Mekelle University

College of Business and Economics

Department of Accounting and Finance

Course Name - Auditing Principles and Practices II

Course Code – AcFn 3162

<u>By:</u>

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Mekelle University
College of Business and Economics
Department of Accounting and Finance

Course Outline

Course Title: *Auditing Principles and Practices II*
Corse code *AcFn 3162*
Credit Hour: *3*
Course Category: *Main course*
Instructor Name: Dr. Gizachew Y., Asmelash A. and Yitbarek A.

Course objective:

At the end of the course the student is expected to:

- Apply his/her knowledge of auditing theory, auditing standards, techniques and procedures to practical situations commonly encountered relative to the audit of major accounts;
- Be acquainted with the principles that underlie audit of Balance Sheet and Income Statement accounts;
- Enumerate and understand the audit objectives for the audit of major accounts;
- Develop audit procedures for the audit of major accounts;
- Comprehend the significance of professional competence, independence, and mental integrity in the practice of accountancy; and
- Be committed to bringing about a prevalence of good reporting practice and contribute to the pursuit of social justice and fairness.

Course Description

The course builds on the knowledge gained in Auditing I. It covers an in depth practical aspects of topics introduced in Auditing I and brings in new concepts as well. The course introduces audit sampling in general and goes on to application of statistical tools in tests of controls and balances. The technical application of auditing procedures for balance sheet and income statement accounts in an audit undertaking are the foremost subject matters of the course. Audit of systems that include EDP application along with tools and techniques used in evaluation and understanding of internal control in such environments will be introduced.

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Chapter 6. Audit of current liabilities

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6.2. Objectives for the Audit of Accounts Payable and Purchases
6.3. Important Issues Related to the Acquisition and Payment Cycle
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6.7. Methodology for tests of detail of Balances of Accounts Payable

Chapter 7: Audit of Debt and Equity capital (Optional)

7.1. Capital Acquisition and Repayment Cycle
7.2. Audit objectives and Audit program of Debt Capital
7.3. Audit objectives and Audit program of Equity Capital

Assessment/Evaluation: The evaluation scheme will be as follows

Tests and Quizzes…………………………………..………….. 40%
Assignments……………………………………………….... 10%
Final………………………………………………………… 50%
Total…………………………………………………………. 100%

Text and reference books

Text Book:

Arens, Elder and Beasley, Auditing and Assurance services: An Integrated Approach, 14th Ed, 2012.

Reference Books

Meigs et al Principles of Auditing, 10th ed.
Hayes, Dassen, Schilder & Wallage, Principles of Auditing, 2nd ed. 2005.

CHAPTER ONE

1. AUDIT SAMPLING

Chapter Outline

- Understand the Nature and Methods of Audit Sampling
- Audit sampling for Tests of controls
- Audit sampling for Substantive tests

1.1Understand the Nature and Methods of Audit Sampling

Audit sampling refers to the process of **using auditing procedures to test less than 100 percent of various items** in a company's account balance such that each unit may have an equal opportunity of being selected. Thus audit sampling can be defined as the process of selecting a subset of a population of items **for the purpose of making inferences to whole population**. In auditing, sampling procedures are used because it is not practical to examine every single item in a population.

Audit sampling is used to conduct **tests of controls** and **substantive tests**.

Audit sampling helps auditors on doing their **audit work at a given period of time**. Normally, it is possible for an auditor to make detailed examination on all the items being examined. Besides, audit sampling helps to detect error and any material misstatements.

- A **representative sample** is one in which the characteristics in the sample of audit interest are approximately the **same** as those of the population.
- In practice, auditors never know whether a sample is representative, even after all testing is complete. (The only way to know if a sample is representative is to subsequently audit the entire population.) However, auditors can increase the likelihood of a sample being representative by using care in designing the sampling process, sample selection, and evaluation of sample results.
- A sample result can be **non representative** due to **non sampling error** or **sampling error**. The risk of these two types of errors occurring is called **non sampling risk** and **sampling risk,** respectively.

Non sampling risk is the risk that audit tests do not uncover existing exceptions in the sample.

- The **two causes** of **non sampling risk** are:

i. The auditor's failure to recognize exception because of exhaustion, boredom, or lack of understanding of what to look for.

ii. Inappropriate or ineffective audit procedures.

Sampling risk is the risk that an auditor reaches an incorrect conclusion because the sample is not representative of the population. **Sampling risk** is an inherent part of sampling that result from testing less than the entire population.

- Auditors have two ways to control sampling risk:

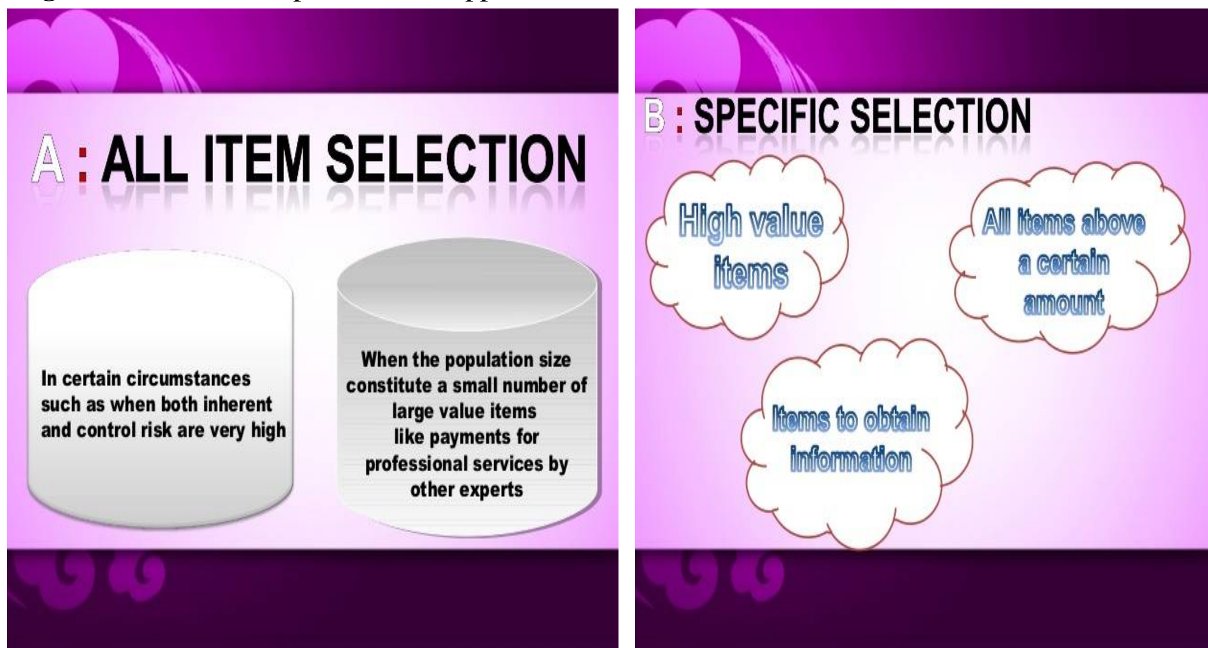
a. Adjust sample size.

b. Use an appropriate method of selecting sample items from the population.

*** Audit Sample selection approaches**

The auditor may prefer to use either (A) **all item selection** or (B) **specific selection**, based on the purpose of selection and other considerations. The following figure depicts when to apply each selection approach.

Figure 1-1: Audit Sample selection approaches



*** Audit Sample Selection Methods**

- **Statistical Vs. Non-statistical Sampling**

Audit sampling methods can be divided into **two** broad categories: statistical sampling and non-statistical sampling. The following table summarizes the meaning, advantage and disadvantage of each category.

Table 1-1 Statistical and Non-statistical sampling

Statistical	Non-statistical
▪ Through the application of mathematical rules. ▪ It allows the quantification (measurement) of sampling risk in planning the sample and evaluating the results. ▪ Example: Statistical result at a 95% confidence level provides a 5% sampling risk.	▪ Auditor does not quantify sampling risk. ▪ Instead, those sample items that auditor believes will provide the most useful information in the circumstances are selected. ▪ Conclusions are reached about populations on judgmental basis.
Advantages	**Disadvantage**
▪ Very accurate. ▪ Economical in nature. ▪ Very reliable. ▪ High suitability ratio towards the different surveys. ▪ Takes less time. ▪ In cases when the universe is very large, then the sampling method is the only practical method for collecting the data.	▪ Inadequacy of the samples. ▪ Chances for bias. ▪ Problems of accuracy. ▪ Difficulty of getting the representative sample. ▪ Untrained manpower. ▪ Absence of the informants. ▪ Chances of committing the errors in sampling.

❖ Probabilistic Vs. Non-probabilistic Sampling

Probabilistic sample selection is a method of selecting a sample such that each population item has a known probability of being included in the sample. It is commonly associated with **statistical sampling**.

Non-probabilistic sample selection is a method in which the auditor uses **professional judgment** rather than probabilistic methods. It is commonly associated with **non-statistical audit sampling**.

Probabilistic sample selection methods include the following:

1) Simple Random sample selection

This method of sampling ensures that all items within a population stand an equal chance of selection by the use of random number tables or computer generation of random numbers. The sampling units could be physical items, such as sales invoices or monetary units.

2) Systematic sample selection

The method divides the number of sampling units within a population into the sample size to generate a sampling interval. The auditor selects the items for the sample based on the size of the interval. The first item in sample is selected at random.

3) Probability Proportionate to Size sample selection (PPS)

A sample is taken where the probability of selecting any individual population item is proportional to its recorded amount. PPS is evaluated using monetary unit sampling (MUS).

Emphasis is on large dollar items!

4) Stratified sample selection

The population is divided into subpopulations by size and larger samples are taken of the larger subpopulations. Stratified sample selection is evaluated using variables sampling.

- In many auditing situations, it is advantageous to select samples that emphasize population items with larger recorded amounts. Thus, this is done by **probability Proportional to Size and Stratified Sample Selection.**

On the other hand, non-Probabilistic sample selection methods include the following:

1) Directed sample selection

In this method item selection is based on auditor judgmental criteria. The following issues should be considered when using directed sample selection method:

- Items most likely to contain misstatements
- Items containing selected population characteristics
- Large dollar coverage

2) Block sample selection

This method of sampling involves selecting a block (blocks) of contiguous items from within a population. Hence several items are selected in sequence forming ‘‘blocks’’ of items. For example, assume the block sample will be a sequence of 100 sales transactions from the sales journal for the third week of March. Auditors can select the total sample of 100 by taking 5 blocks of 20 items, 10 blocks of 10 items, 50 blocks of 2 items or 1 block of 100 items.

- Block selection is rarely used in modern auditing because valid references cannot be made beyond the period or block examined. In situations when the auditor uses block selection as a sampling technique, many blocks should be selected to help minimize sampling risk.

