying its operating liabilities and required debt repayments in the near future.
- b.

ADDITIONAL INFORMATION	REASON FOR ADDITIONAL INFORMATION
1. Debt repayment requirements, lease payment requirements, and preferred dividend requirements	To project the cash requirements for the next several years in order to estimate the company's ability to meet its obligations.
2. Debt to equity ratio	To see the company's capital investment and ability of the company to exist on its present investment.
3. Industry average ratios	To compare the company's ratios to those of the average company in its industry to identify possible problem areas in the company.

7-34 (continued)

ADDITIONAL INFORMATION	REASON FOR ADDITIONAL INFORMATION
4. Aging of accounts receivable, bad debt history, and analysis of allowance for uncollectible accounts	To see the collection potential and experience in accounts receivable. To compare the allowance for uncollectible accounts to the collection experience and determine the reasonableness of the allowance.
5. Aging of inventory and history of markdown taken	To compare the age of the inventory to the markdown experience since the turnover has decreased significantly. To evaluate the net realizable value of the inventory.
6. Short- and long-term liquidity trend ratios	To indicate whether the company may have liquidity problems within the next five years.

- c. Based on the ratios shown, the following aspects of the company should receive special emphasis in the audit:
1. Ability of the company to continue to acquire inventory, replace obsolete or worn-out fixed assets, and meet its debt obligations based on its current cash position.
 2. Reasonableness of the allowance for uncollectible accounts based on the reduction in accounts receivable turnover and increase in days to collect receivables.
 3. Reasonableness of the inventory valuation based on the decreased inventory turnover and increased days to sell inventory.
 4. Computation of the earnings per share figure. It appears inconsistent that earnings per share could remain relatively stable when net earnings divided by common equity has decreased by 50%. This could be due to additional stock offerings during the period, or a stock split.

7-35 Here are expected values for each account except sales and the calculated difference between the expected value and actual recorded balance:

ACCOUNT	EXPECTED VALUE	DIFFERENCE IN EXPECTED AND RECORDED	REASONING TO SUPPORT EXPECTED VALUE
Executive salaries	\$563,348 ($\$546,940 \times 103\%$)	-9.34% $(\$563,348 - \$615,970) / \$563,348$	All executives received a 3% increase in salaries effective November 1, 2015. There were no additions to the number of executives in the current year.
Factory hourly payroll	\$11,167,246 Increase due to 3% pay rate increase: ($\$10,038,877 \times 3\% = \$301,166$ increase due to pay rate increase) 8% increase due to increased production ($\$10,038,877 + \$301,166 = 10,340,043 \times 108\% = \$11,167,246$)	-2.77% $(\$11,167,246 - \$11,476,319) / \$11,167,246$	The increase in factory hourly payroll is attributed to two primary factors. First, payroll expense would be expected to increase 3% over the prior year to account for the 3% wage increase for all employees (except commissioned salespeople). Second, payroll expense should increase 8% to account for the 8% increase in the number of units produced and sold.
Factory supervisors' salaries	\$809,400 ($\$785,825 \times 103\%$)	-.15% $(\$809,400 - \$810,588) / \$809,400$	All factory supervisors' salaries received a 3% increase effective November 1, 2015. There were no additions to the number of factory supervisors in the current year.
Office salaries	\$2,050,005 ($\$1,990,296 \times 103\%$)	-.26% $(\$2,050,005 - \$2,055,302) / \$2,050,005$	All office personnel received a 3% increase in salaries effective November 1, 2015. There were no additions to the number of office personnel in the current year.
Sales commissions	\$2,249,072 Increase in commissions due to increased sales: ($5\% \times \$4,618,461 = \$230,923$) $\$2,018,149 + \$230,923 = 2,249,072$	-5.3% $\$2,249,072 - \$2,367,962 / \$2,249,072$	Sales increased by \$6,157,948. Commissions are only earned on about 75% of the sales. Thus, only 75% of the increase (\$4,618,461) would be considered in the calculation of commission expense. The fact that commissions are paid one month after they are earned does not affect commission expense for the year since management would have to accrue the expense for commissions earned but not paid as of October 31, 2016.

(Note: Sales have increased 12% over prior year. Four percent of that is due to an increase in the average selling price. The remaining 8% is attributed to an increase in the number of units sold.)

- 7-36** a. PCAOB Auditing Standard 3 indicates that audit documentation must not be deleted or discarded after the documentation completion date; however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.
- b. Audit documentation should be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (a) the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements; (b) the results of the audit procedures performed and the audit evidence obtained; and (c) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.
- c. AU-C 500.A50-52 indicates that the auditor should obtain evidence about the completeness and accuracy of information produced by the entity that is used in performing audit procedures.

