Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 236-6220

DATE: September 23, 2011

TO: Audit Committee

FROM: Mara W. Elliott, Deputy City Attorney

SUBJECT: Statement on Auditing Standards: AU section 326

At the Audit Committee meeting on September 12, 2011, a member of the public suggested the Committee confirm outside auditor Macias Gini & O'Connell used AU section 326 when auditing the City's FY 2010 Comprehensive Annual Financial Report.

AU section 326, attached, is a professional standard that describes the responsibilities and functions of the independent auditor when conducting an audit. According to the American Institute of CPAs (AICPA), AUs are an auditing interpretation of Statements on Auditing Standards issued by the Auditing Standards Board. AICPA states on its website[1] that "[t]he auditor should identify interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance."

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[1] http://www.aicpa.org/research/standards/auditattest/pages/sas.aspx

AU Section 326

Audit Evidence

(Supersedes SAS No. 31)

Source: SAS No. 106.

See section 9326 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Introduction

.01 This section provides guidance about concepts underlying the third standard of field work: "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." This section:

- Defines *audit evidence*;
- Defines *relevant assertions* and discusses their use in assessing risks and designing appropriate further audit procedures;[1]
- Discusses qualitative aspects that the auditor considers in determining the sufficiency and appropriateness of audit evidence; and
- Describes various audit procedures and discusses the purposes for which they may be performed.

Concept of Audit Evidence

.02 *Audit evidence* is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to examine all information that may exist.[2] Audit evidence, which is cumulative in nature, includes audit evidence obtained from audit procedures performed during the course of the audit and may include audit evidence obtained from other sources, such as previous audits and a firm's quality control procedures for client acceptance and continuance.

.03 Accounting records generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries, and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations, and disclosures. The entries in the accounting records are often initiated, authorized, recorded, processed, and

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[1] Further audit procedures include tests of the operating effectiveness of controls and substantive procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement. See paragraph .07 of section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.*

[2] See paragraph .13.

reported in electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations, and compliance objectives.

.04 Management is responsible for the preparation of the financial statements based on the accounting records of the entity. The auditor should obtain audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, because accounting records alone do not provide sufficient appropriate audit evidence on which to base an audit opinion on the financial statements, the auditor should obtain other audit evidence.

.05 Other information that the auditor may use as audit evidence includes minutes of meetings; confirmations from third parties; industry analysts' reports; comparable data about competitors (benchmarking); controls manuals; information obtained by the auditor from such audit procedures as inquiry, observation, and inspection; and other information developed by or available to the auditor that permits the auditor to reach conclusions through valid reasoning.

Sufficient Appropriate Audit Evidence

.06 *Sufficiency* is the measure of the quantity of audit evidence. *Appropriateness* is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less the audit evidence that may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate if it is of a lower quality.

.07 A given set of audit procedures may provide audit evidence that is relevant to certain assertions but not to others. For example, inspection of records and documents related to the collection of receivables after the period end may provide audit evidence regarding both existence and valuation, although not necessarily the appropriateness of period-end cutoffs. On the other hand, the auditor often obtains audit evidence from different sources or of a different nature that is relevant to the same assertion. For example, the auditor may analyze the aging of accounts receivable and the subsequent collection of receivables to obtain audit evidence relating to the valuation of the allowance for doubtful accounts. Furthermore, obtaining audit evidence relating to a particular assertion, for example, the physical existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, rights and obligations.

.08 The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made; however, such generalizations are subject to important exceptions. Even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information

obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence are useful:

- Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.
- Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

.09 The auditor should consider the reliability of the information to be used as audit evidence, for example, photocopies; facsimiles; or filmed, digitized, or other electronic documents, including consideration of controls over their preparation and maintenance where relevant. However, an audit rarely involves the authentication of documentation, nor is the auditor trained as or expected to be an expert in such authentication.