3) Haphazard sample selection

This method assumes selection of sample without regard to size, source, or distinguishing characteristics. When the auditor uses this method of sampling, he does so without following a structured technique. This method of sampling is not appropriate when using statistical sampling. Care must be taken by the auditor when adopting haphazard sampling to avoid any conscious bias or predictability.

*** Audit Sampling for Exception Rates**

As an auditor, you need to estimate the proportion of items in a population containing a characteristic or attribute of interest. The ***occurrence rate***, or ***exception rate***, is the ratio of the items containing the specific attribute to the total number of population items. Or **Exception rate** refers to the percent of items in a population that include exceptions in prescribed controls or monetary correctness. **Example**: invoices are not properly verified 2 percent of the time.

Following are types of **exceptions** in populations of accounting data:

1) Deviations from client's established controls
2) Monetary misstatements in populations of transaction data
3) Monetary misstatements in populations of account balance details (requires a dollar estimate)

- Note that the difference between sample exception rate and population exception rate is known as **Sampling Error** and that the reliability of sampling error estimate is **Sampling Risk**.

See the next example:

Assume a 3% sample exception rate and sampling error of 1% with a sampling risk of 10%. We conclude that the population exception rate is between 2% and 4% at a 10% risk of being wrong (or 90% chance of being right).

Formula! Population exception rate = Sample Exception Rate ± Sampling Error

1.2 Audit Sampling for Tests of Controls

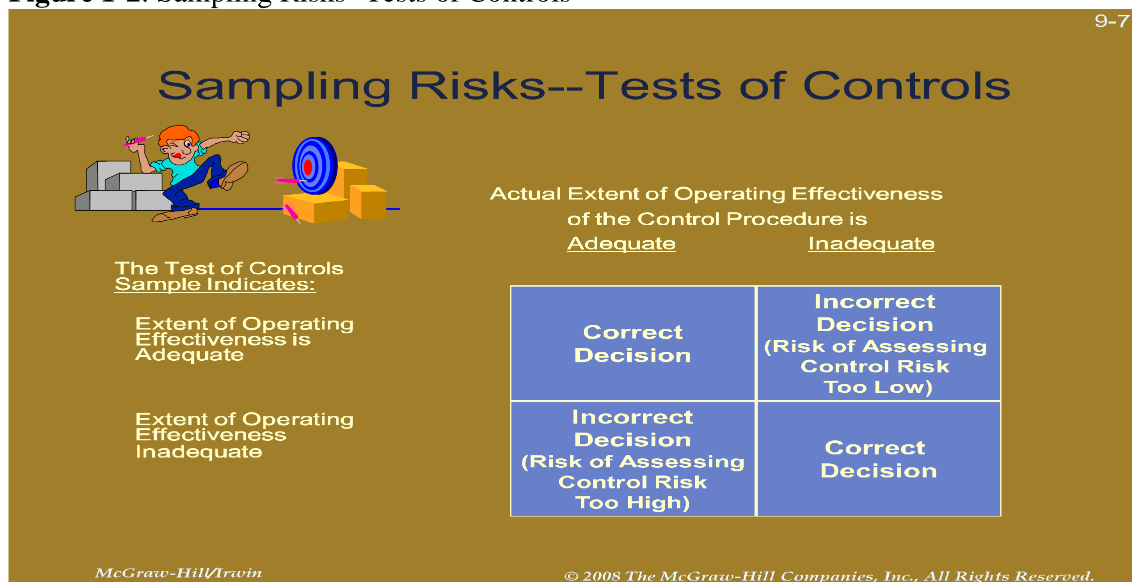
Tests of controls are used to determine the client's internal control systems comply with the stated policies, plans, laws and regulations. Auditors evaluate the design of controls and determine if the controls are in operation. They must also obtain evidence whether the controls are operating effectively.

Tests of controls are established to detect material error and whether the controls are operating effectively throughout the period being audited. Normally tests of control provide information as to the rate of error in terms of control failure rather than to enable direct extrapolation in terms of monetary errors in the financial statements.

Auditors are concerned with the **risk of assessing control risk too high** and **risk of assessing control risk too low**.

- The **risk of assessing control risk too high**: *this risk is the possibility that the sample results will cause the auditor to assess control risk at higher level than is warranted*.
- The **risk of assessing control risk too low**: *this more important risk is the possibility that the sample results will cause the auditor to assess control risk at lower level than is warranted based on the actual operating effectiveness of control*. Auditors will inappropriately reduce the extent of substantive testing.

Figure 1-2: Sampling Risks- Tests of Controls



*** Audit Sampling Steps**

Auditors use 14 well-defined **steps to apply audit sampling to tests of controls and substantive tests of transactions**. These steps are divided into three phases given below. Auditors should follow these steps carefully to ensure proper application of both the auditing and sampling requirements.

Phase 1: *Plan the sample*
Phase 2: *Select the sample and perform the tests*
Phase 3: *Evaluate the results*

I. PLAN THE SAMPLE

1. **State the objectives of the audit test.**

Specifying the audit objective needs combination of sampling and other audit procedures. Sampling is used in two ways:

- ✓ *To estimate account balance that is not recorded.*
- ✓ *To test reasonableness of recorded account balance.*

The objectives of the test must be stated in terms of the transaction cycle being tested. Typically, auditors define the objectives of tests of controls and substantive tests of transactions:

- Test the operating effectiveness of controls
- Determine whether the transactions contain monetary misstatements

2. **Decide whether audit sampling applies.**

Audit sampling applies whenever the auditor plans to reach conclusions about a population based on a sample. The auditor should examine the audit program and select those audit procedures where audit sampling applies.

