



Auditing Standards and Practices Council

Philippine Auditing Practice Statement 1000Ph

**AUDIT EVIDENCE – PRACTICAL PROBLEMS
IN AUDIT OF FINANCIAL STATEMENTS**

**PHILIPPINE AUDITING PRACTICE STATEMENT 1000Ph
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IN AUDIT OF FINANCIAL STATEMENTS**

CONTENTS

	<u>Paragraphs</u>
Introduction	1-2
Auditor's Responsibility When Client Fails to Prepare Certain Audit Requirements	3-5
Audit Procedures	6-15
Other Considerations	16-17
Reporting Considerations	18-20
Effective Date	21

Philippine Auditing Practice Statements (PAPS or Statements) are issued by the Auditing Standards and Practices Council (ASPC) to provide practical assistance to auditors in implementing the Philippine Standards on Auditing (PSAs) or to promote good practice. Statements do not have the authority of PSAs.

This Statement does not establish any new basic principles or essential procedures; its purpose is to assist auditors, and to develop good practice, by providing guidance on the application of the PSAs when conducting an audit of financial statements. The auditor exercises professional judgment to determine the extent to which any of the audit procedures described in this Statement may be appropriate in the light of the requirements of the PSAs and the entity's particular circumstances.

The applicability of this PAPS on Philippine public sector entities has not been addressed by the Council. It is the understanding of the Council that this matter will be addressed by the Commission on Audit itself in due course.

This particular PAPS issued by the Auditing Standards and Practices Council is not based on a specific International Auditing Practice Statements (IAPS) issued by the International Auditing Practices Committee of the International Federation of Accountants but was issued to address specific situations in the Philippines.

**Audit Evidence –Practical Problems
In Audit of Financial Statements**

Introduction

1. The purpose of this Philippine Auditing Practice Statement (PAPS) is to provide practical guidance in addition to that contained in PSA 500, “Audit Evidence,” with respect to certain specific financial statement amounts and other disclosures.
2. Application of the standards and guidance provided in this PAPS will assist the auditor in addressing certain problems in the audit of financial statements, particularly the auditor’s inability to obtain sufficient competent evidential matter due to scope limitations such as the poor condition of the accounting records and supporting documents or the inability of the auditor to obtain sufficient competent evidential matter because certain documents are not existing or are not capable of being reproduced. Instances when the documents or information exist but are not made available to the auditor, when the scope limitation is imposed by the client or by circumstances, when a particular audit procedure is beyond the area of expertise of the auditor, or when other scope limitations exist are excluded from the coverage of this PAPS and are accordingly dealt with based on the provisions of the following:
 - a. PSA 200 – Objectives and General Principles Governing an Audit of Financial Statements
 - b. PSA 240 – The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements
 - c. PSA 580 – Management Representations
 - d. PSA 620 – Using the Work of an Expert
 - e. PSA 700 – The Auditor’s Report on Financial Statements
 - f. PSA 720 – Other Information in Documents Containing Audited Financial Statements

Auditor’s Responsibility When Client Fails to Prepare Certain Audit Requirements

3. As stated in PSA 210, “Terms of Audit Engagements,” the form and content of audit engagement letters may vary for each client, but they would generally include reference to: “...unrestricted access to whatever records, documentation and other information requested in connection with the audit.”

The sample engagement letter in the Appendix to PSA 210 explicitly provides: “We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with the audit.” This means that, at the outset, the auditor and his client have already established the nature and extent of audit evidence (documents, records and information) that the auditor could require from his client to enable him to conduct his audit and come up with a report on the client’s financial statements.

4. If an auditor is unable to obtain the necessary audit evidence, a scope limitation exists. As discussed in PSA 700, “The Auditors’ Report on Financial Statements,” paragraphs 41 and 42, a scope limitation may be imposed by the client, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary. It may also be imposed by circumstances such as the timing of the auditor’s appointment. Further, it may arise when in the opinion of the auditor, the entity’s accounting records are inadequate or when the auditor is unable to carry out audit procedures believed to be desirable. This standard focuses on the scope limitations due to the inability of the client to prepare schedules, reports or computations or the failure to reconcile differences in audit due to the poor condition of the accounting records. See paragraph 5 for more specific examples.
5. More specific examples of the scope limitations covered under this standard are the following:
 - a. ***Failure or inability of the client to prepare the necessary schedules, reports or computations supporting a financial statement item. Said schedules, reports or computations may include, but may not be limited, to the following:***
 - (1) Schedules
 - obsolete inventory items due to lack of reliable inventory records,
 - certain bank reconciliation statements of active bank accounts maintained by the client,
 - trade receivables, including the aging of such receivables,
 - details of fixed asset movements,

- cash flow items to be presented at gross in the statement of cash flows,
- receivables from directors, officers, employees, related parties and principal stockholders with the required columns prescribed by the SEC (for public companies), and
- segment information to support disclosures on reportable segments.

