

## ***AUDIT EVIDENCE IN MIMINIZING THE FINANCIAL AUDIT RISK***

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*Abstract: This paper describes one relevant and critical chapter of the financial audit, the audit evidence, and its role from conducting a financial audit to the final part, the audit report that contains the opinion expressed by the financial auditor and its responsibility.*

*I presented the financial audit evidence and expressed my opinion on the relevance of the audit evidence determining a scale of the most relevant and helpful evidence to the level of the audit evidence that contains less quality.*

*The key of success in my opinion is not only in gathering as many audit evidence as possible, is reflected by the financial auditors judgment in using qualitative evidence at a sufficient level of quantity, also taking into concern that time is limited in conducting a financial audit.*

*Keywords: audit risk, audit evidence, evidence quality, evidence quantity, financial audit standards.*

### **1. Introduction regarding financial audit evidence**

The foundation of every financial audit is represented by **probative information gathered and assessed by the auditor**. The auditor must have necessary knowledge and aptitude in order to collect sufficient and solid audit evidence in order to conform to the standards that define his / her profession as a whole. In this paper, I shall present the decisions that auditors embrace regarding audit evidence, the evidence at financial auditor's disposal and the way this evidence is used in certain financial audit.

**The audit evidence is defined as any information used by the financial auditor in order to determine if the data of the audit is presented according with particular preset criteria.** Probative information is very different according with the degree that convinces the financial auditor regarding the financial situations meets the requirements of Generally Accepted Audit Standards. *The audit evidence* represent the whole set of information used by the financial auditor in order to achieve the conclusions his / her opinion is based, containing both information gathered from accounting and also that represented the fundamentals of elaborating the financial situations (transactions / economic operation, trial balance) and also other relevant information regarding with the financial situations<sup>1</sup>.

The technique of gathering probative information is not a method that characterizes financial audit, and although it was imported from other majors, it has become of relevant importance and typical characteristics of the financial auditor's profession. In this context, in planning and selecting an auditing technique of financial situations, the most troublesome

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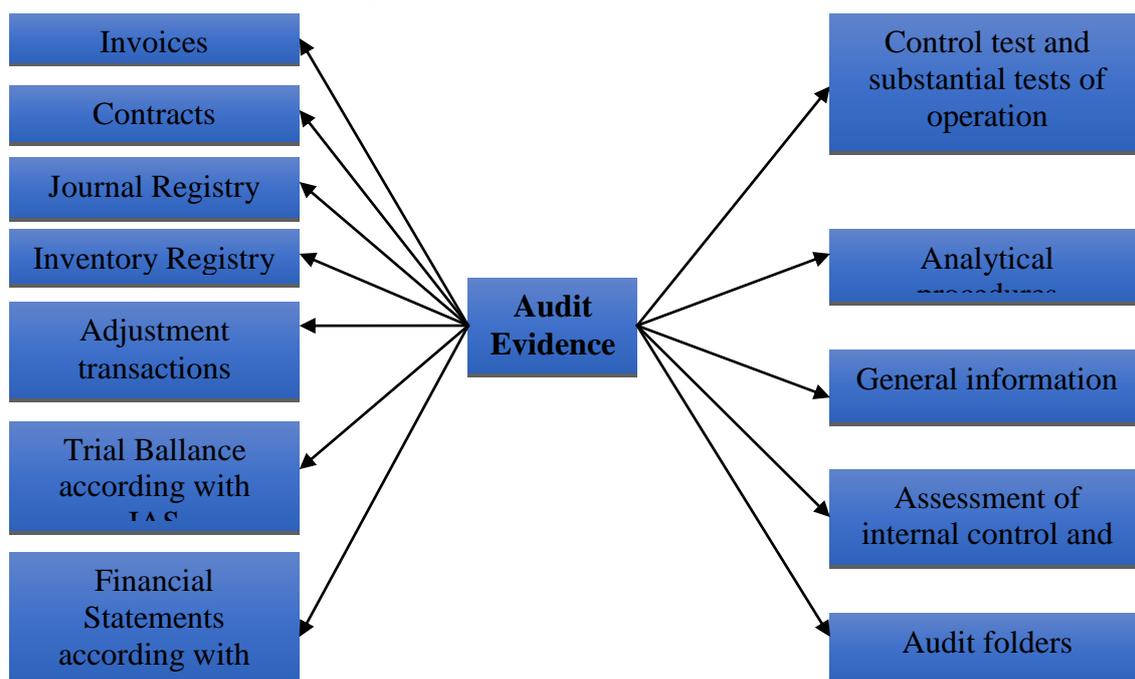
<sup>1</sup> Borthick, A. F. and J. E. Kiger, *Designing audit procedures when evidence is electronic*, Issues In Accounting Education, 2009

