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## **Audit Evidence**

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### **Abstract**

The users of financial reports of certain business entity, expect the auditor to express an opinion, on the basis of what they will base their further decisions, both for expressing the further confidence of the management, as well as for additional investments – investments in the business entity. The auditor again, to express an opinion on the financial reports of the entity, gathers accessible and appropriate evidence on the bases of which he will support his opinion.

**Keywords:** audit evidence; process of audit; audit report.

### **1. Introduction**

Audit evidences are documents and informations which the auditor should gain during the process of audit, in purpose the constructed and expressed opinion, which is expressed in the audit report, to be credible and well founded. The audit evidence include source documents and accounting records on which are based the financial reports (journal entries, synthetic and analytic evidence, calculations and adjustments etc.) and informations supported by facts (invoices, contracts, minutes of meetings of the Board, confirmation received from a third person, letters with statements of the management, informations that are available or accessible to the auditor by interrogation, observation, checking and physical analysis).

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While gathering the audit evidence, the auditor should take into account the relationship between costs and time requirements for obtaining the evidence and the usefulness of the information received. The existence of these restrictions does not mean that the auditor should fail to carry out an audit procedure, because it is expensive or difficult to carry out.

These are the steps that the auditor uses to obtain the evidence:

- Obtaining audit evidence
- Adequacy or sufficiency of audit evidence
- Procedure for collecting audit evidence

## **2. Obtaining audit evidence**

The most important thing in this procedure for providing evidence is to have the evidence to be competent and true, but also it is very important how this evidence is obtained, or methods of obtaining them. To perform the audit process it is necessary to provide enough audit evidence through inspection, observation, analysis and independently repetition of balances, in order to provide a reliable basis for expressing the opinion of the financial reports entity to the audit [1]. As an evidence is considered every information which confirms or denies a certain assertion of the management. The proof evidence is consisted of accountant data and supporting information, accountant data include: journal entries, writing in the nominal and the supplementary ledgers, accounting manuals, and the supporting information includes source documents such as checks, invoices, etc. Then, this includes the information obtained through research, observation, physical observation, as well as other information received by the auditor. Evidence must have two qualities of competence and sufficiency. Competence refers to the quality of the evidence, and the sufficiency of the quantity of evidence. The competence relates to the truthfulness and veracity of the evidence. For some evidence to be competent, it should be relevant and credible. The relevance is that the evidence has an impact on the auditor's ability to accept or reject a particular statement contained in the financial reports. Reliability is the quality of information that provides evidence that this information does not contain errors and that it faithfully reflects what it should represent.

Factors that determine the competence of the evidence are:

- the source from where the evidence was obtained
- the qualification of the one that provides the evidence
- the structure of the system of internal control
- the objectivity of the acquired evidence
- the time of obtaining the evidence
- the costs of obtaining the evidence

### **2.1. Adequacy or sufficiency of audit evidence**

In order to be of use to the auditor, the audit evidence should in some degree possess each of the following four characteristics:

- relevance
- impartiality (free from prejudice)
- objectivity
- conviction

Every evidence in different degree features four characteristics, and by that it has a different proof power. The auditor should select those types of evidence that come out ahead with the defined goals of the auditory, and the costs connected with their search should not exceed the determined optimal level.

The auditor has eight types of evidence available as support for achieving given audit objectives, those are:

- Physical evidence
- Mathematical evidence
- Verbal (oral) evidence
- Electronic evidence
- Documented evidence
- Confirmatory evidence
- Written statements
- Analytical evidence

The physical evidence are primary types of audit evidence used by the auditor, which the auditor can see and they are compiled by analyzing the assets and observing the client's activities. The physical evidence is exceptionally competent very often used to verify the physical existence of funds such as cash stock and equipment. The physical evidence can also be used in determining the quality or condition of assets that are entity to valuation or allocation. In accordance with professional auditing standards, the auditor may recruit specialists for analyzing physical evidence (if the auditor is not qualified for that). Although physical evidence provides solid evidence of the existence of assets or activities, they offer only limited evidence of remaining audit goal, for example, they do not offer evidence of asset ownership.

