Overview of GAAS

Generally Accepted Auditing Standard (GAAS)

- There are 10 generally accepted auditing standards (GAAS), which were developed by the AICPA.
- GAAS fall into three categories:
  1. General standards
  2. Standards of field work
  3. Reporting standards

Generally Accepted Auditing Standards (GAAS)

General Standards	Standards of Field Work	Reporting Standards
1. The auditor must have adequate technical training and proficiency.	1. Audit work must be adequately planned.	1. The auditor must state in the report whether financial statements were prepared in accordance with generally accepted accounting principles.
2. The auditor must have independence of mental attitude.	2. The auditor must gain a sufficient understanding of the internal control structure.	2. The report must identify those circumstances in which generally accepted accounting principles were not applied.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.	3. The auditor must obtain sufficient, competent evidence.	3. The report must identify any items that do not have adequate informative disclosures.
		4. The report shall contain an expression of the auditor's opinion on the financial statements as a whole.

Audit Evidence

Audit Evidence

- Evidence was defined as ***any information used by the auditor*** *to determine* whether the information being audited is stated in accordance with the established criteria.

What audit evidence includes?

- Audit evidence includes the information contained in the
  - *accounting records* underlying the financial statements and
  - *other information* gathered by the auditors

Why Audit Evidence?

- Generally
  - Audit evidence is required to enable the auditor *to express an opinion* on the financial statements.
- *Specifically*: audit evidence is required to:
- Obtain an understanding of the entity and its environment to assess the risks of material misstatement at the financial statement and assertion levels *(risk assessment procedures)*
- Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level *(tests of controls)*
- Detect material misstatements at the assertion level *(substantive procedures)*

Which items to select for a given procedure and how?

- Auditors are not expected to look at all the information that might exist. They will often select *samples* to test.
- Auditors can vary the sample size *from one to all* the items in the population being tested.
- The auditor can
  - (1) *select a week* and examine the first 50 checks,
  - (2) select the 50 checks with the *largest amounts*,
  - (3) select the checks *randomly*, or
  - (4) select those checks that the auditor thinks are *most likely to be in error*.
- Or, a *combination* of these methods can be used.

When to accumulate the evidence?

- An audit of financial statements usually covers a period such as a year.
- *The timing decision is affected by:*
  - *when the client needs the audit to be completed.*
  - *when the auditor believes the audit evidence will be most effective and when audit staff is available.*
  - *For example*: auditors often prefer to do counts of inventory as close to the balance sheet date as possible.

Financial statement Assertions

- *Management* of an entity are *responsible* for the financial statements, however, *auditors are responsible* for providing an assurance whether management assertions about financial statements are fairly represent the entity.
- Financial statement assertions are
  - the representations by management, explicit or otherwise, about the financial statements,
  - as used by the auditor to consider the different types of potential misstatements that may occur and design appropriate audit procedure.

Financial statement Assertions

Occurrence: Transactions and events that have been recorded have occurred or disclosed have occurred, and such transactions and events pertain to the entity.

Completeness: All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

Accuracy: Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

Cut-off: Transactions and events have been recorded in the correct accounting period.

Classification: Transactions and events have been recorded in the proper accounts.

Presentation: Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Financial statement Assertions

Existence: Assets, liabilities and equity interests exist.

Rights and obligations: The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

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ምሉዕነት/Completeness/	ሁሉም ቫውቸር የተቆረጠላቸው ሂሳቦች በሌጀር መመዝገባቸው ማጣራት፣
መኖር /Existence/	በሪፖርት የተጠቀሱት ንብረቶችና እዳዎች ያሉ መሆናቸውን ማጣራት፣
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Financial Statement Assertions and Audit Evidence

- ISA 315 states that the auditor must use assertions in sufficient detail *to form the basis for* design and performance of further *audit procedures*
- Financial statement assertions are the *basis* for determining for which *audit evidence and procedure* is required and to be used.

Persuasiveness of Evidence

- ISA 315 requires the auditor to accumulate *persuasive* (*sufficient and appropriate*) *evidence to support the opinion issued.*

Persuasiveness of Evidence

- ***Appropriateness of evidence :***
  - *is a measure of the quality of evidence, meaning its relevance and reliability in providing support for audit opinion.*
- Appropriateness cannot be improved by selecting a ***larger sample size*** or different population items.
- It can be improved only by selecting audit procedures that are more *relevant* or provide more *reliable* evidence.
- ***Relevance of Evidence :***
  - *Evidence must pertain to or be relevant to the audit objective*
  - *Relevance deals with the logical connection with the purpose of the audit procedure and the assertion under consideration*

Persuasiveness of Evidence

- ***Reliability of Evidence :***
- Reliability of evidence refers to the *degree* to which evidence can be *believable* or worthy of *trust*.
- Reliability, and therefore appropriateness, depends on the following *six characteristics* of reliable evidence:
- 1. ***Independence of provider:***
  - *Evidence obtained from a source outside the entity is* more reliable than that obtained from within.
- ***2. Effectiveness of client's internal controls:***
  - *When a client's internal controls are* effective, evidence obtained is more reliable than when they are weak.
- ***3. Auditor's direct knowledge***.
  - *Evidence obtained directly by the auditor through* physical examination, observation, recalculation, and inspection is more reliable than information obtained indirectly.