aspect is represented by gathering and adequate quantity of audit evidence, with minimal costs and without disturbing the normal flow of developing the economic activity of the entity.

The International Audit Standards highlight that audit evidence are necessary in order to prove the credibility of management's assertions contained in the financial situations. Hence, with his / her professional knowledge and available methods, the financial auditor collects audit evidence in developing his / her whole activity, evidence that must be adequate in order to express an audit opinion regarding the audited company.

**Audit evidence used in the financial audit** represent the aggregate of information used by the financial auditor in order to present a conclusion that the audit opinion reflects and includes all the information contained in accounting registries that are reflect in the financial statements. Financial audit evidence is considered any document or statement obtained by the auditor in developing his / her activity and is relevant to the financial auditor in obtaining a reasonable opinion.

One can mention that the financial auditor can use a large and variable set of probative information of different pattern, such as oral statements of the client or of a third party, written discussion with third parties and the financial auditor's own remarks. Accounting



registries usually gather audit evidence such as: initial transaction registration and supporting documents, invoices, contracts, journal registry, financial statements accommodation that are not reflected in the financial transactions and other documents ( such as: spread sheets that justify cost allocation, calculus, reconciliations and information presentation).

## 2. The quality and quantity of audit evidence within the financial audit framework

In order to express an audit opinion, the financial auditor examines all the available information because the conclusions can be obtained using sampling and other methods of selecting the elements to be tested. It is necessary that the auditor to rely on audit evidence

that is more persuasive rather than conclusive<sup>2</sup>. In the stage of the audit that the financial auditor assesses the quantity and quality of audit evidence and therefore the degree of sufficiency and pertinence the financial auditor uses the professional judgment and skepticism. The origin of the audit evidence is presented in **Figure no. 1 – Origin of financial audit evidence**:

**Figure no. 1 – Origin of financial audit evidence**

Any financial auditor has to take a major decision regarding audit evidence, meaning to assess the types and quantity that must be gathered in order to conclude that the financial statements of a client are fairly presented. The importance of this judgment is determined by the **prohibitive cost of examination and the assessment of every possible probative information**.

**According with their nature**, audit evidence can be:

- a) Obtained from accounting documents (invoices, contracts, accounting journals and so on) by applying different audit procedures;
- b) Obtained from other sources (prior audit engagements, imposed procedures of quality control system, and so on);

**The credibility of collected audit evidence** is appreciated according with their internal or external origin, their written or oral nature, and the circumstances they were obtained:

- External audit evidence (for example a third party confirmation) are more credible than the evidence generated internally;
- Internal audit evidence are more reliable when the internal control and accounting system are functional;
- Audit evidence gathered exclusively by the auditor are more reliable than the ones the entity presents;
- Written audit evidence such as written documents are more reliable than oral statements.

The two factors that determine the credibility of the audit evidence are the appropriateness and the sufficiency.

**The appropriateness of the audit evidence** represents the extent the probative information can be considered plausible or trustful. If the audit evidence is considered very trustworthy this fact contributes very much to the financial auditor's belief that the financial statements present a fair image. For example if the financial auditor would take stock of inventory himself / herself it is a more trustworthy probative information rather than the warehouse operative of the entity is providing data regarding inventory.