Audit sampling does not apply for some procedures in a given audit program. Example:
1. Review sales transactions for large and unusual amounts (analytical procedure).
2. Observe whether the duties of the accounts receivable clerk are separate from handling cash (test of control).

3. **Define attributes and exception conditions.**

When audit sampling is used, auditors must carefully define the characteristics (attributes) being tested and the exception conditions. *Exception or Misstatement: a difference that affects the correctness of the overall account balance.*

- ✓ Unless auditors carefully define each attribute in advance, the staff person who performs the audit procedures will have no guidelines to identify exceptions.
- ✓ Attributes of interest and exception conditions for audit sampling are taken directly from the auditor’s audit procedures.

Example: "Credit is approved" is an attribute for tests of billing function of ABC Trading and "Lack of initials indicating credit approval" is the related exception condition.

4. **Define the population.**

Audit population refers to all items constituting an account balance or class of transactions defined by auditor’s characteristic of interest. The population is those items about which the auditor wishes to generalize. Auditors can define the population to include any items they want, but when they select the sample, it must be selected from the entire population as it has been defined. The auditor should test the population for completeness and detail tie-in before a sample is selected to ensure that all population items are subjected to sample selection.

5. **Define the sampling unit.**

Sampling units are the individual auditable elements as defined by the auditor. Auditor needs assurance that the list accurately represents the population. The sampling unit is the physical unit that corresponds to the random numbers the auditor generates. It is often helpful to think of the sampling unit as the starting point for doing the audit tests.

For the sales and collection cycle, the sampling unit is typically a sales invoice or shipping document number. For example, if the auditor wants to test the occurrence of sales, the appropriate sampling unit is sales invoices recorded in the sales journal. If the objective is to determine whether the quantity of the goods described on the customer’s order is accurately shipped and billed, the auditor can define the sampling unit as the customer’s order, the shipping document, or the duplicate sales invoice, because the direction of the audit test doesn’t matter for this audit procedure.

6. **Specify the tolerable exception rate (TER).**

Exception rate that the auditor will permit in the population and still be willing to conclude the control is operating effectively and/or the amount of monetary misstatements in the transactions established during planning is acceptable (tolerable materiality).

- ✓ *TER is the result of auditor judgment and is affected by materiality.*
- ✓ *More controls operating for an audit objective result in higher TER.*
- ✓ *High TER => Low sample size; Low TER =>High sample size*

7. **Specify acceptable risk of assessing control risk too low (ARACR).**

The risk that the auditor is willing to take of accepting a control as effective or a rate of monetary misstatements as tolerable, when the true population exception rate is greater than TER.

- ✓ *ARACR is a measure of sampling risk.*
- ✓ *The lower the assessed CR => The lower the ARACR => The fewer tests of detailed balances.*

The guidelines used for ARACR and TER Tests of controls are summarized in Table 1-2 below.

Table 1-2: Guidelines for ARACR and TER Tests of Controls

Judgment	Guideline
❖ Lowest assessed control risk ❖ Moderate assessed control risk ❖ Higher assessed control risk ❖ 100% assessed control risk	❖ ARACR of low ❖ ARACR of medium ❖ ARACR of high ❖ ARACR is not applicable
✓ Highly significant balances ✓ Significant balances ✓ Less significant balances	✓ TER of 4% ✓ TER of 5% ✓ TER of 6%

8. **Estimate the population exception rate (EPER).**

Estimated population exception or error rate is exception rate that the auditor expects to find in the population before testing begins.

- ✓ *EPER is a judgmental estimate based on knowledge of client.*
- ✓ *Low EPER => Low sample size.*
- ✓ *As EPER approaches TER, more precision is needed and larger sample size is needed.*

9. **Determine the initial sample size.**

Initial sample size refers to sample size decided after considering the above factors in planning.

II. SELECT THE SAMPLE AND PERFORM THE TESTS

10. **Select the sample.**

After auditors determine the initial sample size for the audit sampling application, they must choose the items in the population to include in the sample. Auditors can choose the sample using any of the probabilistic or non-probabilistic methods we discussed earlier in this chapter.

11. **Perform the audit procedures.**

The auditor performs the audit procedures by examining each item in the sample to determine whether it is consistent with the definition of the attribute and by maintaining a record of all the exceptions found.

III. EVALUATE THE RESULTS

12. **Generalize from the sample to the population.**

*The **sample exception rate (SER)** can be easily calculated from the actual sample results. SER equals the actual number of exceptions divided by the actual sample size.* It is improper for the auditor to conclude that the population exception rate is exactly the same as the sample exception rate, as there is only a slight chance they are identical.

For non-statistical methods, auditors use two ways to generalize from the sample to the population:

1. Add an estimate of sampling error to SER to arrive at a computed upper exception rate (CUER) for a given ARACR.

2. Subtract the sample exception rate from the tolerable exception rate to find the calculated sampling error (TER – SER), and evaluate whether it is sufficiently large to conclude that the true population exception rate is acceptable.

- ✓ When SER exceeds the EPER used in designing the sample, auditors usually conclude that the sample results do not support the preliminary assessed control risk. In that case, auditors are likely to conclude that there is an **unacceptably high risk** that the true deviation rate in the population exceeds TER.