- Mathematical evidence

The mathematical evidence arises from the calculations made by the auditor and by comparing the results obtained with the calculations of the client in order to verify the mathematical accuracy of his statements. The mathematical evidence is an integral and necessary part of the engagement of the auditor, because even when separate items are accurately shown, if the collections are incorrect, the financial reports will be materially misleading. This evidence has the treatment of a direct form of evidence, but, on its own account, do not have the treatment of sufficiently competent evidence.

- Verbal (oral) evidence

The oral responses that the auditor receives on the issues addressed to management are not considered highly confidential evidence, but their primary value is to direct other sources of evidence, verify other evidence materials, and present facts that may serve in further investigations and documentation.

- Electronic evidence

The electronic evidence are information obtained or calculated by electronic means (computers, scanners, sensors, magnetic strips, discs etc.), that are used by the auditor in the process of formation of an opinion in the statements from the financial reports. The degree of the confidentiality of the electronic evidence is largely conditioned by the controls associated with the creation, transmission and complementation of the data, as well as from the auditor's knowledge of the functioning of the internal control system of the client and the competence of the funds – the audit software, used by the auditor, for access to electronic evidence.

- Documented evidence

The documented evidence supports the transactions and the changes listed in the company's accounting records. They cover a wide range of source documents and accounting reviews such as: general ledger, diary, procurement order, invoice receipts, salary schedules, inventory lists, contracts, business correspondence, meeting minutes, periodical financial reports, etc. There are internal and external documentary evidence. The internal documents are prepared within the enterprise, and their confidentiality and demonstration power are increased if they are backed up or confirmed by external sources. The external documents are prepared by external - third person, and are an integral part of the client's documentation (wire receipts received from banks, invoices from suppliers). The external documents as evidence have higher confidentiality than internal documents. The documented evidence, in contrast to the physical, are more regarded as derived than factual evidence, since the auditor is often unable to draw a direct conclusion on the reality of certain accounts or transactions only on the basis of internal and external documents.

- Confirmatory evidence

The confirmations are special group of documented evidence that focuses on the answers received directly from familiar third person, external for the clients, at the request of the auditor, in order to confirm the reality and objectivity of the information presented in relation to the existence, valuation or ownership of the assets, sources, expenditures and revenues. The conformations obtained from third person directly as the auditor's address have a high level of reliability treatment, so the auditor should have complete control over: selecting items and transactions being confirmed, delivery of third-person confirmation requests, and direct piercing the responses from the sent confirmations. Confirmations can be positive and negative.

- Written evidence

The written evidence can originate from the enterprise itself – from a client or from external sources and may

contain information about the entity or opinion about the entity on particular objects. They are evidence in the form of signed reports from the responsible person of the client or oral statements from the client's staff. These statements can disclose information that is not shown in accounting reviews and require further research. The credibility of written communication with statements depends on the ability and the inventiveness of the auditor to substantiate the statements with other types of audit evidence [2].

- Analytic evidence

In IAS 520 – Analytical procedures, the need to use the analytical procedures is emphasized throughout the audit engagement, in particular during the audit planning phase and at the end of the audit engagement, as part of the overall audit review. Through the analytical procedure, evidence are received that refer to the relationship – relation between the data. Analytical evidence compares the client's data from the current period in relation to the planed data, compared to previous years, compared to the industry in which it operates, compared to the total economy etc. and it is used for making conclusions about the reality of the statements of the management about the financial reports.

Examples for audit standards connected with audit evidence

- IAS 500 – Audit evidence
- IAS 501 – Audit evidence – external review of specific items
- IAS 505 – External confirmation
- IAS 520 – Analytic procedures
- IAS 530 – Methods of sample in the audit and other selective procedures
- IAS 550 – Connected clients
- IAS 580 – Management statements

IAS 500 – Audit evidence

The audit evidence is the foundation of every review, so according to that, It has to contain informations that are gathered in the accountant evidence, on which basis are formed the financial reports. The client's accountant evidence contains records of the starting accountant amounts and supportive records, such as checks and records about electronic transfer of the means: invoices, contracts, nominal ledger, journal entries, etc. The quantity of the audit evidence that are needed for the auditor to state an adequate opinion depends of the assessment of the audit's risk of misrepresentation as well as the quality of the audit evidence[3].