The appropriateness of the audit evidence cannot be improved by selecting a larger test sample or by choosing other elements of the whole set of analyzed data. **The probative information must be related only a certain audit objective in order to be reliable** and must meet a set of characteristics such as<sup>3</sup>:

- a. **The external audit evidence is more reliable than the one collected from within of the entity**; for example external probative information as bank reports,

<sup>2</sup> Sanchez, M. H., K. F. Brown C. P. Agoglia, *Consideration of control environment and fraud risk: A set of instructional exercises*. Journal of Accounting Education, 2012

<sup>3</sup> Viorel Horațiu Rotaru, *Audit evidence, a strong argument in assessing conclusions regarding audit opinion*, Analele Universității din Craiova Seria Științe Economice, 2008

lawyers or clients / customer are considered more reliable than the answers given by management interrogation of audited entity; in the same context, the financial documents that originate from outside the audited organization are considered more reliable than the ones generated from within the company and that never left the audited entity.

- b. **Audit evidence collected directly by the financial auditor, physical examination, calculus and inspection are more reliable than the probative information obtained indirectly;** for example if the financial auditor assesses the gross margin as a percent of incomes and compares the data with the prior periods the audit evidence obtained is more reliable than that case where the financial auditor takes into consideration only the assessment generated by the accounting department of audited entity;
- c. **Audit evidence is more reliable if the person that provides information is qualified to do so, even if that authority is independent;** therefore, statements received from lawyers and bank acknowledgements, usually, a more trustful information than the acknowledgment of commercial receivables by persons that are not familiar with the economic environment;
- d. **The opportunity of audit evidence can regard the moment when the probative information is collected or the period the financial audit refers to;** Usually, the audit evidence regarding balance accounts are more reliable if collected as close as possible to the period of financial statements presentation; regarding profit or loss account, the audit evidence is more reliable if there is a sample that covers the whole period of financial audit and if the sampling contains elements belonging only to a segment of this period.

**The sufficiency of audit evidence is linked with the quantity of audit evidence to be achieved.** The sufficiency of probative information is determined by the size of sampling selected by the financial auditor. For an audit procedure, audit evidence collected of a sample of 1.000 elements is more sufficient than evidence collected of a sample of 500 elements.

Many factors influence the adequate character of sampling dimensions used in the financial audit. The two most important factors are **the errors that the financial auditor expects to find and the efficiency of the internal control of the entity.**

*The credibility of audit evidence can be assessed only after a combined analysis of appropriateness and sufficiency, taking in account the impact of factors that influence these two characteristics. A large sample of audit evidence supplied by a party or an independent person is not concluding only if it is relevant to the financial audit tested objective.* A large sample that is relevant, but does not represent the objective of the financial audit is to be considered inconclusive. In the same context, a reduced sample of only two elements that are very reliable is not to be concluding.

The financial auditor must assess the extent that both trustworthy and sufficiency criteria and that all the factors that influence these two characteristics have been evaluated according with the assessment of concluding audit evidence.

In conclusion, in the process of decision taking regarding audit evidence the **financial auditor must take in consideration both the credibility and the involved costs. The purpose of the audit professional is to obtain a sufficient quantity of reliable audit evidence**

*at the lowest possible cost.* Yet, the cost is never a justification for excluding a necessary procedure or insufficient sampling.

### 3. Types of audit evidence and their relevance to the financial audit

The types of audit evidence represent another relevant aspect. In the process of decision regarding the audit procedure that must be used, the financial professional chooses between two types of audit evidence<sup>4</sup>. **Figure no. 2 – Essential techniques regarding financial audit procedures** presents the methods that and financial auditor can chose regarding financial audit procedures.



**Figure no. 2 – Essential techniques regarding financial audit procedures**

#### 3.1. Documentation (*inspection of documents or economic transaction registration*)

Documentation represents the inspection of accounting registries (financial and managerial accounting) regarding performed transactions or operations and of the documents that support them (paper or electronic format), in order to collect audit evidence with different degree of credibility **with the objective of justifying the information that is presented or should be presented in the financial statements.**

This financial audit technique is widely used in any audit because it is easy accessible to the auditor at a low cost. In some situations, it represents the only reasonable type of probative information at the financial auditor's disposal.

