Evidential matter; Statement on auditing standards, 031

American Institute of Certified Public Accountants. Auditing Standards Board

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Evidential Matter

(Supersedes Statement on Auditing Standards No. 1, section 330, “Evidential Matter”)

1. The third standard of field work is:

   Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

2. Most of the independent auditor’s work in forming his opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under examination. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Assertions

3. Assertions are representations by management that are embodied in financial statement components. They can be either explicit
or implicit and can be classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

4. Assertions about existence or occurrence deal with whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that finished goods inventories in the balance sheet are available for sale. Similarly, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.

5. Assertions about completeness deal with whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

6. Assertions about rights and obligations deal with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

7. Assertions about valuation or allocation deal with whether asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.

8. Assertions about presentation and disclosure deal with whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts
that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described.

**Use of Assertions in Developing Audit Objectives and Designing Substantive Tests**

9. In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. For example, one audit objective related to the assertion about completeness that an auditor might develop for inventory balances is that inventory quantities include all products, materials, and supplies on hand.

10. There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures may relate to more than one objective. On the other hand, a combination of auditing procedures may be needed to achieve a single objective. The Appendix to this Statement provides illustrative audit objectives for inventories of a manufacturing company for each of the broad categories of assertions listed in paragraph 3 and examples of substantive tests that may achieve those audit objectives.

11. In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the extent of reliance, if any, to be placed on internal accounting control, the relative risk of errors or irregularities that would be material to financial statements, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. For example, in designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the
auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

12. The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor, based on the specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of financial statements. The combination of the auditor’s reliance on internal accounting control and on selected substantive tests should provide a reasonable basis for his opinion (see SAS No. 1, section 320.73).

Nature of Evidential Matter

13. Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor.

14. The books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. By itself, accounting data cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted.

15. Corroborating evidential matter includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observa-
tion, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him to reach conclusions through valid reasoning.

16. The auditor tests underlying accounting data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets and allocations involved, by recalculation, and by reconciling related types and applications of the same information. In a soundly conceived and carefully maintained system of accounting records, there is internal consistency discoverable through such procedures that constitutes persuasive evidence that the financial statements do present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

17. The pertinent documentary material to support entries in the accounts and assertions in the financial statements ordinarily is on hand in the company's files and available to the auditor for examination. Both within the company's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his inspection. Activities of company personnel can be observed. Based on certain conditions as he observes them, conditions of internal accounting control for example, he can reason to conclusions with respect to the validity of various assertions in the financial statements.

Competence of Evidential Matter

18. To be competent, evidence must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

a. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of relia-
bility for the purposes of an independent audit than that secured solely within the entity.

b. When accounting data and financial statements are developed under satisfactory conditions of internal accounting control, there is more assurance about their reliability than when they are developed under unsatisfactory conditions of internal accounting control.

c. The independent auditor’s direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

**Sufficiency of Evidential Matter**

19. The independent auditor’s objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances in the particular case. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles, are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being examined.

20. An auditor typically works within economic limits; his opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him within the limits of time and cost is sufficient to justify expression of an opinion.

21. As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. In determining the usefulness of evidence, relative
risk may properly be given consideration. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test.

**Evaluation of Evidential Matter**

22. In evaluating evidential matter, the auditor considers whether specific audit objectives have been achieved. The independent auditor should be thorough in his search for evidential matter and unbiased in its evaluation. In designing audit procedures to obtain competent evidential matter, he should recognize the possibility that the financial statements may not be presented in conformity with generally accepted accounting principles. In developing his opinion, the auditor should give consideration to relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. To the extent the auditor remains in substantial doubt about any assertion of material significance, he must refrain from forming an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion.
Appendix

Financial Statement Assertions, Illustrative Audit Objectives, and Examples of Substantive Tests

Illustrations for Inventories of a Manufacturing Company

This appendix illustrates the use of assertions in developing audit objectives and designing substantive tests. The following examples of substantive tests are not intended to be all-inclusive nor is it expected that all of the procedures would be applied in an examination.