IAS 501 – Audit evidence – external review of specific items

So that it can be made final and independent opinion, often auditor should gather other information about specific items that most often apply to the stock, but also on other different reports. If the stock is important item, it needs specific treatment and special audit evidence. The auditor usually participates on the physical counting of the stock. If the auditor is not able to participate when counting the stock, auditor should make

additional audit procedures to provide audit evidence about the existence and the condition of the stock. If that is not possible, the auditor should modify the auditor's opinion.

#### IAS 505 – External confirmation

While gathering audit evidence, the auditor must gather relevant and confident audit evidence. The external confirmation is one of the most convincing audit evidence, because it is derived by independent source, the responses of the confirmation are directly from the auditor that is why they are more relevant from the evidence obtained indirectly or deductively. The external confirmation is audit evidence received as a written response by the auditor – third person, in electronic or other form. The external confirmation can be positive, negative, without a response or exception.

#### IAS 520 – Analytic procedure

Analytic procedures include comparison of the financial information of the entity with information from the previous years or with information in the branch.

Evident analytic procedure help the auditor to:

- to determine whether certain analytic procedure are relevant, considering the risk percentage of important false display, as well as the analysis of the details of those claims;
- to analyze the reliability and persuasiveness of the data of which the auditor's expectation are performed about certain amounts and indicators, considering the source, comparability, type and relativity of the information available and inspection in the process of preparation of the information;
- to create expectations about the recorded amounts or indicators and to value if the expectations are precise enough to recognize false display, that is individually or together with the other false displays. It can contribute for a false display of the financial reports;
- to determine the amount of the difference between the recorded amounts and the expected values.

#### IAS 530 – Audit sampling

Audit sampling is applied to less than 100% of the items, so each individual sample has the opportunity to be selected to provide the auditor with a reasonable basis for compiling the conclusion. The risk that can appear represents risk of getting different audit evidence based on data sampling, than the evidence which would be obtained if the audit data of all data were implemented. Two types of false evidence can appear:

- in case of application of analyzed control, to come to the conclusion that control is more successful than in reality or in the case of analyzing of the details, to come to the conclusion that there are no significant misstatements, although in reality they really exist.
- in case of application of analyzed control, to come to the conclusion that the control is less successful, than it really is successful in the reality or in case of analyzing details, to come to the conclusion that there are significant misstatements, although in reality they do not really exist.

## IAS 550 – Connected clients

The transactions with connected clients arise in the course of the entity's ordinary operations, so the auditor must determine all related persons to the client. The entities are connected if one of them has the opportunity to control the other one or to make a significant implement in making a decision. The audit should understand the relation of the transactions between the connected clients, so he can evaluate if it is fair presented, to recognize the risk factors of fraud and to gather available and sample audit evidence. Displaying the transactions with connected clients, according to the law the management is responsible[4].

## IAS 580 – Management statements

The written statements are statements which the management gives to the auditor to confirm certain issues or as a support of the other audit evidence. Management submits statement to the auditor about the responsibility related to the financial reports, or that he is giving a relative information. Beside this statements, the auditor can require other statements from the management which give additional explanation about certain transactions, items and activities. An evidence like that presents audit evidence that the auditor uses while making the statement, on the basis of which the auditor's opinion is made.

### **3. Procedure for collecting audit evidence**

To gather certain amount of component evidence, the auditors use more procedures, whose time schedule partly depends of the time periods in which stand the necessary evidence. The auditor gets audit evidence trough one or more of the following procedure: inspection, observation, analysis and confirmation, calculating and analytic procedure.

#### **3.1. *Inspection***

Inspection is the procedure of analyzing the statements, documents and material items. Inspection of the statements and document secure audit evidence and different degree of reliability depending on their type, source and effectiveness of the internal controls of their processing. Auditors apply four types of different technics of inspections, such as:

- Physical analysis of the items

This is about analysis of property in physical form. The physical analysis should secure evidence about an existing property, but at the same time they must secure additional documents that confirm the ownership of the property, the economic condition, but for certain property forms for which we cannot determine their possession by physical analysis. As an example the analysis of the stock, the auditor cannot secure evidence about their possession by physical analysis, as well as the fleet of the company, but cannot determine purchase value, because it can be taken on lease[5]. Physical analysis is used so that the auditor can check the existence of the items, their economical usage, the quantity and the quality. Inventory represents one type of physical analysis with whom are determined the physical quantity of the property, other form of analysis is checking whether all

pre-numbered documents are included into the processing and whether they are accrued in the accounting records.