*In order for this technique to be reliable, the auditor should take in consideration the source of the documents, either internal or external. An internal document* is one elaborated and used in the entity and is archived without being seen by persons outside the entity (copies of invoices, timekeeping sheet and inventory notes). **An external document** represents a document that has been in the possession of a third party, outside the entity and in the present is archived in the audited company. In some cases, external documents are generated outside the audited entity and finally are archived by the audited company's employees (acquisition invoices, bank reports, insurance policies)

<sup>4</sup> Pae, S., S. Yoo, *Strategic interaction in auditing: An analysis of auditors' legal liability, internal control system quality, and audit effort.* The Accounting Review, 2010

**External documents are considered more reliable audit evidence in comparison with internal documents**, due to their external possession, the third parties involved in the commercial transaction and to the agreement, the entity and third parties have settled regarding the information reflected in them is authentic.

### **3.2. Physical examination**

*Represents the verification of the assets, bringing credible audit evidence especially regarding the asset's existence.* This audit technique brings a reduced level of assurance regarding entity's rights and obligations regarding certain assets but confirms the existence audit objective and considered one of the most reliable and advantageous type of audit evidence.

This type of audit evidence is associated with inventory or treasury liquidities but also applies to stock certificates, commercial papers, and corporal assets.

*Generally, the physical examination represents an objective method to determine both quantity and the asset's characteristics.* In some cases, it represents a facile method to assess the quality and state of an asset, yet this audit technique is not sufficient to determine if the assets are the property of the audited company and in many cases, the financial auditor is not sufficiently qualified to assess qualitative factors such as authenticity or degree of obsolescence.

### **3.3. Detection**

Represents *using certain senses in order to assess certain activities*. Along a financial audit there, are many opportunities to appeal hearing, seeing, touching, or tasting in order to appreciate certain elements. For example, the auditor might visit a facility to make an impression regarding production assets of the audited company, to observe if the assets are rusty, to determine if they are depreciated irreversibly or to observe the employees that exercise accounting functions in order to determine if a person was settled a certain task; another example is represented by stock taking by employees of the audited company.

This type of audit evidence is rarely sufficient by itself due to the risk that the employees of the client, implied in the set activities to be aware of the financial auditor's presence and needs supplementary confirmation obtained by the auditor (data or documents of accounting transactions, other information). Therefore, the employees could have the tendency to accomplish their tasks according with the company policy and to get back to the normal activities as soon as the financial auditor has disappeared out of sight. That is why it is necessary the first impressions to be collaborated with other audit evidence types.

Inspection and detection are two terms that many times can be considered as identical, but from the point of view of financial audit, it is necessary to differentiate them, inspection referring to documents or assets and detection referring to processes (transactions).

### **3.4. Inquiry**

*Inquiry represents gaining information (financial and non-financial) of persons with competence and experience situated in the audited entity or external to the company, in a written form (official) to oral, verbal questioning (unofficial).*

Despite a large volume of audit evidence can be gathered from the client by inquiry, usually, this technique **cannot be considered concluding because the obtained information do not represent an independent source and can be manipulated in favor of the audited entity**. Therefore, when the auditor wishes to gather audit evidence by inquiring it is also necessary to collect a set of supplementary probative information using other methods.

Generally, the inquiry does not offer sufficient audit evidence and is not sufficient for internal control testing.

### ***3.5. Confirmation***

Confirmation is a specific type of inquiry and describes **the receipt of a written or oral answer from a third party, independent, confirming the accuracy of information requested by the auditor**. The request to answer is made in the name and for the client, and the client requests an independent third party to answer to the financial auditor. Because the confirmation comes from independent sources, they represent a much-appreciated type of probative information and many times used. Though, obtaining confirmation is relatively expensive and can have certain inconvenient for those that are asked to offer information, Therefore, this type of audit evidence are not used in any situation where they could be applied. Due to high reliability of confirmations, the financial auditors seek to obtain written answers rather than verbal answers; written acknowledgments are easier to verify by superiors and offer a better justification in the situation of proving that an acknowledgment was received.