(2) Reports

- material intervening transactions (such as sales, purchases, loans or advances, shared or joint costs) between a parent company and its related entities occurring between its year-end date and the year-end dates of its subsidiaries, if there are differences in reporting dates of the parent and any of its subsidiaries, and
- consolidated financial statements and all the necessary elimination entries for intercompany balances and transactions.

(3) Computations/ projections

- asset impairment loss supported by financial budgets/forecasts for five years or for a longer period, particularly for oil and gas and mining companies or other capital-intensive companies,
- income tax under deferred tax accounting,
- valuation allowance for deferred income tax asset,
- allowance for: bad debts; inventory obsolescence; decline in market value of investments; or decline in the value of an exchange seat, and
- current or long-term portions of loans with consideration for default situations.

b. Failure to reconcile differences noted in the audit. Said differences may either be in one or more of the following areas:

- reconciliation of general ledger and subsidiary ledger balances of accounts receivables or accounts payable or intercompany accounts,
- reconciliation of the confirmed balance of trade receivables with the recorded (book) balance,
- reconciliation of the net income or loss per parent company only financial statements with the consolidated financial statements where the figures are different,
- general ledger beginning balances of certain balance sheet accounts of a repeat engagement with the balances appearing in the latest audited financial statements,
- general ledger beginning balances of balance sheet accounts of a new client with the prior period audited financial statement balances reported on by another auditor,
- trial balance that is off balance, and
- reconciliation of count of inventory items with the stock cards or their equivalent, etc.

Audit Procedures

6. The additional audit procedures to be performed by the auditor when he encounters audit matters which may fall under one or a combination of the situations described in paragraph 5 above may be determined based on the, materiality and the importance of the account(s) affected by the matters described, the quality of the audit evidence obtained thus far, whether it is an initial audit or a recurring audit, the feasibility and timeliness of coming up with a solution for the problem and the agreed-upon reporting requirements.

7. The determination as to the sufficiency and appropriateness of evidence is a matter of professional judgment. The auditor collects and evaluates evidence to determine whether the same is already sufficient for his purpose. The auditor should not prepare: (a) original data (schedules such as trial balance or subsidiary ledger) used to generate financial statements or, (b) other records (such as lapsing schedule, analysis of doubtful accounts, etc.) that are the subject matter of the assurance engagement. The audit engagement letter clearly delineates each party's (external auditor's and management's) responsibilities in regard to the audit of financial statements. The auditor's doing things which management ought to do might be regarded as a breach of the independence rules. (As described in International Federation of Accountants' Code of Ethics, this situation creates self-review threats.) The auditor may also decide to do alternative procedures to obtain sufficient appropriate audit evidence but in doing so he should consider the relationship between the cost of obtaining evidence and the usefulness of the evidence obtained to ensure that only reasonable alternative audit procedures are performed.
8. Thus, when management fails to prepare schedules or reports for an item that is material to the financial statements needed by the auditor in his audit despite an earlier agreed-upon timetable, the auditor should:
 - a. evaluate the reasons why management is unable to prepare his audit requirements,
 - b. discuss with management his position concerning the preparation of the audit requirements (such as financial statements and notes thereto, consolidated financial statements) as early as the planning stage and not when the audit is almost completed, and
 - c. agree on a revised timetable within which the requirements are to be prepared by the management and, where management is still unable to prepare the schedules/reports, decide on the most appropriate course of action under the circumstances.
9. The course of action that may be adopted by the auditor depends on various factors such as:
 - a. the professional and personal relationships between the client and the auditor which would affect how the auditor and his client will deal with the failure by the client to prepare the audit requirements,
 - b. the need to meet audit deadline/timetable,