13. Analyze exceptions.

Auditors must analyze individual exceptions to determine the breakdown in the internal controls that allowed them to happen. Exceptions can be caused by many factors, such as carelessness of employees, misunderstood instructions, or intentional failure to perform procedures.

14. Decide the acceptability of the population

When generalizing from the sample to the population, most auditors using non-statistical sampling subtract SER from TER and evaluate whether the difference (calculated sampling error) is sufficiently large. If the auditor concludes the difference is sufficiently large, the control being tested can be used to reduce assessed control risk as planned, assuming a careful analysis of the exceptions does not indicate the possibility of other significant problems with internal controls.

When the auditor concludes that TER – SER is too small to conclude that the population is acceptable, or when SER exceeds TER, the auditor must follow one of four courses of action:

- ➢ Revise TER or ARACR
- ➢ Expand the sample size
- ➢ Revise assessed control risk
- ➢ Communicate with the audit committee or management

*** Sensitivity of Sample Size to a Change in Factors (*Tests of controls*)**

Four factors determine **sample size** for audit sampling (for tests of controls): *population size, TER, ARACR, and EPER*. Population size is not a significant factor and typically can be ignored, especially for large populations. To understand the concepts underlying sampling in auditing, you need to understand the effect of increasing or decreasing any of the four factors that determine sample size, while the other factors are held constant.

Table 1-3 shows the effect on sample size of independently increasing each factor. The opposite effect will occur for decreasing each factor. A combination of two factors has the greatest effect on sample size: TER minus EPER. The difference between the two factors is the ***precision*** of the initial sample estimate. A smaller precision, which is called a more precise estimate, requires a larger sample.

At one extreme, assume TER is 4% and EPER is 3%. In this case, precision is 1%, which will result in a large sample size. Now assume TER is 8% and EPER is zero for an 8% precision. In this case the sample size can be small and still give the auditor confidence that the actual exception rate is less than 8%, assuming no exceptions are found when auditing the sample.

Table 1-3: Effect on Sample Size of Changing Factors

Type of Change	Effect on Initial Sample Size
✓ Increase ARACR too low	Decrease
✓ Increase TER	Decrease
✓ Increase EPER	Increase
✓ Increase population size	Increase (minor)

1.3 Audit Sampling for Substantive Tests

Substantive tests are conducted to provide audit evidence to the completeness, accuracy and validity of the information contained in the financial statements.

Substantive tests are designed to detect material misstatements that may exist in the financial statements. Hence the sampling techniques should be designed in such a way that auditors are able to estimate the amount of misstatement in a particular account balance. Based on the sample results therefore auditors are able to conclude whether there is high risk of material misstatement in the account balance.

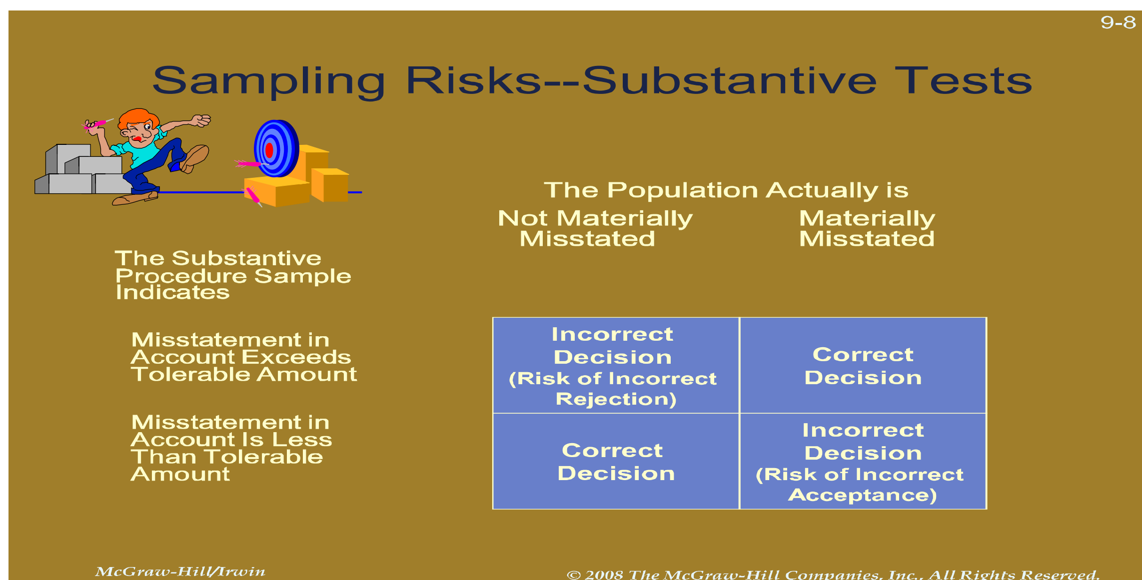
Sampling risk *for substantive test* includes:

- **The risk of incorrect rejection (alpha risk):-** this is the possibility that the sample results will indicate that an account balance is *materially misstated when in fact it is not* misstated.

- **The risk of incorrect acceptance (beta risk):-** this is the possibility that the sample results will indicate that an account balance is *not materially misstated when in fact it is* materially misstated.

Figure 1-3 illustrates the sampling risks associated with substantive tests.