This type of technique is frequently used regarding balance accounts and their content, but must not be limited only to these elements; confirmations are also used for obtaining audit evidence regarding the existence or inexistence of certain conditions (transactions, documents) such as the absence of a contract that can influence the recognition of some incomes.

### ***3.6. Reperformance***

*Reperformance represents the application of procedures and controls the entity has applied initially in its internal control, independently by the auditor, manually or using computer assisted audit techniques (CAAT).*

Because the financial auditor verifies directly with these type of audit evidence the reliability of the internal control system, reperforming is perceived with a high degree of credibility.

### ***3.7. Recalculation***

*Recalculation represents the verification of mathematical accuracy of information contained in documents or accounting registered transactions, being applied by using IT (obtaining some files or database, the use of CAAT) and assumes **the revision of a sample piece of calculus and information transfer accomplished by the audited entity during the financial audit period.***

*Recalculation aligns in procedures such as merchandise calculus of income invoices and inventory evidence, calculus of totals written in journals and analytical registries and verification of the mean of assessing irreversible depreciation costs and future expenses. The*

recompose of information transfer represents to re-establish the pathway of certain amounts in order to achieve the conclusion that, where the same information is mentioned in other registries, the same amount is registered every time.

### **3.8. Revision (verification)**

*Revision represents the process that analyses and verifies accounting data in order to identify situation important or unusual.* This procedure implies the identification of irregularities (values, content) of the existent of balance account or of other amounts presented in the financial statements; it includes identification of unusual transactions (of great value) of the registered accounting transactions and the verification / analyzing of data (operations) regarding certain categories of expenses (usual or unusual).

*Revision (verification) is used according with the analytical procedures but as a sole procedure, being applied either manually or by using computer assisted audit techniques (CAAT).*