<table>
<thead>
<tr>
<th>Illustrative Audit Objectives</th>
<th>Examples of Substantive Tests</th>
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<tbody>
<tr>
<td><strong>Existence or Occurrence</strong></td>
<td></td>
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<tr>
<td>Inventories included in the balance sheet physically exist.</td>
<td>• Observing physical inventory counts.</td>
</tr>
<tr>
<td></td>
<td>• Obtaining confirmation of inventories at locations outside the entity.</td>
</tr>
<tr>
<td></td>
<td>• Testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.</td>
</tr>
<tr>
<td>Inventories represent items held for sale or use in the normal course of business.</td>
<td>• Reviewing perpetual inventory records, production records, and purchasing records for indications of current activity.</td>
</tr>
<tr>
<td></td>
<td>• Comparing inventories with a current sales catalog and subsequent sales and delivery reports.</td>
</tr>
<tr>
<td></td>
<td>• Using the work of specialists to corroborate the nature of specialized products.</td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
<td></td>
</tr>
<tr>
<td>Inventory quantities include all products, materials, and supplies on hand.</td>
<td>• Observing physical inventory counts.</td>
</tr>
<tr>
<td></td>
<td>• Analytically reviewing the relationship of inventory balances to recent purchasing, production, and sales activities.</td>
</tr>
<tr>
<td></td>
<td>• Testing shipping and receiving cutoff procedures.</td>
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</tbody>
</table>
Illustrative Audit Objectives

Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

Examples of Substantive Tests

- Obtaining confirmation of inventories at locations outside the entity.
- Analytically reviewing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Testing shipping and receiving cutoff procedures.
- Tracing test counts recorded during the physical inventory observation to the inventory listing.
- Accounting for all inventory tags and count sheets used in recording the physical inventory counts.
- Testing the clerical accuracy of inventory listings.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

Inventories exclude items billed to customers or owned by others.

Valuation or Allocation

Inventories are properly stated at cost (except when market is lower).

- Examining paid vendors' invoices.
- Reviewing direct labor rates.
- Testing the computation of standard overhead rates.
Illustrative Audit Objectives

Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.

Inventories are reduced, when appropriate, to replacement cost or net realizable value.

Examples of Substantive Tests

- Examining analyses of purchasing and manufacturing standard cost variances.
- Examining an analysis of inventory turnover.
- Reviewing industry experience and trends.
- Analytically reviewing the relationship of inventory balances to anticipated sales volume.
- Touring the plant.
- Inquiring of production and sales personnel concerning possible excess or obsolete inventory items.
- Obtaining current market value quotations.
- Reviewing current production costs.
- Examining sales after year-end and open purchase order commitments.

Presentation and Disclosure

Inventories are properly classified in the balance sheet as current assets.

The major categories of inventories and their bases of valuation are adequately disclosed in the financial statements.

The pledge or assignment of any inventories is appropriately disclosed.

- Reviewing drafts of the financial statements.
- Reviewing drafts of the financial statements.
- Comparing the disclosures made in the financial statements to the requirements of generally accepted accounting principles.
- Obtaining confirmation of inventories pledged under loan agreements.
The Statement entitled Evidential Matter was adopted by the assenting votes of the fifteen members of the board, of whom two, Messrs. Gotlieb and Williamson, assented with qualification.

Mr. Gotlieb approves issuance of this Statement, but qualifies his assent with respect to the Appendix because he believes it would have been of greater benefit if it included additional examples of audit objectives and substantive tests of other asset, liability, equity, income, and expense accounts.

Mr. Williamson qualifies his assent because he objects to the information in the Appendix. He believes that the nature of the interrelations of assertions, objectives, procedures, and evidential matter and its evaluation requires no illustrative examples to be understood. He is concerned that a reader who relies on the Appendix to enhance an understanding of the Statement may be misled by the inherent incompleteness of the Appendix and may misinterpret the examples of substantive tests that were chosen.

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