7-37 In general, the audit schedule is not set up in a logical manner to show what the auditor wants to accomplish. The primary objective of the audit schedule is to verify the ending balance in notes receivable and interest receivable. A secondary objective is to account for all interest income, cash received and cash disbursed for new notes, collateral as security, and other information about the notes for disclosure purposes.

Specific deficiencies of the audit schedule presented in the question are included below.

a. DEFICIENCY	b. IMPROVEMENT
1. Tick mark explanation "tested" does not indicate specifically what was done.	Should have separate tick marks meaning: ■ Agreed to confirmation ■ Footed ■ Traced to cash receipts journal ■ Recomputed, etc.
2. Explanation of some tick marks is not given.	Explain all tick marks on the same page of the audit schedule.
3. Classification of long-term portion indicates no verification.	Recompute portions of notes that are long-term.
4. Paid-to-date row is confusing.	Column should say "date paid to" and this should be confirmed.
5. Due dates are missing for J.J. Co., P. Smith, and Tent Co.	Include due dates on the audit schedule for these notes.

7-37 (continued)**c. Spreadsheet Solution (See P737.xls on text website)**

The purpose of using an Excel spreadsheet in this problem is to give the student some experience in preparing a simple audit schedule using an Excel spreadsheet. It should be explained to students that this type of audit schedule may or may not be prepared in actual practice, and that templates are often used to prepare more time-consuming audit schedules. Also, whether or not tick marks are computerized is a matter to be decided. The advantage is that the completed audit work can then be stored and reviewed electronically. On the other hand, it may be more efficient to indicate audit work manually as it is performed.

The following solution was prepared with Excel (Filename P737.xls). The formulas used are self-evident, so no listing is provided, although it is available on the text website. Two items deserve comment:

1. An advantage of using a spreadsheet program for these types of analyses is that footing and crossfooting are done automatically.
2. When auditor tick marks are done by computer, a problem arises as to how to place them on the worksheet. One could use narrow columns inserted between the scheduled client data, or, as done here, the tick marks are placed in blank rows beneath the related data.

7-37 (continued)

VANDERVOORT COMPANY
A/C #110 - NOTES RECEIVABLE
12/31/16

Schedule
Prepared by
Approved by

N-1	Date
JD	01/21/17
PP	02/15/17

Account #110 - Notes Receivable									Interest			
Maker	Date Made/ Due	Interest Rate/Date Paid to	Face Amount	Value of Security	Balance 12/31/15	Additions	Payments	Balance 12/31/16	Receivable 12/31/15	Earned	Recd	Receivable 12/31/16
Apex Co.	c * 6/15/15 / 06/15/17	5% / None pd.	5000	None	4000 Tp	0	1000 r	3000	104 Tp	175 <	0	279
Ajax, Inc.	c * 11/21/15 / Demand	5% / 12/31/16	3591	None	3591 Tp	0	3591 r	0	0 Tp	102 <	102 r	0
J.J. Co.	c * 11/1/15 / 04/01/21 (\$200/Mo.)	5% / 12/31/16	13180	24000	12780 Tp	0	2400 r	10380	24 Tp	577 <	601 r	0
P. Smith	c * 7/26/16 / 08/01/18 (\$1000/Mo.)	5% / 09/30/16	25000	50000	0	25000 r	5000 r	20000	0	468 <	200 r	268
Martin-Peterson	c * 5/12/15 / Demand	5% / 12/31/16	2100	None	2100 Tp	0	2100 r	0	0 Tp	105 <	105 r	0
Tent Co.	c * 9/3/16 / 02/01/19 (\$400/Mo.)	6% / 11/30/16	12000	10000	0	12000 r	1600 r	10400	0	162 <	108 r	54
					22471	37000	15691	43780	128	1589	1116	601
					f Tp	f	f	f, cf wtb	f Tp	f op	f	f, cf wtb

Legend of Auditor's Tick Marks

f	Footed
cf	Crossfooted
Tp	Traced to prior year audit files
wtb	Traced total to working trial balance
op	Traced total to operations audit schedule - OP6
*	Examined note for payee, made and due dates, interest rate, face amount, and value of security. No exceptions noted.
c	Received confirmation, including date interest paid to, interest rate, interest paid during 2016, note balance, and security. No exceptions noted.

r Traced to cash receipts records
< Recomputed for the year

■ Cases

7-38 The following are deficiencies in the sufficiency and appropriateness of the evidence in the audit of accounts payable for Grande Stores:

McClure Advertising Credits – An insufficient number of confirmations (four) were sent. The use of alternative procedures is probably acceptable. However, one credit was confirmed by telephone, rather than by written confirmation. Although the differences found were immaterial, the auditors should have determined the reason for the differences, and any errors should have been projected to the population.