Figure 1-3: Sampling Risks- Substantive Tests



*** Sensitivity of Sample Size to a Change in Factors (*Substantive tests*)**

- Six factors determine **sample size** for substantive procedures: *Alpha risk, Beta risk, Tolerable misstatement, Population size, Standard deviation, and Expected misstatement*.

- To understand the concepts underlying sampling for substantive procedures, you need to understand the effect of increasing or decreasing any of the six factors that determine sample size, while the other factors are held constant. See Table 1-4 for details.

Table 1-4: Factors Affecting Sample Size for Substantive Procedures

Factor	Change in Factor	Effect on Required Sample Size
Auditors' Requirements:		
Risk of incorrect rejection	Increase	Decrease
Risk of incorrect acceptance	Increase	Decrease
Tolerable misstatement	Increase	Decrease
Population Characteristics:		
Population size	Increase	Increase (if population is small)
Standard deviation	Increase	Increase
Expected misstatement	Increase	Increase

*** Attributes Sampling and Variables Sampling**

The statistical sampling method most commonly used for tests of controls and substantive tests of transactions is ***attributes sampling***. Attributes sampling enables the auditors to estimate the rate of occurrence of certain characteristics in the population. It is frequently used in performing **tests of controls**.

- For **example**, the auditor might use attributes sampling to estimate the percentage of the cash disbursements processed during the year that were not approved.

Variables sampling on the other hand provides the auditors with an estimate of a numerical quantity, such as the dollar balance of an account. It defines the sampling unit as each transaction or account balance in the population. This technique is primarily used by auditors to perform **substantive tests**.

- For **example**, variables sampling might be used to plan, perform, and evaluate a sample of accounts receivable selected for confirmation.

Frequently used classical variable sampling plans for confirmation include **mean per unit estimation (MPU)**, **ratio estimation** and **difference estimation**.

Mean Per Unit (MPU) Illustration

Assume the following data for a hypothetical audit client.

- Population Size = 100,000 accounts
- Book value of accounts= $6,250,000

Other information:

- Tolerable misstatement = $364,000
- Estimated Standard Deviation= $15
- Sampling risk:
  - Incorrect Acceptance = 5%
  - Incorrect Rejection = 4.6 %
- MPU Risk Coefficients:

Acceptable Level of Risk (%)	Incorrect Acceptance Coefficient	Incorrect Rejection Coefficient
1.0	2.33	2.58
4.6	1.68	**2.00**
5.0	**1.64**	1.96
10.0	1.28	1.64
15.0	1.04	1.44
20.0	.84	1.28
25.0	.67	1.15
30.0	.52	1.04
40.0	.25	.84
50.0	.00	.67

Required:

(A) Determine sample size

(B) Compute acceptance interval for substantive procedure

Solution:

A) Determining Sample Size

First compute **Planned Allowance for Sampling Risk (Planned ASR)** using following formula:

$$\text{Planned ASR} = \left(\frac{\text{Tolerable misstatement}}{1 + (\text{Incorrect acceptance coefficient} / \text{Incorrect rejection coefficient})} \right)$$

$$\text{Planned ASR} = \left(\frac{\$364,000}{1 + (1.64 / 2.00)} \right) = \$200,000$$

Then determine **Sample Size** as follows:

$$\text{Sample Size} = \left(\frac{\text{Population size} * \text{Incorrect rejection coefficient} * \text{Est. std. dev.}}{\text{Planned allowance for sampling risk}} \right)^2$$

$$\text{Sample Size} = \left(\frac{100,000 * 2.00 * \$15}{\$200,000} \right)^2$$

= **<u>225 Accounts</u>**

B) Computing Acceptance Interval

To determine acceptance interval for substantive test, we first compute **Adjusted Allowance for Sampling Risk** as follows:

$$\text{Adjusted allowance for sampling risk} = \text{Tolerable misstatement} - \frac{(\text{Population size} * \text{Incorrect accept. coef.} * \text{Sample SD}}{\sqrt{\text{Sample size}}}$$

- This formula "adjusts" the allowance for sampling risk to consider the standard deviation of the audited values in the sample. It holds the risk of incorrect acceptance at its planned level.

- Additional information:
  Standard deviation of audited values= $16
  Estimate of total audited value= $6,100,000

$$\text{Adjusted allowance for sampling risk} = \text{Tolerable misstatement} - \frac{(\text{Population size} * \text{Incorrect accept. coef.} * \text{Sample SD}}{\sqrt{\text{Sample size}}}$$

$$= \$364{,}000 - \frac{(\$100{,}000 * 1.64 * \$16)}{\sqrt{225}}$$

= $364,000 - $174,933

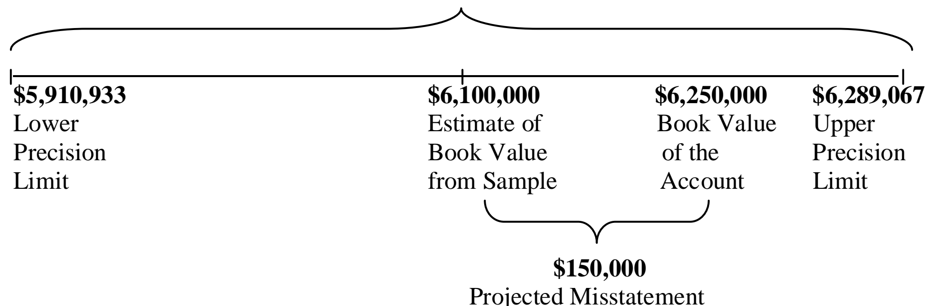
= **$189,067**

■ We would still "**accept**" the book balance because the $6,250,000 (book value) falls within this interval.