.10 When information produced by the entity is used by the auditor to perform further audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information.[3] In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor should consider the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity's information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed. For example, these additional procedures may include using computer-assisted audit techniques (CAATs) to recalculate the information.

.11 The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from a management representation. Conversely, when audit evidence obtained from one source is inconsistent with that obtained

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[3] See paragraphs .14 and .57 of section 318.

from another, the auditor should determine what additional audit procedures are necessary to resolve the inconsistency.

.12 The auditor may consider the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an audit procedure for which there is no appropriate alternative.

.13 In forming the audit opinion, the auditor does not examine all the information available (evidence) because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor may find it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance,[4] the auditor must not be satisfied with audit evidence that is less than persuasive. The auditor should use professional judgment and should exercise professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion.

The Use of Assertions in Obtaining Audit Evidence

.14 Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity.[5] In representing that the financial statements are fairly presented in conformity with generally accepted accounting principles,[6] management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures.

.15 Assertions used by the auditor (see paragraph .16) fall into the following categories:

a. Assertions about classes of transactions and events for the period under audit:

i. *Occurrence.* Transactions and events that have been recorded have occurred and pertain to the entity.

ii. *Completeness.* All transactions and events that should have been recorded have been recorded.

iii. *Accuracy.* Amounts and other data relating to recorded transactions and events have been recorded appropriately.

iv. *Cutoff.* Transactions and events have been recorded in the correct accounting period.

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

b. Assertions about account balances at the period end:

i. *Existence.* Assets, liabilities, and equity interests exist.

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

iii. *Completeness.* All assets, liabilities, and equity interests that should have been recorded have been recorded.

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[4] Section 230, paragraphs .10 through .13, provides guidance on reasonable assurance as it relates to an audit of financial statements.

[5] See section 110, paragraph .03.

[6] Reference to generally accepted accounting principles in this section includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles as defined in section 623, *Special Reports*.

iv. *Valuation and allocation.* Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

c. Assertions about presentation and disclosure:

i. *Occurrence and rights and obligations.* Disclosed events and transactions have occurred and pertain to the entity.

ii. *Completeness.* All disclosures that should have been included in the financial statements have been included.

iii. *Classification and understandability.* Financial information is appropriately presented and described and disclosures are clearly expressed.

iv. *Accuracy and valuation.* Financial and other information are disclosed fairly and at appropriate amounts.

.16 The auditor may use the relevant assertions as they are described above or may express them differently provided aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

.17 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

.18 Relevant assertions are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertion separately in connection with the period-end financial reporting process.

.19 For each significant class of transactions, account balance, and presentation and disclosure, the auditor should determine the relevance of each of the financial statement assertions. To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant class of transactions, account balance, and presentation and disclosure. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate:

a. The nature of the assertion;

b. The volume of transactions or data related to the assertion; and

c. The nature and complexity of the systems, including the use of information technology, by which the entity processes and controls information supporting the assertion.

Audit Procedures for Obtaining Audit Evidence

.20 The auditor should obtain audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:

a. Obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels (audit procedures performed for this purpose are referred to as *risk assessment procedures*);

b. When necessary, or when the auditor has determined to do so, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *tests of controls*); and

c. Detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *substantive procedures* and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

.21 The auditor must perform risk assessment procedures[7] to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

.22 Tests of controls are necessary in two circumstances. When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor should test those controls to support the risk assessment. In addition, when the substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness.[8]

.23 As described in section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor should plan and should perform substantive procedures to be responsive to the related planned level of detection risk, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement.[9] Further, there are inherent limitations in internal control, including the risk of management override, the possibility of human error, and the effect of systems changes. Therefore, regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence.

.24 The auditor should use one or more types of the audit procedures described in paragraphs .27 through .41 of this section. These audit procedures, or combinations thereof, may be used as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor. Paragraph .05 of section 314, *Understanding the*

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[7] See paragraph .05 of section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, for an explanation of risk assessment procedures.

[8] See paragraphs .117 through .120 of section 314 and paragraph .24 of section 318.

