CHARTA LEARNING · INTERVIEW PREPARATION

Audit Evidence and Procedures

Interview preparation summary · AU track

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INT.UE.1.a · Evidence

Explain what makes audit evidence sufficient and appropriate, rank sources of evidence by reliability, and say how the level of risk changes the amount and quality of evidence needed.

Audit evidence is all the information an auditor uses to reach an opinion. Auditing standards judge it on two measures. Sufficiency is quantity: how many items were tested and how much of the balance they cover. Appropriateness is quality, made up of relevance (does it bear on the assertion being tested) and reliability (can it be trusted). More evidence cannot make up for poor quality, and a higher assessed risk calls for more persuasive evidence, meaning more of it, better quality, or both. Reliability depends on the source and the circumstances. Evidence is generally stronger when it comes from an independent external party, when the auditor obtains it directly rather than through the client, when it is an original document rather than a copy or a scan, when it is written rather than oral, and when it comes from a client system with effective controls. Evidence from different sources that points the same way is more convincing, and where sources conflict the auditor investigates. The usual mistake is to count pages of documents without asking where each came from and who could have altered it.

WORKED EXAMPLE: OSTLER HARDWARE: HOW MUCH OF THE RECEIVABLES BALANCE IS SUPPORTED, AND HOW WELL

Ostler Hardware is an invented trade wholesaler with trade receivables of 2.40m at the year-end. The audit team selected balances worth 2.10m for confirmation. Customers replied agreeing balances worth 1.62m. The other selected balances, worth 0.48m, did not reply: for 0.24m the team found cash received after the year-end on the bank statement, and for the other 0.24m it inspected the invoice and a signed delivery note. The remaining 0.30m is made up of small balances that were not selected. Performance materiality is 0.20m. The manager asks how well supported the balance is and what to do next.

Answer: The balance is well supported: 87.5% has specific evidence, and the strongest evidence (confirmations) covers 67.5%. The untested 0.30m, 1.5 times performance materiality, still needs a lighter procedure before the team concludes.

> **Interview tip:** Say where each piece of evidence came from before you say how much of it there is. Quote the coverage percentage, then name what is left untested and what you would do about it.

INT.UE.1.b · Evidence

Name the assertions for transactions, balances and disclosures, say which are most at risk for a given balance, and choose the direction of testing that addresses overstatement or understatement.

Assertions are the claims management implicitly makes by presenting the financial statements. For transactions they are occurrence, completeness, accuracy, cut-off and classification. For balances they are existence, rights and obligations, completeness, and valuation and allocation. For presentation and disclosure they cover occurrence and rights, completeness, classification and understandability, and accuracy and valuation. Naming the assertion matters because a risk such as receivables being wrong cannot be tested, while receivables not existing or being overvalued can. Each assertion points to a procedure and a direction. Risks of overstatement (existence, occurrence) are tested from the ledger back to source documents or the physical item. Risks of understatement (completeness) are tested the other way, from the source, such as the warehouse floor or goods received notes, forward to the ledger. Assets and revenue are typically at risk of overstatement and liabilities and expenses of understatement, but incentives such as tax saving can reverse this. The usual mistake is testing completeness from the ledger, which can only find what is already recorded.

WORKED EXAMPLE: MARLOWE FOODS: TESTING INVENTORY IN BOTH DIRECTIONS

Marlowe Foods is an invented food packer. The inventory listing has 1,150 lines worth 9.60m. At the count the auditor tests 25 lines picked from the listing and finds each one on the shelves. The auditor then picks 25 items from the shelves, worth 190,000 in total, and traces them to the listing: three are missing from it, worth 4,200, 1,100 and 6,500. Performance materiality is 0.30m. What does each test show and what happens next?

Answer: Existence is supported with no exceptions, but completeness is not: 11,800 of the 190,000 floor sample (6.2%) was missing from the listing, which if representative could be around 0.60m, so the team must investigate the cause and extend testing.

> **Interview tip:** Say the direction of each test out loud: from the list to the floor for existence, from the floor to the list for completeness. Then give the error rate and what it might mean at the scale of the balance.

INT.UE.1.c · Evidence

Describe the main audit procedures, say what each can and cannot prove, and design a simple analytical procedure with an independent expectation and an investigation threshold.

The auditor has seven kinds of procedure. Inspection examines records, documents or physical assets. Observation watches a process, such as a stock count. External confirmation is a direct written reply from a third party, such as a customer or bank. Recalculation checks arithmetic. Reperformance independently carries out a procedure or control the client performed. Analytical procedures compare recorded figures with an expectation. Inquiry asks people. Inquiry gives leads but is weak on its own, because answers come from people with an interest in the outcome, so it needs corroboration. Observation shows only what happened while the auditor was there, and inspecting a document shows it exists, not that it is genuine or complete. A good analytical procedure builds an independent expectation from data that does not come from the figure being tested, such as volumes multiplied by prices, sets a threshold for the difference (often a fraction of performance materiality), investigates differences above it, and corroborates explanations with evidence. The usual mistake is comparing to last year and accepting management's explanation.

WORKED EXAMPLE: HALLAM COACHES: AN EXPECTATION FOR FUEL COST

Hallam Coaches is an invented coach operator. Last year it drove 1,700,000 miles and recorded fuel cost of 612,000. This year it drove 1,850,000 miles (from tachograph data, which is independent of the ledger), the fuel price per litre rose 5%, and recorded fuel cost is 742,000. Performance materiality is 120,000 and the team investigates any difference above 25% of it. Management says two new coaches use more fuel. Test the figure.

Answer: The expectation was 699,300 against 742,000 recorded. The 42,700 gap was above the 30,000 threshold, and the corroborated explanation of 20,160 leaves 22,540 unexplained, below the threshold.