- Analysis of the documents and records

This is about analysis of the documents that the client prepared as internal documents, and documents that have been prepared by third person as an external documents. In internal documents are included outgoing invoices for the sold stock, receivers for goods purchased, procure materials, and in external documents includes purchase orders from goods to customers, input invoices for goods from suppliers. The auditor follows from the transactions of the documents until the records, if the auditor will go from the source documents to the financial reports, it is about warranty or confirmation and monitoring or analysis. In the first case it is about confirmation, or analysis of the documents of the accountant records against source documents of the business transactions. The warranty is important for a bond to determine the assessment of some business transactions. In the second case it is about monitoring of the documents that lead to the financial reports. The monitoring is very important to determine of the eventual understatement, of some balanced positions. The warranty helps improving the statement about its existence, but the monitoring helps to check the claim for the completeness of the transaction[6].

- Checking the mathematical correctness

It is about checking the correctness from other third person. If the check is about some other calculations, than it is called a re-performed procedure, such as re-checks or recalculation of collections from supplier accounts.

### **3.2. Analytic procedures**

The technic of the analytic procedures is used by the auditor and in the phase of planning and in the phase of collecting audit evidence and the phase of completing as well as in expressing an opinion. It is considered that this technique can be more effective and more efficient from some other types of check. What technique of analytic procedure will be implemented, it depends a lot from the complexity of the mathematic models, from complexity of the immediate analysis of the trends and coefficients, including the numerous interdependencies and data from array previous years. As the simplest analytic procedure is considered the comparison of the amounts between income and expenses from current period with the ones from the previous period, determination of the bigger differences. More complex analytic procedures can be involved into more complex regression models for evaluation of the realization in one year. Analytic procedures also can be involved into calculating of the percentage relationship between the various positions of the financial reports, such as the percentage of profit. The auditor's goal in such approaches is to identify unexpected differences that may signal certain failures and mistakes that the auditor must investigate.

There are three main categories of documented audit evidence that provide a different degree of authenticity:

- documentary audit evidence created and stored by third person (external documents);
- documentary audit evidence that is made by third person, but kept by the client (internal-external)



documents);

- documentary audit evidence that is prepared and kept by the client (internal documents).

Inspection of tangible assets provides credible evidence of their existence.

### ***3.3. Collecting sufficient and appropriate evidence***

The procedures carried out during the audit are performed by the detailed direction of the auditor for collecting certain types of evidence needed during the audit. For example, evidence such as: physical inventory counting, checking the documentation for a particular building, comparing canceled checks with cash payments, etc. are collected using audit procedures. When composing procedures, care must be taken to be clearly written, in order to not cause a doubt.

### ***3.4. Testing and conducting procedures for collecting sufficient and adequate evidence***

The purpose of the test is to provide sufficient and adequate evidence for verifying the truth, accuracy and objectivity of the financial statements. Such procedures for collecting evidence are:

- Tests related to the operation and conducted control in the entity
- Tests on the details of the transactions
- Tests on details of balances
- Analytical procedures
- Confirmation of the status of the partitioned account
- Completing legal documentation
- Statements from the management for financial statements
- Compilation of evidence

In the phase, evaluation and reporting, the audit procedures are completed and an audit opinion is formed. Planning the audit is crucial because the auditor needs to plan well the steps for providing adequate evidence as well as to avoid misunderstanding with the client. The collection of sufficient evidence is important for the audit firm to reduce the legal responsibility and to maintain a good reputation in the professional environment. Maintaining a reasonable price helps the entity to remain competitive and thus retain clients, on the assumption that it has a reputation to perform well.

### ***3.5. Sample size***

After selecting procedures in the audit, the size of the sample should be determined. The auditor decide how many items will be tested for each procedure individually. If during the work there are deviations from the expected results there is a possibility to modify the scope of the procedures. For example, if an order is given to inspect and compare 50 invoices by the random sampling method, and if there is a deviation exceeding the expected values, it is possible to extend the sample to 100 invoices or to check all invoices relating to a particular district, person, company, channel, etc. There is no initial size for any procedure in any case. In each

case, the size and the tolerated deviations are separately calculated.