- c. willingness of auditor to educate his client, and client's willingness to learn, in performing his responsibilities, by for example, preparing a proforma reconciliation statement or schedule format for the client staff to complete or to use as a guide (format of acquisition and disposal of property and equipment; analysis of intercompany accounts; bank reconciliation statement using the proof of cash format), advising the client staff on the more efficient and effective way of, or approach to, resolving difficult accounting computations (calculating discounted cash flows when assessing impairment loss; determining the percentage of completion of projects in progress; ensuring that all potentially dilutive common shares are considered in computing diluted earnings per share), and
 - d. the need for the auditor to consider withdrawing from the engagement should circumstances so warrant.
10. Whatever reasons management has for its failure to prepare the audit requirements (or to prepare schedules or report that do not comply with the audit requirements) have to be carefully evaluated by the auditor. However, the auditor should not prepare his own audit requirements if doing so would compromise his independence since he might end up auditing his own work. For example, the auditor cannot perform bookkeeping work or prepare his client's bank reconciliation statements since doing so results in the auditor auditing his own work as pointed out in paragraph 5.
11. The auditor has the responsibility to ensure that management addresses the reasons that prevent management from preparing the auditor's requirements, such as lack of manpower, inadequate financial resources, or poorly trained accounting personnel.
12. When the inadequacy in recordkeeping or accounting records of the client that gives rise to its inability to provide the information being required by the auditor, such as a reconciliation of differences or an analysis of an account, is not corrected or addressed within a reasonable period of time of, say, one year, this could indicate the existence of situations or weaknesses in the system that require the auditor to exercise professional skepticism. The auditor is responsible for informing the audit committee or equivalent, or the client's Board of Directors, about the existence of such unusual delays, particularly if the delay would affect his audit and the type of report he expects to issue. (See PSA 160, "Communication of Audit Matters with those Charged with Governance".)

13. It is not sufficient for client to merely prepare a schedule or analysis required by the auditor. What is needed is for management to review such analysis or schedule and record the necessary adjustment and/or implement any improvement or correction in the existing system of control to ensure that the situation is not repeated. Under such circumstances, the auditor should have greater professional skepticism when making an independent check of the schedules prepared by his client.
14. Sometimes, the auditor might do what is clearly a management responsibility, say, for example, preparing a schedule or an analysis of a particular account if it would be economical and less time-consuming for the auditor to do, instead of waiting for his client to complete such schedule or analysis. While it is possible that this could be resorted to by the auditor to meet his and/or client's reporting requirements, as previously pointed out, the auditor can do so only if this will not impair his independence. While the auditor should not prepare schedules or documents that may form part of his audit requirements, he may assist his client in identifying intercompany accounts to be eliminated on consolidation or even in preparing the consolidated or parent financial statements, and the related notes thereto. Likewise, it is also possible for the auditor to rewrite or reformat a particular schedule prepared by the client to suit his purpose since in this particular case, the client is considered to have prepared the schedule.
15. Limiting the discussion of problems or issues encountered during the audit to middle management without involving the people who make decisions is self-defeating and not advisable, regardless of circumstances. It is always prudent to involve the top management, audit committee or board of directors to facilitate resolution of problems or issues and to prevent the recurrence of similar incidents in the future. As discussed in PSA 260, "Communications of Audit Matters with Those Charged with Corporate Governance," paragraph 11, audit matters of governance interest to be communicated by the auditor to those charged with governance include expected limitations in the audit scope, material weaknesses in the internal controls, among others.

Other Considerations

16. Client education and training is one area that would help the auditor in completing his audit since the client staff would know how to handle difficult accounting matters that impact on his compliance with the audit requirements. If the auditor does not have the facility to educate his clients through training, he may just refer the client's staff to professional CPA groups or to the Philippine Institute of Certified Public Accountants who conduct such training courses. (For example,

the auditor may help client staff appreciate: (a) how to identify and report business segments in the financial statements; (b) how to prepare supporting schedules for inclusion in the financial statements, such as schedule of investments in, and advances to, subsidiaries; (c) how to account for business combinations, that is, whether purchase or pooling-of-interests accounting or a method similar to the latter method, applies in the circumstances.)

17. The auditor needs to also be aware that problems or audit issues arising during the planning phase of his work or at the execution phase thereof could have been anticipated if a thorough and meticulous pre-acceptance investigation of the client is conducted before submitting a proposal letter or signing an engagement contract. Under PSA 220, "Quality Control for Audit Work," among the quality control policies to be adopted by an audit firm is the evaluation of prospective clients and a review on an ongoing basis, of existing clients, whereby the firm's independence, ability to serve the client properly and the integrity of client's management are to be considered.