> **Interview tip:** State the expectation, the threshold and the gap in that order, then say that you would corroborate the explanation with evidence, not accept it because the finance team said so.

INT.UE.2.a · Applying procedures

Design and evaluate substantive tests for revenue, receivables and cut-off, including confirmations, alternative procedures for non-replies and the treatment of differences.

Revenue is usually treated as a presumed fraud risk, because management and sales staff often have incentives to bring sales forward. To test occurrence, select recorded sales and vouch them to the order, despatch note, invoice and cash received. To test accuracy, recalculate quantity times price against the approved price list. To test completeness, select despatch notes and trace them to invoices and the ledger. For cut-off, take the last despatches before the year-end and the first after, and check each sale is in the period in which control of the goods passed. For receivables, send confirmations (an external reply received directly by the auditor). If a customer does not reply, use alternative procedures such as cash received after the year-end or the invoice with signed delivery evidence. A difference is not automatically an error: separate timing differences (cash in transit) from true misstatements (goods returned, disputed prices), and ask whether any pattern suggests fraud. Valuation uses ageing, post year-end receipts and credit notes. The usual mistake is relying on later cash alone to prove the sale was in the right period.

WORKED EXAMPLE: PENHALLOW TOOLS: A CUT-OFF TEST AT THE YEAR-END

Penhallow Tools is an invented tool maker with a 31 March year-end. The team inspected the last 15 despatch notes before and the first 15 after the year-end and compared each with its invoice date. Two goods despatched on 2 April were invoiced on 31 March, worth 84,000 and 36,000. One order despatched on 30 March was invoiced on 1 April, worth 20,000. Cost of sales is booked when the invoice is raised and the gross margin is 35%. Performance materiality is 150,000.

Answer: Revenue is net overstated by 100,000 and profit before tax by 35,000, which is 23.3% of performance materiality. The pattern matters more than the amount: widen the test and ask why invoices were raised early.

Interview tip: Give the revenue effect, then the profit effect after margin, then compare with performance materiality. Finish by saying what the pattern suggests, because that shows scepticism.

INT.UE.2.b · Applying procedures

Plan the audit of inventory, payables, payroll and fixed assets, including count attendance, the search for unrecorded liabilities and the key tests for each.

For inventory, the auditor attends the count, checks that the client's instructions are followed, makes test counts in both directions (list to floor for existence, floor to list for completeness), notes damaged or slow stock, records the last goods received and despatch numbers for cut-off, and later traces the test counts to the final listing. If the count is not at the year-end, movements between the two dates are rolled back or forward. Valuation tests compare cost with net realisable value, checking cost to supplier invoices and selling prices after the year-end. For payables the main risk is understatement, so the search for unrecorded liabilities covers payments after the year-end, unpaid invoices, goods received notes around the year-end and supplier statements. Payroll tests include analytics (headcount times average pay), starters and leavers, and checks for fictitious employees. For fixed assets, vouch additions to invoices, check capital against revenue spending, test disposals and recalculate depreciation. The usual mistake is to test payables only from the ledger, which cannot find invoices that were never recorded.

WORKED EXAMPLE: COUNT ROLL-FORWARD AT CORVAN FITTINGS

Corvan Fittings is an invented plumbing wholesaler with a 31 March year-end. Because of staffing, the count was held on 28 March and valued at cost at 5.20m. Between 29 and 31 March, goods received at cost were 0.46m and goods despatched at cost were 0.58m. The inventory ledger at 31 March shows 5.31m. Performance materiality is 0.15m. Reconcile the count to the year-end and explain the difference.

Answer: The year-end inventory from the count is 5.08m against 5.31m in the ledger. The 0.23m gap is 0.14m cut-off (no profit effect) and 0.09m unexplained, which is recorded as a possible misstatement.

Interview tip: Describe the reconciliation as a simple sum, then explain that a cut-off error moves both inventory and payables, so the profit effect is only in what stays unexplained.

INT.UE.2.c · Applying procedures

Explain what drives sample size, compare statistical and non-statistical sampling, project errors found in a sample to the population, and say what audit documentation must show.

Sampling means testing less than all items and drawing a conclusion about the population. Sample size is driven by tolerable misstatement (the smaller it is, the larger the sample), assessed risk (higher risk means a larger sample), the errors expected, and, only for small populations, the population size. Statistical sampling uses random or monetary unit selection and probability theory, so sampling risk can be measured. Non-statistical sampling relies on judgement but must still be representative. Items that are individually significant or high risk are tested in full, not sampled. Errors found are projected to the untested population, and the projected figure plus known errors is compared with tolerable misstatement, allowing for sampling risk. Errors should never be dismissed as one-offs without investigating their cause. Documentation records the purpose of the test, the population, how the sample was chosen, the work done, the results, the conclusion, and who prepared and reviewed it, so that an experienced auditor with no previous link to the engagement can understand what was done. The usual mistake is writing only a conclusion.

WORKED EXAMPLE: PROJECTING ERRORS IN A RECEIVABLES SAMPLE

Wexford Components is an invented supplier with trade receivables of 8.0m in 400 balances. The team tests the ten largest balances (2.6m) in full and finds a known overstatement of 22,000. From the remaining 5.4m the team samples 45 balances worth 0.9m and finds overstatements totalling 18,000. Tolerable misstatement is 200,000. Is the evidence enough?

Answer: Total projected misstatement is 130,000, which is 65% of tolerable misstatement. That is too close to be comfortable, so investigate the cause and extend or correct before concluding.

Interview tip: Say that the largest items are tested in full, project only the sampled portion, add the known errors, and compare the total with tolerable misstatement. Then say what you would do about it.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.