Persuasiveness of Evidence

- ***4. Qualifications of individuals providing the information.***
  - *Although the source* of information is independent, the evidence will not be reliable unless the individual providing it is qualified to do so.
- ***For example***, examining an inventory of diamonds by an auditor not trained to distinguish between ***diamonds and glass*** is not reliable evidence for the existence of diamonds.
- ***5. Degree of objectivity.***
- *Objective evidence is more reliable than evidence that* requires considerable judgment to determine whether it is correct.
- ***6. Timeliness.***
- *The timeliness of audit evidence can refer either to when it is* accumulated or to the ***period covered*** by the audit.
- ***For Example:***
  - Evidence is usually more reliable for *balance sheet* accounts when it is *obtained as close to the balance sheet date as possible.*
  - *For income statement accounts, evidence is more reliable if there is a sample from the entire period under audit, such as a random sample of sales transactions for the entire year, rather than from only a part of the period, such as a* sample limited to only the first 6 months.

Persuasiveness of Evidence

- ***Sufficiency***:
  - The *quantity of evidence obtained determines its sufficiency.*
- *Sufficiency of evidence is* measured primarily by the *sample size* the auditor selects.
  - For Example: the evidence obtained from a sample of 100 is ordinarily more sufficient than from a sample of 50.

❖ ***Factors determine to select appropriate sample size in audits:***

➢ *auditor's expectation of misstatements and*
  - ***For Example,*** If auditor concludes that there is a high likelihood of obsolete inventory, the auditor *will sample more inventory items for obsolescence* in this audit than one where the likelihood of obsolescence is low.

➢ *the effectiveness of the client's internal controls*
  - For example, a smaller sample size will be taken if effective.

Persuasiveness of Evidence

- ***NB:*** The persuasiveness of evidence can be evaluated only after considering the ***combination of appropriateness and sufficiency***
- ***For example:***
  - *A large sample of evidence provided by an independent party is not persuasive unless it is relevant to the audit objective being tested.*
  - *A large sample of evidence that is relevant but not objective is also not persuasive.*
  - *Similarly, a small sample of only one or two pieces of highly appropriate evidence also typically lacks persuasiveness.*
- *In general*, when determining the persuasiveness of evidence, the auditor must evaluate the degree to which ***both appropriateness and sufficiency***, including all factors influencing them, have been met.

Persuasiveness and Cost

- The *persuasiveness* and *cost* of all alternatives should be considered before selecting the best type or types of evidence.
- The auditor's goal is to obtain a sufficient amount of appropriate evidence *at the lowest possible total cost*.
- *However*, cost is ***never an adequate justification for omitting a necessary procedure*** or not gathering an adequate sample size.

Which audit procedures to use?

- ISA 500 requires Auditors to design and perform audit procedures that are useful to obtain *sufficient and appropriate* audit evidence.

TYPES OF AUDIT EVIDENCE PROCEDURES

- Auditors obtain evidence by one or more of the following procedures. Such as:
  - 1. *Physical examination*
  - *2. Confirmation*
  - *3. Documentation*
  - *4. Inquiries of the client*
  - *5. Recalculation*
  - *6. Re-performance*
  - *7. Observation*
  - *8. Analytical procedures*

1. Physical examination

- ***Physical examination /inspection/***
  - *is the inspection or count by the auditor of a tangible asset.*
- *This* type of evidence is most often associated with ***inventory and cash***, but it is also applicable to the verification of securities, notes receivable, and tangible fixed assets.
- Physical examination is a direct means of verifying that an asset *actually exists (Existence)*.

2. Confirmation

- ***Confirmation***
  - describes the *receipt of a direct written* ***response from a third party*** verifying the accuracy of information that was *requested by the auditor.*
- *For Example:* Assume the auditor determines that there are two ***extraordinarily large sales*** transactions recorded 3 days before year-end. Confirmation of these two transactions may be appropriate.

