

## **HOW TO APPLY INTERNATIONAL STANDARDS AT OBTAINING AUDIT EVIDENCES**

**Botir Qayumov**\*

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### **Abstract**

This article discusses issues of applying international standards on auditing for obtaining audit evidence. Moreover, it is devoted to the analysis of the current condition of the market of audit services in the Republic of Uzbekistan. In addition, we represent the developed model for assessing risks when collecting evidences.

**Key words: audit, audit evidence, international standards on auditing (ISA), model of audit risk.**

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\* **Senior researcher, Banking and Finance Academy of the Republic of Uzbekistan**

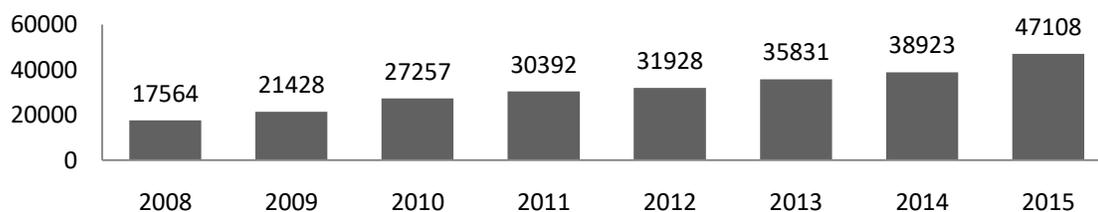
## Introduction

This article considers the issue on raising attention to the organization of planning and collection of audit evidence. Audit evidence is the information obtained by an auditor during the audit process and the result of the analysis of this information, on which the auditor's opinion is based. Primary documents and accounting records which constitute the basis of accounting and financial reporting, written explanations of the authorized officials of the audited entity and information obtained from different sources are referred to the audit evidence. Thus the main aim of the article is a comparison of the national standard of auditor's activities of Uzbekistan with International standards on auditing, as well as the reflection of the current condition of the development of auditing activity in Uzbekistan. The article also represents the mathematical model of risk assessment while obtaining reliable audit evidences.

## Development of the auditing activity in Uzbekistan

Current market of the audit services of Uzbekistan is characterized by raising competition and increasing demand of consumers of audit services and users of audit reports, who have become more interested in obtaining reliable information about the financial situation of their enterprises. Moreover, the entry of these enterprises in the international capital markets, the integration of Uzbekistan into the world economic community and the conditions of transition to international financial reporting standards and international standards on auditing bring us to the necessity to pay a more particular attention to improving the quality and reputation of regional and local audit

**Figure 1. Dynamics of the volume of revenues of audit firms**



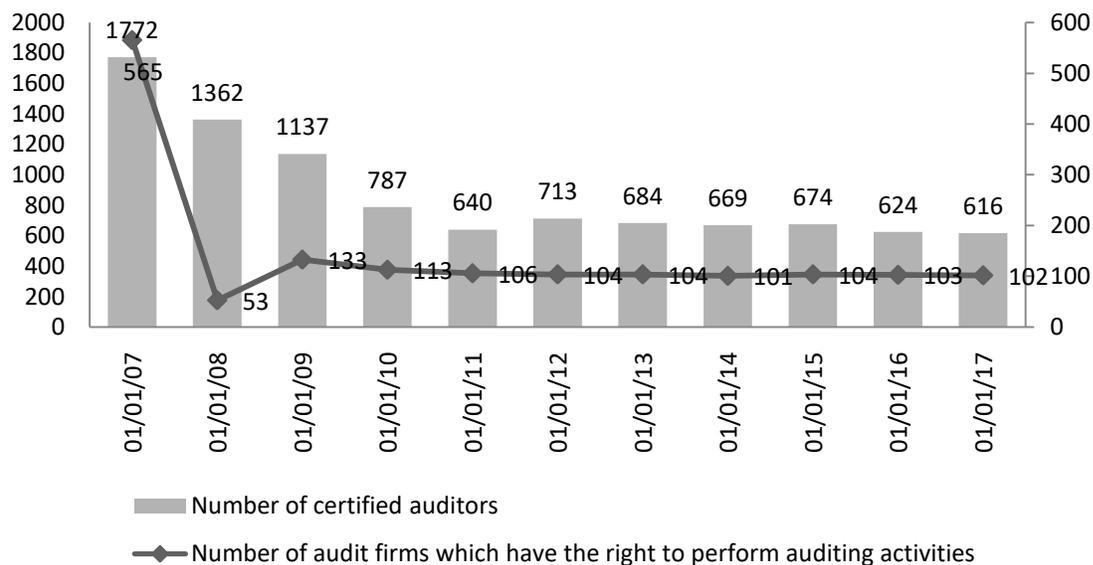
■ Volume of services rendered – total in million UZS

firms.