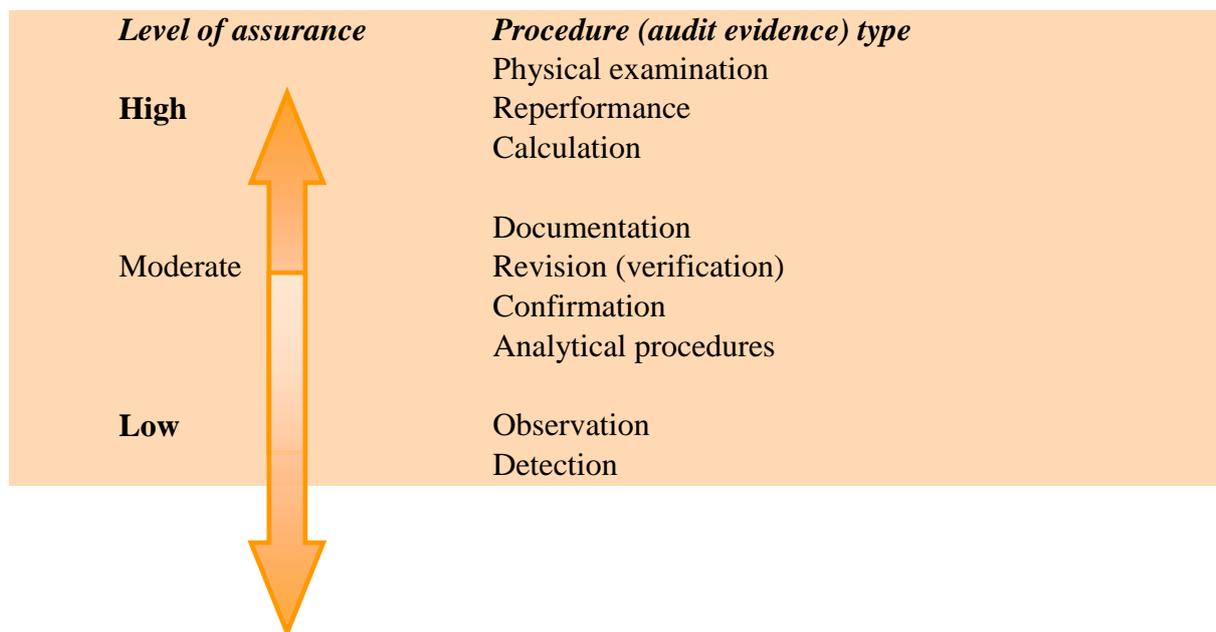
### **3.9. Analytical procedures**

*Analytical procedures also represent important and efficient probative information, collected in the financial audit mission and presenting assessments of financial statements information, based on indicators analyses (evolution, comparison) and of correlation between these information and / or between these and other data / nonfinancial information.*

Analytical procedures also presume analyses (investigation) of some fluctuations and / or some relations / identified correlations that are not consequent (correlated) with other relevant information or that differ in a major way from the reasonable values (provisional).

**These type of audit evidence use comparison and indicators with the purpose of determining if the balance accounts or other data seem reasonable.** For example, the comparison of gross margin of current tax period with the one of prior tax period. ***For certain audit objectives or insignificant balance accounts, the analytical procedures could represent the only necessary audit evidence.*** In some cases, analytical procedures are used with the intention of highlighting certain balance accounts or transactions that should be investigated in detail, in order for the auditor to decide if supplementary investigation is necessary. An example is represented by comparing the total expenses with reconditioning of current period tax with the prior tax period and analyzing the difference and, in case it is considerable, to determine the cause of rise or decrease of the reconditioning balance account.

In conclusion, to this subchapter, I would like to highlight the importance of audit evidence towards audit risk, more precise the role probative information plays in decreasing audit risk that is highly related to the quality and quantity of probative information. **Figure no. 3 – Safety degree hierarchy of different types of audit procedures** presents the assurance level according to different audit evidence used in the financial audit mission.



**Figure no. 3 – Safety degree hierarchy of different types of audit procedures**

#### **4. The correlation between audit evidence and audit risk**

In the financial audit, the terms audit risk and audit evidence are closely linked and inseparable.

The relation between audit risk and the planned quantity of audit evidence are highly linked and reverse proportional. Therefore, in order for the financial auditor to maintain a constant audit risk but reduces the materiality threshold it is necessary to rise the quantity of audit evidence. In the same way, if the auditor maintains the materiality threshold constant and reduces the quantity of audit evidence, the impact of audit risk is of importance, the audit risk rising<sup>5</sup>.

The professional judgment of the auditor regarding the selection of adequate and sufficient audit evidence represents an important objective towards minimizing audit risk; the financial auditor takes in concern the following factors:

- ✓ Materiality threshold;
- ✓ Audit risk level, respectively inherent and control risk;
- ✓ Gathered experience and professionalism of the auditor;
- ✓ Source and credibility of obtained information;

What must be highlighted regarding audit risk is that the probative information is directly influenced by the appropriateness and sufficiency and depends of a series of factors that are presented below.

***Internal control efficiency of audited entity has a great impact on the appropriateness of most audit evidence used.*** For example, the internal documents of an entity where internal control mechanisms are efficient are more reliable due to the document's probability of presenting a fair transaction; vice-versa, analytical procedures are not appropriate audit evidence if internal control mechanism that generates that data do not supply correct information.

<sup>5</sup> O'Donnell, E., J. Prather-Kinsey, *Nationality and differences in auditor risk assessment: A research note with experimental evidence*. Accounting, Organizations and Society, 2011

Both calculation and physical inspection are probably the most reliable if internal control mechanisms are efficient, but their usage in the financial audit mission differs considerably. These two types of audit evidence prove that with an identical reliability level they can be different.