Estimate of total audited value	±	Adjusted allowance for sampling risk
$6,100,000	±	$189,067
[$5,910,933	**to**	**$6,289,067]**

- The **Acceptance Interval** for substantive test is drawn below.

Figure 1-4: Acceptance Interval for Substantive Procedure



End of Chapter Notes!

CHAPTER TWO

2. AUDIT OF CASH AND MARKETABLE SECURITIES

Chapter Outline

- Internal control over cash transactions, receipts and disbursements
- Audit program for cash
- Internal control over marketable securities
- Audit program for marketable securities

2.1 Introducing the Nature and Types of cash

Cash, the most liquid of assets, is the standard medium of exchange and the basis for measuring and accounting for all other items. Companies generally classify cash as a current asset. Cash consists of coin, currency, money orders, certified checks, cashier's checks, personal checks, ordinary checks, selling checks, negotiable checks, bank drafts, etc.

Cash is **the only account** included in every business transactions and cycles. Cash is important because of its susceptibility to theft and it can also be significantly misstated. The relationship between cash in the bank and the other transaction cycles serves a **dual function**: (1) it shows the importance of audit tests of various transaction cycles on the audit of cash and (2) it aids in further understanding of the integration of the different transaction cycles.

Cash typically has a small account balance, but auditors devote a large proportion of total audit hours because:

- Liabilities, revenues, expenses and most other assets flow through cash.
- It is the most liquid asset; so greater temptation for misappropriation.
- It is a high risk account.

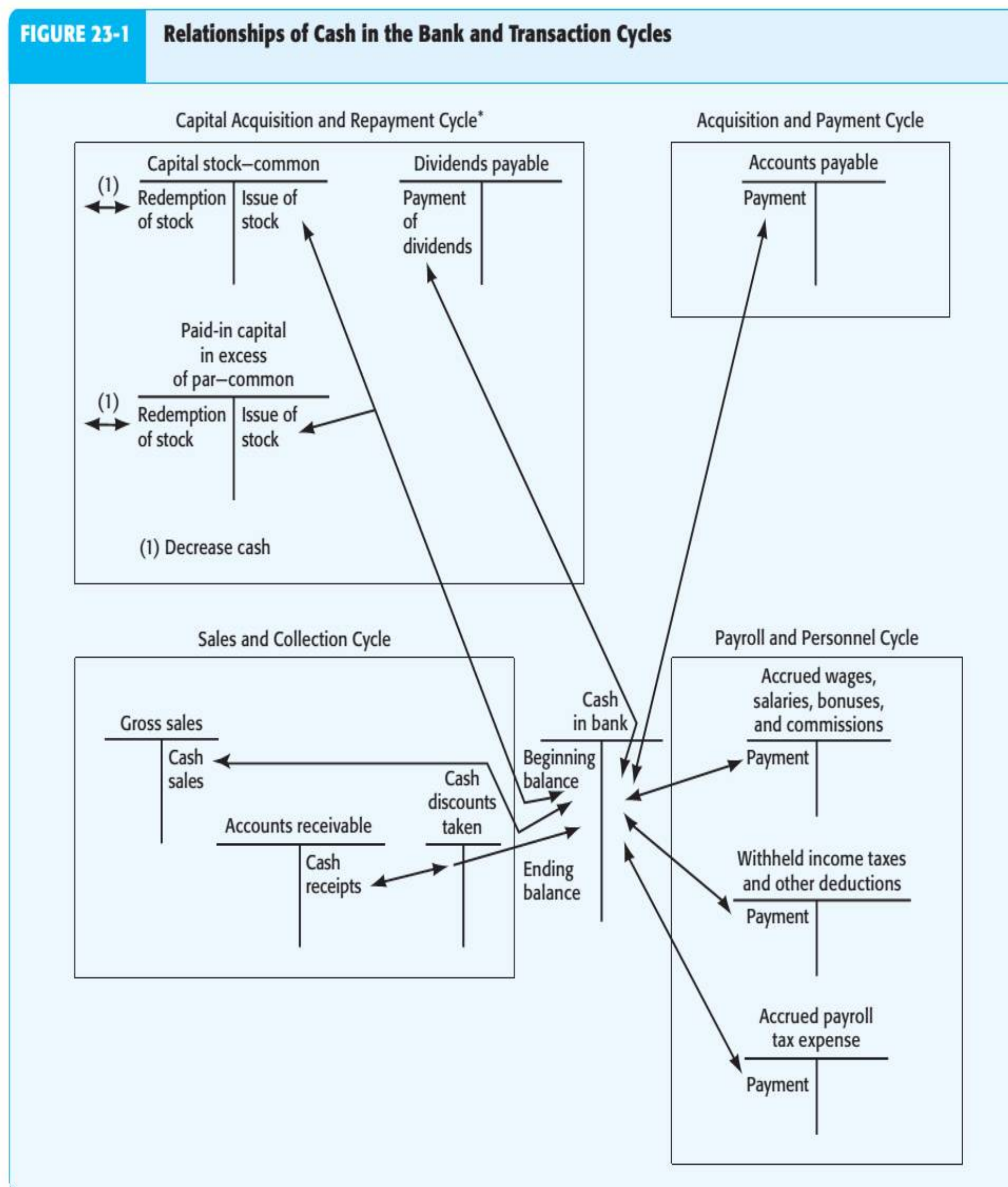
The overall objective of the audit of cash is to determine that cash is fairly presented in conformity with GAAP. The auditors' objectives in the audit of cash are to:

1. Consider *internal control* over cash transactions
2. Substantive test of *existence* of recorded cash
3. Establish *completeness* of recorded cash
4. Determine the client has *right* to the recorded cash

5. Establish clerical *accuracy* of cash schedules
6. Determine *presentation* and *disclosure* of cash including restricted funds (such as compensating balances and bond sinking funds), are appropriate.