Twenty additional credits were selected for testing. Whether this is a sufficient number is a matter of judgment, and depends on several factors. With a fairly small sample, it is critical that the items selected for testing adequately represent the population. The testing relied on internal documentation, which is insufficient to support the credits. The placing of the ad is insufficient evidence without supporting evidence from the vendor supporting the reduction in accounts payable.

Springbrook Credits – These credits were confirmed by telephone, and were not supported by a written confirmation. The staff auditor was suspicious of the client's unwillingness to allow written confirmation of the amounts, as well as the client's changing explanation of the nature of the credits, but did not perform additional testing to resolve any doubts about the validity of the credits.

Ridolfi Credits – The auditor obtained an oral confirmation that these credits were not valid. The client indicated that the auditor's information was incorrect, but would not allow the auditor to obtain written confirmation for these credits. In addition, the credit memos had been altered, which should have further indicated to the auditor that the credits were not valid.

Accounts Payable Accrual – The auditors sent 50 accounts payable confirmations. Whether this is a sufficient number of confirmations is a matter of auditor judgment. However, the adequacy of the confirmations as evidence is significantly undermined by the knowledge that the client told suppliers how to respond. As a result, the auditor should have verified the confirmed balances using alternative procedures. There is no discussion of the performance of alternative procedures for nonresponses, or the resolution of the six responses that were not reconciled to Grande's records.

The auditors agreed to an adjustment of \$260,000 when their cutoff tests indicated a potential liability of \$500,000. It would be appropriate for the auditors to agree to a lower amount only if additional testing supported a lower accrued liability.

7-39 ACL Problem

- There are 5,801 payroll transactions in the Payroll_details file. *(This is determined by reading the number at the bottom of the screen.)*
- The largest and smallest gross pay amounts are \$20.13 and \$14,889.77, respectively. *(Use Quick Sort.)*
- Total gross pay was \$10,097,295.52 *(Use the Total command.)*
- The report below shows gross pay by pay period. *(Use the Summarize command on the Gross Pay column, save to a file, and print.)* Note that this file was produced by exporting the saved file to Excel. Students' hardcopy printouts will appear slightly different, but will contain the same departmental totals.

pay_period	gross_pay	COUNT
4646	389248.69	218
4647	387944.03	220
4648	386699.59	214
4649	389000.55	220
4650	387059.43	218
4651	388215.60	222
4652	388056.95	220
4653	390325.51	225
4654	388645.48	227
4655	388845.66	225
4656	390622.15	228
4657	387892.38	226
4658	389763.65	227
4659	388177.38	226
4660	388229.88	226
4661	388814.15	227
4662	388177.38	226
4663	388289.88	226
4664	388274.88	226
4665	388267.38	226
4666	388184.88	226
4667	387719.88	226
4668	387368.40	221
4669	387306.31	221
4670	389296.25	217
4671	386869.20	217

7-39 (continued)

- e. There are 14 exceptions in the calculation of net pay. (Use the following Filter: $Gross\ Pay - Deductions < > Net\ Pay$.)

pay_period	employee_number	gross_pay	deductions	net_pay
4646	0000125053	2294.50	573.38	1720.12
4647	0000126112	1103.47	165.49	937.78
4649	0000127262	753.06	112.95	640.05
4649	0000127346	1383.06	345.75	1037.25
4651	0000126713	1139.33	284.82	854.45
4652	0000125653	932.33	139.84	792.43
4653	0000125170	1496.33	374.07	1122.2
4653	0000125703	1509.10	377.25	1131.75
4654	0000127185	903.10	135.45	767.55
4655	0000125399	1130.33	282.57	847.7
4656	0000126030	1060.00	158.85	900.15
4656	0000126038	1572.27	393	1179
4670	0000126962	1151.50	288.38	865.12
4670	0000126976	984.83	147.72	837.05

- f. There are no gaps in the pay period sequence. A gap would indicate the potential that some of the payroll was omitted from the accounting records.
- g. Type of evidence:

Part.	Description	Evidence
a.	Determine number of payroll transactions	Inspection, Recalculation
b.	Determine largest and smallest payroll transaction	Inspection, Recalculation
c.	Determine total gross pay	Recalculation
d.	Determine gross pay by pay period	Recalculation
e.	Recalculate gross pay	Recalculation
f.	Determine if there are any gaps	Inspection