Reporting Considerations

Reporting

18. The inability of the client to prepare certain audit requirements as discussed in paragraphs 3 to 5 constitutes a limitation on the auditor's scope of work. After doing certain audit procedures under those circumstances as discussed in paragraphs 6 to 17, the auditor will be able to conclude as to the sufficiency of the audit evidence he has obtained. If he is unable to obtain the appropriate audit evidence, however, paragraph 18 of PSA 500 states that the auditor should express a qualified opinion or a disclaimer. Unresolved problems, issues or differences between the auditor and his client can normally be addressed in the audit report. Paragraphs 40-42 of PSA 700 provide guidance relating to the wording of the report.

Limitation on Scope of Audit

19. Paragraph 42 of PSA 700 states that when there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

20. Illustrations of reports with scope limitation are set out below.

Example A – Limitation on Scope – Qualified Opinion *(The client failed to prepare bank reconciliation statements for major bank accounts because of inadequate records, hence, the auditor was unable to obtain sufficient competent evidential matter on bank balances and related expense accounts.)*

We have audited the accompanying balance sheets of ABC Company as of December 31, 20X2, and the related statements of income, changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audit in accordance with.....

The Company was not able to prepare bank reconciliation statements for three major bank accounts with a total balance of P50 million as of December 31, 20X2, or to provide us sufficient competent evidential matter regarding such bank accounts due to inadequate accounting records. Accordingly, we were unable to satisfy ourselves as to the propriety of the balances of the Cash account as of the end of the year, or to determine the effects, if any, of such scope limitation on other accounts.

In our opinion, except for the effects on the financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to obtain and examine sufficient competent evidential matter regarding the bank accounts referred to in the third paragraph, the financial statements referred to above, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles in the Philippines.

Example B – Limitation on Scope – Qualified Opinion *(The auditor was unable to obtain sufficient competent evidential matter on certain expenses in view of the inadequacy of documentation over said expenses.)*

We have audited the accompanying balance sheets of ABC Company as of December 31, 20X2, and the related statements of income, changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audit in accordance with

The Company did not provide any supporting documents covering certain expense accruals in 20X2 aggregating P39.5 million, representing, after tax effect, 9% percent of total liabilities as of December 31, 20X2, and 30% of operating expenses and 18% of net income for the year then ended. We were not able to satisfy ourselves by other auditing procedures as to the propriety of the balance of accrued expenses as at December 31, 20X2 and the reasonableness of the operating expenses for the year.

In our opinion, except for the effects on the financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to obtain and examine sufficient competent evidential matter regarding certain expense accruals referred to in the third paragraph, the financial statements referred to above, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles in the Philippines.

Example C – Limitation on Scope – Disclaimer of Opinion *(The auditor was not able to obtain the basis for verifying the computations of the projected cash inflows for purposes of determining asset impairment.)*

We were engaged to audit the accompanying balance sheet of the ABC Company as of December 31, 20X2, and the related statements of income, changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management.

During the year, the Company adopted Statement of Financial Accounting Standards/International Accounting Standards No. 36, "Impairment of Assets." As required under SFAS 36/IAS 36, the Company made a formal assessment of the recoverable amount of its property and equipment, resulting in the recognition of an asset impairment loss of P120 million by reference to the value in use of the said property and equipment. However, the Company was not able to provide us the basis for the calculation of the projected cash inflows, as well as the basis for the discount rate used in arriving at the present value of such projected cash inflows.

Because of the significance of the matters discussed in the proceeding paragraph, we do not express an opinion on the accompanying financial statements.

Effective Date

21. This PAPS shall be effective for audits of financial statements for periods ending on or after March 31, 2005.

This Philippine Auditing Practice Statement 1000Ph was unanimously approved on May 31, 2004 by the members of the Auditing Standards and Practices Council:

Benjamin R. Punongbayan, <i>Chairman</i>	Antonio P. Acyatan, <i>Vice Chairman</i>
Felicidad A. Abad	David L. Balangue
Eliseo A. Fernandez	Nestorio C. Roraldo
Joaquin P. Tolentino	Editha O. Tuason
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Jesus E. G. Martinez	Roberto G. Manabat