Selection of items. In a particular audit procedure, the auditor determines the size of the sample. It can also be determined in the way in which a sample for a review will be created from the sum. Typically, the auditor could:

- to examine the first 50 invoices
- to select 50 invoices based on a random number table
- to choose 50 invoices with the highest amount
- to select those invoices that he considers most likely to have an error

Combinations of these methods can also be used. The timing of the audit processes may vary from the beginning to the end of the accounting period. Depending on the scope of the work and the location of the activities, the audit firm determines the end of the audit. Based on the global schedule, separate procedures are planned. Some procedures can be performed for the most part during the calendar year (such as an assessment of the internal control system, inventories and other checks), while some have inevitably need to be carried out during the preparation of the accounting reports, and some are implemented even after the preparation of the accounting statements.

#### **4. The conviction of the evidence**

One of the standards and requirements for fieldwork requires the auditor to collect sufficient valid evidence to support the opinion expressed. In some cases, there is a contradiction of the need for a wider number of evidence and the available budget for collecting that evidence. Due to this contradiction, the planning of the audit must take into account the limited resources to achieve the provision of the most favorable number of evidence. For the audit evidence to be conclusive, they must be valid and sufficient. By combining all the evidence in the overall audit process, the auditor should assess whether the evidence is sufficient and appropriate to submit an appropriate audit report. The evidence to be collected must be bound to the main purpose of the audit. The main function of audit evidence is on their base to form the audit opinion. For example, let's assume that the auditor is interested in checking whether the down payment for the sale of quality differs from the regular sales. For that purpose, the auditor should provide an adequate number of invoices for advance sale with the corresponding documentation and an appropriate number of invoices for regular sale with the corresponding documentation. The difference in delivery and payment times must be justified. In addition to this aspect, it should be checked whether the conditions for advance sale are carried out only for the quantities that correspond with the upstream quantities or the value is breached. In some cases it is very complicated to check which delivery is related to the advance payment because internal control systems do not publish their function in the correct way. Independence of the source – The source of data for audit evidence may have an impact on the validity of the evidence itself. It can be principally defined: evidence obtained outside the entity is more reliable than that obtained within the entity. Degree of objectivity – Objective evidence is more relevant than evidence whose accuracy needs to be further determined. Examples of objective evidence include: presence for inventories, physical counting and measurement, software testing to check the reliability of the database, etc.

The sufficiency of the evidence – The quantity and quality of evidence determine the amount of evidence. So, in

determining whether the evidence is in sufficient numbers, the size of the sample selected by the auditor is important. For certain audit procedures, the evidence obtained from a sample of 200 items would most likely be sufficient to a greater extent than the evidence obtained with a sample of 100 items. Quality of internal control – When the structure of the client's internal control is quality, the evidence obtained from the entity can be highly relevant. For example, if internal sales and invoice controls are effective, the audit could collect more relevant evidence from outgoing invoices and transport documents than when these controls would be inadequate. Reliability of audit evidence – The validity of the audit evidence relates to the extent to which the evidence can be considered as reliable. The reliability depends on the nature of the matters for which the auditor collects the evidence. If the evidence is deemed to be exceptionally valid, it can greatly assist the auditor in the conviction that the financial statements are correct. For example, a much higher degree of authenticity is the confirmation, that is, the confirmation statement of open items that the business partner of the audit entity provided to the auditor, than the immediate insight of the auditor in the analysis of buyers and suppliers. The reliability of the audit evidence depends on:

- the relevance of the evidence
- independence of the source of evidence
- the quality of the client's internal controls
- direct knowledge of the auditor
- the qualifications of the persons who provide information
- the degree of objectivity

Nature of the audit tests – Audit procedures which are used to collect evidence are called audit tests. The classification of the audit tests can be performed according to:

- the ultimate goal of the tests
- the main types of tests
- special audit techniques

Tests according to the ultimate objective of the audit - The audit program consists planning for conducting audit tests aimed at achieving the ultimate objective of the audit through the implementation of:

- control tests - that determine the effectiveness, shape and action of the structure of internal controls.
- essential tests - determine whether there are material errors or errors in the presentation of the financial statements

If the structure of the internal control is strong, it is less likely that the financial statements contain material misstatements, than when the internal control structure would be weak, that is, the control risk would be high. If the client has established a good internal control structure, the auditor may decide whether to reduce substantive testing, as internal control would prevent material errors.

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