*Source: compiled by the author on the basis of the data of the Ministry of Finance of the Republic of Uzbekistan for 2008-2016.*

The market of audit services of the Republic of Uzbekistan recently has been demonstrating positive results of the development, as it is obvious from the figure data. It should be noted that achieving such results was possible due to the improvement of legislative and normative-legal acts regulating auditing activities in the Republic of Uzbekistan. There have been issued the Law of the Republic of Uzbekistan “On auditor’s activities” in new edition, the Regulation “On the procedure for issuing the license and the qualification certificate of the auditor”, which facilitated establishing additional license requirements and conditions aimed at improving the quality of services and responsibility of audit organizations. Since January 1, 2008 the differentiated system of licensing of auditing activities, depending on the object being inspected was introduced. Data of the following figure illustrate how these normative acts contributed to reduce the amounts of active certified auditors and audit firms. Thus it is possible to say that the most responsible and professional participants perform their activities in this market.

**Figure 2. Dynamics of the number of audit firms and auditors**



*Source: compiled by the author on the basis of the data of the site [www.norma.uz](http://www.norma.uz)*

Thus, it is possible to make a conclusion that Uzbekistan has already formulated the basic mechanism of audit activity and currently the quantitative aspect of the problem has been solved. At present, national policy in the field of auditing should be focused on the priority of problems of qualitative improvement of the rendered auditor services, which enable to enhance efficiency and effectiveness of audit to the economy as a whole.

To solve this problem and improve the competitiveness of domestic audit it is necessary to solve at least some main tasks such as youth and lack of real effective sanctions for poor quality audit, a large backwardness in the creation and implementation of audit standards, which, by the author's opinion, are considered to be barriers for the entry of the Uzbek audit in the international level.

Development of mechanisms for spreading the experience of application of international standards on auditing (ISA) as well as the organization of the system of quality control of auditors' activities, additional training of existing auditors on the ISA would facilitate efficient solution of these tasks.

### **Obtaining audit evidence**

To achieve the quality of the audit performed, auditor's opinion must be justified. Audit evidence serves as the means of such justification. The quality of audit is a direct reflection of the quality of the collected audit evidences.

Audit evidence is the information obtained by the auditor during the audit, and the result of the analysis of this information, on which the auditor's opinion is based. They include the following (Arabyan, 2009):

- Primary documents and accounting entries which constitute the basis for financial reporting;
- Written explanations of the authorized officials of the audited entity;
- Information obtained from various sources.
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### **International and national standards on auditing**

International standards on auditing consider the main aspects of the auditor evidence in Section 5 which is entitled "Audit evidence". This section includes the following standards:

- ISA 500 «Audit evidence»;
- ISA 501 «Audit evidence: peculiarities of assessing certain articles»;
- ISA 505 «Confirmation from external sources»;

- ISA 510 «Primary audit assignment: initial balance»;
- ISA 520 «Analytical procedures»;
- ISA 530 «Audit sampling»;
- ISA 540 «Audit of accounting estimates, including fair value and related disclosed information»;
- ISA 550 «Related parties»;
- ISA 560 «Subsequent events»;
- ISA 570 «Assumption of continuity of the organization»;
- ISA 580 «Written submissions».

The following standards on obtaining audit evidence (National Standards on Auditing) on the basis of the above-stated standards have been developed in Uzbekistan:

- NSA №10 «Other information contained in the financial statements»;
- NSA №11 «Audit in conditions of computer data processing»;
- NSA №13 «Analytical procedures»;
- NSA №14 «Audit sampling»;
- NSA №16 «Using the work of an expert»;
- NSA №50 «Audit evidences»;
- NSA №55 «Procedures for obtaining audit evidence on transactions between related parties».
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### **Description of audit standards**

The main aim of the ISA 500 is to establish standards and provide guidance regarding the quantity and quality of the audit evidence necessary for auditing financial statements. While checking the economic entity auditor is obliged to obtain sufficient and appropriate audit evidence for the formation required for expressing his opinions and conclusions. The section “Adequate appropriate audit evidence” provides definition of concepts of “adequacy” and “appropriateness”. Adequacy is defined as quantitative measure while the relevance is determined as a qualitative measure. The principal factors influencing the auditor’s opinion about the adequacy and appropriateness of audit evidence have been demonstrated. These include the following factors:

- audit estimation of the nature and size of the inherent risk at the level of the financial statements and account balances and classes of transactions;
- significance of the article verified;
- experience gained during prior audits;
- results of audit procedures including fraud and mistakes which could be detected;
- source and reliability of the available information.
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In the process of obtaining audit evidence tests of verification means can be used and audits in facts can be conducted. Tests of verification means are the tests performed to obtain audit evidence, characterizing efficiency of functioning of systems of accounting and internal control systems. Procedures of audit in facts are the procedures that are performed with the aim of obtaining sufficient audit evidence to detect sufficient misinterpretations in the financial statements. These procedures can be carried out in the form of detailed tests of transactions and analytical procedures.

ISA 501 «Audit evidence – additional consideration of specific articles» - is the section which considers additional articles which have a particular importance in the process of auditing financial reporting. The main aim of the ISA 501 is establishing standards and providing the guidance in addition to ISA 500.

With the aim of establishing standards and providing guidance on the use of external evidence used by the auditor as external confirmations, there has been developed standard ISA 505 “External confirmation”. External confirmation is the process of obtaining and evaluating audit evidence through the submission of information by third parties directly to the auditor by the request of the audited company regarding certain articles (ISA 505, 2012).

The adoption of this standard has been stipulated by the factor that the auditor should determine whether it is necessary to use external confirmations to obtain adequate appropriate audit evidence. In making this determination the auditor should consider significance, assessed level of inherent risk and risk of verification means, and how the evidence obtained as a result of other planned audit procedures will reduce audit risk to an acceptably low level.

The section “Interconnection of procedures of external verification with audit evaluation of the risk of material misstatement” illustrates the essence of requirements of ISA 315 “Determining and assessing the risks of material misstatement through study of activities and commercial environment of the organization”. In addition it states that as the level of inherent risk and risk of verification means increases, the auditor should realize the activities of the enterprise and its environment, including the system of internal control, and assess the risks of material misstatement (ISA 315, 2012).

In addition, ISA 315 provides basic audit procedures to assess the risks of material misstatement of financial statements to plan and perform further audit procedures. The auditor also should be guided by ISA 330, which establishes the responsibility of the auditor to determine overall responses to develop and perform further audit procedures, to determine their nature, timing and the volume that meets assessed risks of material misstatement.

The necessity for implementation of external confirmation procedures to obtain adequate and appropriate audit evidence depends on the assessed level of risk of material misstatement. Paragraph 11 of ISA 330 indicates that the higher the level of risk assessed by the auditor, the more reliable and adequate audit evidence is necessary to be obtained by fact (ISA 330, 2012).

The auditor’s responsibility for the initial account balances in cases where the audit of financial statements are conducted for the first time or in the previous year it was conducted by another auditor, is defined in ISA 510 “Primary audit assignment: initial balance”. This standard is also applied in cases when the auditor has identified conditional facts, obligations that existed at the beginning of the period. The standard says that at the first audit the auditor does not normally have previously obtained evidence that would confirm initial balance, and thus he must obtain adequate and appropriate evidence.

The concept “Initial balance” in ISA 510 is defined as the balance of accounts existing at the beginning of the reporting period. Initial balances are based on balances of accounts at the end of the previous period and reflect the influence of economic transactions of previous periods and accounting policies applied in the previous period.

Aspects of the audit related to analytical procedures are considered in ISA 520 “Analytical procedures”. At the request of ISA 520 “Analytical procedures”, the auditor is obliged to apply them throughout the audit assignment.

The researches of foreign scientists prove that analytical procedures can help to detect 27.1% of mistakes, forecasts and discussions – 18.5%, and taken together – 45.6% of mistakes (Baryshnikov, 2008).

When formulating the auditor’s opinion, auditor does not usually check all the information available because conclusions on the groups of the same operations, balances on accounts in the accounting or the disclosed information may be based on a selective approach to verification and other methods of selection of articles for testing. Issues related to the sampling method are discussed in ISA 530 “Audit sampling”. On the basis of ISA 530 we have developed NSA №14 “Audit sampling”, which establishes for the auditor uniform requirements for random inspections in audit, as well as the methods of selecting items for testing to collect audit evidence. When developing audit procedures, auditor should determine appropriate methods for selecting items to be examined when gathering audit evidence to achieve the objectives of audit tests.