[9] See paragraph .22 of section 312, *Audit Risk and Materiality in Conducting an Audit*, for definition of *risk of material misstatement*.

Entity and Its Environment and Assessing the Risks of Material Misstatement, provides guidance to the auditor to perform a combination of audit procedures when performing risk assessment procedures. In addition, a combination of two or more of these audit procedures may be necessary to obtain sufficient appropriate audit evidence when performing tests of controls or substantive procedures at the relevant assertion level. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor should perform audit procedures to establish its continuing relevance.[10]

.25 The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.[11] Source documents, such as purchase orders, bills of lading, invoices, and checks, may be replaced with electronic messages. For example, entities may use electronic commerce or image processing systems. In electronic commerce, the entity and its customers or suppliers use connected computers over a public network, such as the Internet, to transact business electronically. Purchasing, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic information may exist at a certain point in time. However, such information may not be retrievable after a specified period of time if files are changed and if backup files do not exist. An entity's data retention policies may require the auditor to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

.26 When the information is in electronic form, the auditor may carry out through CAATs certain of the audit procedures described in the following sections.

Inspection of Records or Documents

.27 Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form, or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records or documents for evidence of authorization.

.28 Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition.

Inspection of Tangible Assets

.29 Inspection of tangible assets consists of physical examination of the assets. Inspection of tangible assets may provide appropriate audit evidence with respect to their existence, but not necessarily about the entity's rights and

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[10] See paragraph .64 of section 318.

[11] See paragraphs .57 through .63 of section 314.

obligations or the valuation of the assets. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting. For example, when observing an inventory count, the auditor may inspect individual inventory items (such as opening containers included in the inventory count to ensure that they are not empty) to verify their existence.

Observation

.30 Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. See section 331, *Inventories*, for further guidance on observation of the counting of inventory.

Inquiry

.31 Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, inside or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

.32 Inquiry normally involves:

- Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned.
- Asking clear, concise, and relevant questions.
- Using open or closed questions appropriately.
- Listening actively and effectively.
- Considering the reactions and responses and asking follow-up questions.
- Evaluating the response.

.33 In some cases, the auditor should obtain replies to inquiries in the form of written representations from management. For example, when obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source. See section 333, *Management Representations*, for further guidance on written representations.

.34 Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. The auditor should resolve any significant inconsistencies in the information obtained.

.35 The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement at the relevant assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

.36 Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management's intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions with respect to assets or liabilities, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information about management's intent.

Confirmation

.37 Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, the auditor may seek direct confirmation of receivables by communication with debtors. Confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. A confirmation request can be designed to ask if any modifications have been made to the agreement, and if so, what the relevant details are. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties. Confirmations also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of an undisclosed agreement that may influence revenue recognition. See section 330, *The Confirmation Process*, for further guidance on confirmations.

Recalculation

.38 Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed through the use of information technology, for example, by obtaining an electronic file from the entity and using CAATs to check the accuracy of the summarization of the file.

Reperformance

.39 Reperformance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable.

Analytical Procedures

.40 Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See section 329, *Analytical Procedures*, for further guidance on analytical procedures.

.41 An analytical procedure might be scanning, which is the auditor's use of professional judgment to review accounting data to identify significant or unusual items and then to test those items. This includes the identification of anomalous individual items within account balances or other data through the reading or analysis of entries in transaction listings, subsidiary ledgers, general ledger control accounts, adjusting entries, suspense accounts, reconciliations, and other detailed reports. Scanning includes searching for large or unusual items in the accounting records (for example, nonstandard journal entries), as

well as in transaction data (for example, suspense accounts, adjusting journal entries) for indications of misstatements that have occurred. CAATS may assist an auditor in identifying anomalies. Since the auditor tests the items selected by scanning, the auditor obtains audit evidence about those items. The auditor's scanning also may provide some audit evidence about the items not selected since the auditor has used professional judgment to determine that the items not selected are less likely to be misstated.

Effective Date

.42 This section is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.