2. Confirmation

Information	Source
Assets	
Cash in bank	Bank
Accounts receivable	Customer
Notes receivable	Maker
Owned inventory out on consignment	Consignee
Inventory held in public warehouses	Public warehouse
Cash surrender value of life insurance	Insurance company

2. Confirmation

Information	Source
Liabilities	
Accounts payable	Creditor
Notes payable	Lender
Advances from customers	Customer
Mortgages payable	Mortgagor
Bonds payable	Bondholder

2. Confirmation

Information	Source
Owners' Equity	
Shares outstanding	Registrar and transfer agent
Other Information	
Insurance coverage	Insurance company
Contingent liabilities	Bank, lender, and client's legal counsel
Bond indenture agreements	Bond holder
Collateral held by creditors	Creditor

3. Documentation

- ***Documentation***
  - is the auditor's inspection of the *client's documents and records to verify* the information that is, or should be, included in the financial statements.
- *Each transaction* in the client's organization is normally supported by at *least one document*, a large volume of this type of evidence is usually available.
- ***For example***, the client often retains a customer order, a shipping document, and a duplicate sales invoice for each sales transaction.

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4. Inquiries of the Client

- ***Inquiry***
  - is the obtaining of *written or oral information from the client in response to* questions from the auditor.
- Although considerable evidence is obtained from the client through inquiry, it usually *cannot be regarded as conclusive* because it is *not from an independent* source and may be biased in the client's favor.
- Therefore, when the auditor obtains evidence through inquiry, it is normally necessary to obtain *corroborating evidence* through other procedures.
- *Corroborating evidence* is additional evidence to support the original evidence.

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5. Recalculation

- ***Recalculation***
- involves *rechecking* a sample of calculations made by the client.
- Rechecking client calculations consists of testing the client's ***arithmetical accuracy*** and includes such procedures adding journals and subsidiary records, and checking the calculation of depreciation expense and prepaid expenses.

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6. Reperformance

- ***Reperformance***
- is the auditor's independent tests of client accounting procedures or controls that were originally done as part of the entity's accounting and internal control system.
- *recalculation* involves rechecking a computation, *reperformance* involves checking other procedures.

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7. Observation

- ***Observation***
  - is the use of the senses to assess client activities.
- Throughout the engagement with a client, auditors have many opportunities to use their senses—sight, hearing, touch, and smell—to evaluate a wide range of items.
- The auditor may *tour* the plant to obtain a general impression of the client's facilities, or watch individuals perform accounting tasks to determine whether the person assigned a responsibility is performing it properly.

8. Analytical procedures

- ***Analytical procedure:***
  - use *comparisons* and relationships to assess whether account balances or other data appear reasonable compared to the auditor's expectations.
- ***For example***, an auditor may compare the gross margin percent in the current year with the preceding year's.

AUDIT DOCUMENTATION

- ***Audit documentation***
  - is the *principal record of* *auditing procedures* *applied,* *evidence obtained*, *and* *conclusions reached* *by the auditor in the engagement.*
- *Audit documentation should include all the information the auditor* considers *necessary to adequately conduct the audit* and to provide support for the audit report.
- Also called *working papers*.

Purposes of Audit Documentation

- *The overall objective*
  - is to *aid* the auditor in providing reasonable assurance that an adequate audit was conducted in accordance with auditing standards.
- More *specifically*, audit documentation, provides:
  - ➢ *A Basis for Planning the Audit*
  - ➢ *A Record of the Evidence Accumulated and the Results of the Tests*
    - *i.e.* the audit was well planned and adequately supervised; the evidence accumulated was appropriate and sufficient; and the audit report was proper
  - ➢ *Data for Determining the Proper Type of Audit Report*
  - ➢ *A Basis for Review by Supervisors and Partners*

Ownership of Audit Files

- is the *property of the auditor*.
- The only time anyone else, including the client, has a legal right to examine the files is when they are *requested by a court as legal evidence.*

Confidentiality of Audit Files

- During the course of the audit, auditors obtain a considerable amount of information of a confidential nature, including:-
  - officers' salaries,
  - product pricing and
  - advertising plans, and
  - product cost data.
- An auditor shall ***not disclose*** any confidential information & ***care*** must be taken to safeguard the audit files at all times.

Requirements for Retention of Audit Documentation

- At the completion of the engagement, audit files are *retained* on the CPA's premises for future reference.
- Auditing standards require that records for audits of *private companies* be *retained for a minimum of five years.*
- The Sarbanes–Oxley Act requires auditors of *public companies* to prepare and maintain audit files and other information related to any audit report in sufficient detail to support the auditor's conclusions, for a period of *not less than seven years*.

Preparation of Audit Documentation

- The proper preparation of audit documentation should contain the following parts:

- *schedules to document the audit evidence accumulated,*
- *the evidence obtained and its source*
- *the results found, and*
- *the conclusions reached*