According to this standard, audit sampling implies application of audit procedures to less than 100% of the articles included in the account balance or class of transactions so that all elements of the sample have an equal opportunity to be selected. This enables the auditor to obtain and evaluate audit evidence on some characteristics of the elements selected in order to formulate conclusions concerning the general set from which the sample has been made.

### **Model for risk assessment in obtaining audit evidence**

In practice there are many methods for quantitative assessment of audit risk. Traditional model of the audit risk is represented by the following formula:

$$AR = IR \times CR \times DR$$

where: AR — audit risk; IR — inherent risk; CR — risk of control; DR — risk of non-detection.

However, some authors consider this model to be not very accurate. Krasnov and others (2012) suppose since the values in the right-hand side of the equation are the numbers less than one, then according to the appropriate rules AR will be less than each of the quantities IR, CR or DR, and it doesn't make any logical sense. Bobrovych (2013) takes into account the mutual influence of control risk and inherent risk, and in our opinion it is correct because there is a high correlation between these factors will lead to errors in the calculation of audit risk.

However, which model of calculating the audit risk is used, the technique for calculating separate elements of the model of the audit risk must be applied to obtain accurate and adequate values. We propose the methodology of quantitative determination of the size of the inherent risk and risk of internal control system, totality of which represents the risk of material misstatement. To assess the role of factors we assign a weight (importance) that determines the degree of influence of the factor on the overall risk level for this company. Weight or rank will be a number less than one.

Each factor is assessed by the degree of "danger" on the scale from 1 to 10 – the higher risk is able to generate the factor, the higher the assessment is.

Then the size of the inherent risk can be calculated by the following formula:

$$IR = \frac{\sum_{i=1}^n r_i v_i}{10 * n}; \quad 0 < r < 1, \quad v \{0 \dots 10\}$$

where: n – number of considered factors of risk; i– ordinal number of the factor; r<sub>i</sub>– weight or the importance rang of i factor; v<sub>i</sub>– assessment of risk of i factor.

Here the size of the risk, which is calculated by the proposed method, can vary between 0 (when all factors are important, or they all are evaluated as zero) to 1 (when the importance of all factors is maximal and their assessment equals to 10).

Among the factors there are some circumstances which do not only increase the risk, but reduce it. In each certain case, the structure and the number of factors are determined by the auditor on the basis of the specific situation, and their ranking and assessment are based on the professional judgment of the auditor or expert.

From my point of view it is necessary to separate the risk of material misstatement and, accordingly, to calculate separately its components, following the regulation of A40 of ISA 200. Thus, we determined the numerical values of two components of risk of material misstatement. To obtain the risk assessment of material misstatement (MMR), it is possible to define it as a function of inherent risk and control risk according to the following formula:

$$\text{MMR} = \text{IR} + \text{CR} - \text{IR} \times \text{CR}$$

In our example the integral value of the material misstatement risk is equal to:

$$\text{MMR} = 0.4539 + 0.5047 - 0.4539 \times 0.5047 = 0.7294.$$

By the method of successive iterations we determined the boundaries of the qualitative risk assessment of material misstatement.

### **Conclusion**

The conclusion of the study of ISA indicates that the structure of ISA is significantly different from our system of the national auditing standards which refer reviews and other tasks providing reliability, to the accompanying services. Many of ISA standards have no analogues with the national standards on auditing of the Republic of Uzbekistan.

In our opinion, it is not advisable to invent something new in the standards, however, it is necessary to transfer ISA successfully with the account of our conditions. In fact, ISA has much longer history in the development, implementation and specific application. Work on ISA never ends and they are always subject to amendments, various comments and recommendations on the practical application of this or that standard. Thus, ISA is regularly changing and improving system and the national auditing standards sometimes lag behind these processes.

The use of international standards regulating the quantity and quality of audit evidence as well as audit procedures required to obtain these proofs is undoubtedly a necessary factor in improving the quality of audits. Taking into account professional significance of the national auditing standards, we need to further improve their methodology based on the international experience and national peculiarities.

The availability of the technique for quantitative assessment of audit risk will enable to improve the planning process of the audit and make the audit more justified process. We propose to use the integrated multiplier as it more reflects the essence of the probabilistic quantities and doesn't possess multicollinearity. This method of calculating the values of the risk of material misstatement is based on the principles of International auditing standards. Moreover, it is easy to use and takes into account the degree of influence of individual factors of the inherent risk and risk of the control environment for the overall level of risk of material misstatement.

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