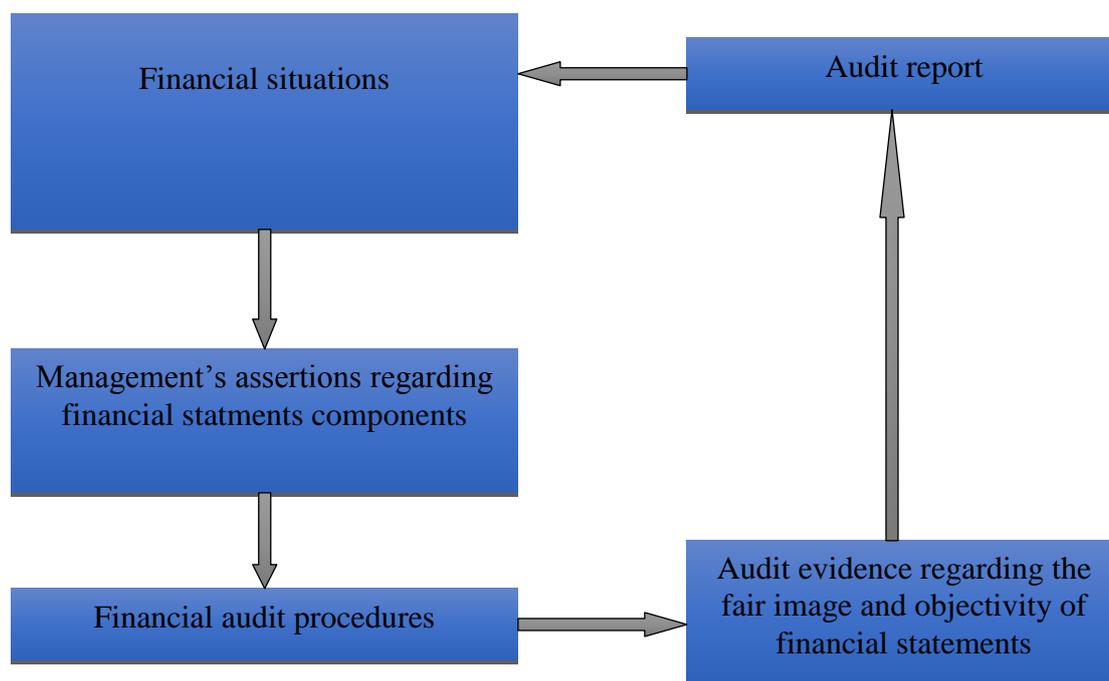
A certain type of probative information is rarely sufficient to supply appropriate audit evidence necessary for achieving any audit objective; observation, confirmation and analytical procedures are examples that represent such situations.

Two of the most expensive types of audit evidence are physical inspection and confirmation. Corporal asset inspection is costly because the financial auditor must be present in the moment the client takes stock of assets, many times before the financial statements are presented. For example, inventory catalogue can require many auditors to shift in the same time to different distant areas. Confirmation is costly because the auditor must apply very rigorous procedures when determining the confirmation letter, sending it, receiving the reply, and analyzing the irregularity or requests without an answer.

Documentation and analytical procedures is costly moderate. If the entity's personnel identifies the documents the auditor needs and arranges them in such a manner that facilitates their use, then documentation is in many cases at a low cost. Analogue, if the auditor must search himself / herself the documents this audit procedures becomes very expensive. Regarding analytical procedures, the auditor must decide which of these procedures are to be used, if all calculus must be determined and asset the results; all these activities are time consuming.

The most inexpensive types of audit evidence are observation, inquiry, reperformance, and calculation. Normally, observation is done in the same time with other procedures being applied. An auditor can observe easily if entity's personnel respect the inventory policies and in the same time physically examining a sample of inventory. Inquiry is present in any audit with a low cost; some inquiry can be expensive, such as obtaining written statements. Reperformance and calculation is usually inexpensive because it assumes simple comparison and mathematical calculus that can be applied as the auditor wishes.

In conclusion, in the above figure (**Figure no. 4 – Audit evidence and financial statements relation**) is presented the impact audit evidence has on financial statements, influencing the analytical procedures to be used (and the most relevant the analytical procedure's quality) and the audit report that among others represents an image of audit risk.



**Figure no. 4 – Audit evidence and financial statements relation**

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