Notice that valuation is generally not major concern in the audit of cash because the financial statements are presented in monetary units; valuation of cash is typically a problem only if conversion to or from foreign currency is involved.

The relationships between cash in the bank and transaction cycles have been illustrated in the following diagram.



2.1.1 Types of Cash Accounts

Cash normally includes general, payroll, petty cash and less frequently saving accounts.

- The **General cash account**: General accounts are checking accounts similar in nature to those maintained by individuals. The general cash account is the focal point of cash for most organizations because virtually all cash receipts and disbursements flow through this account. Cash sales, collections of receivables, and investment of additional capital typically increase the account; business expenditures decrease it.

- **Imprest payroll Accounts**: many companies establish a separate imprest payroll account to improve internal control over payroll disbursements. When payroll is paid, a check from the general account is drawn to deposit funds into the payroll account.

- **Imprest Petty cash**: An imprest petty cash fund is not a bank account, but it is sufficiently similar to cash in the bank to merit inclusion. A petty cash account is often something as simple as a preset amount of cash set aside in a cash box for incidental expenses. It is used for small cash acquisitions that can be paid more conveniently and quickly by cash than by check, or for the convenience of employees in cashing personal or payroll check. Petty cash fund is replenished as necessary.

  A fixed balance is maintained in the imprest account, and the authorized personnel uses these funds for disbursements at their own discretion as long as the payments are consistent with company policy.

- **Branch Bank Account**: For a company operating in multiple locations, it is often desirable to have a separate bank balance at each location. Branch bank accounts are useful for building banking relations in local communities and permitting the centralization of operations at the branch level. In some companies, the deposits and disbursements for each branch are made to a separate bank account, and the excess cash is periodically transferred electronically to the main office general bank account.

2.1.2 The Auditors' Objectives in Audit of Cash

The overall objective of the audit of cash is to determine that cash is fairly presented in conformity with GAAP. The auditors' objectives in the audit of cash are to**:**

1. Use the understanding of the client and its environment to consider ***inherent risk***, including **fraud risks**, related to **cash**.
2. Obtain an understanding of **internal control** over cash transactions.
3. Determine the **existence** of recorded cash and the client's **ownership** (right) of cash.
4. Establish the **completeness** of recorded cash.
5. Establish the clerical **accuracy** of cash schedules.
6. Determine that the statement **presentation** and **disclosure** of cash are appropriate.

2.2 Internal control over Cash transactions, Receipts and Disbursements

Internal control consists of all of the related methods and measures adopted within a business to:

a. **Safeguard assets** from employee theft, robbery, and unauthorized use; and

b. **Enhance the accuracy and reliability of its accounting records** by reducing the risk of errors (unintentional mistakes) and irregularities (intentional mistakes and misrepresentations) in the accounting process.

2.2.1 General Principles of Internal Controls over Cash

To safeguard assets and enhance the accuracy and reliability of its accounting records, a company follows internal control principles. The following six internal control principles apply to most companies:

Principle1: Establishment of Responsibility

An essential characteristic of internal control is the assignment of responsibility to specific individuals.

a. Control is most effective when only one person is responsible for a given task.

b. Establishing responsibility includes the authorization and approval of transactions.

Principle 2: Segregation of Duties

Segregation of duties is indispensable in a system of internal control. The rationale for segregation of duties is that the work of one employee should, without a duplication of effort, provide a reliable basis for evaluating the work of another employee. There are two common applications of this principle:

a. The responsibility for **related activities should be assigned to different individuals**. When one individual is responsible for all of the related activities, the potential for errors and irregularities is increased.

- Related purchasing activities should be assigned to different individuals. Related purchasing activities include ordering merchandise, receiving goods, and paying (or authorizing payment) for merchandise.
- Related sales activities also should be assigned to different individuals. Related sales activities include making a sale, shipping (or delivering) the goods to the customer, and billing the customer.

b. The responsibility for **record keeping for an asset should be separate from the physical custody** of an asset. The custodian of the asset is not likely to convert the assets to personal use if one employee maintains the record of the asset that should be on hand and a different employee has physical custody of the asset.

Principle 3: Documentation Procedures

Documents provide evidence that transactions and events have occurred.

- Documents should be pre-numbered and all documents should be accounted for.
- Source documents for accounting entries should be promptly forwarded to the accounting department to help ensure timely recording of the transaction and event.

Principle 4: Physical, Mechanical, and Electronic Controls

Physical controls relate primarily to the safeguarding of assets. Mechanical and electronic controls safeguard assets and enhance the accuracy and reliability of the accounting records. Use of physical, mechanical, and electronic controls is essential.

Examples of these controls include:

a. Safes, vaults, and safety deposit boxes for cash and business papers.

b. Locked warehouses and storage cabinets for inventory and records.

c. Computer facilities with pass key access or fingerprint or eyeball scans.

d. Alarms to prevent break-ins.

e. Television monitors and garment sensors to deter theft.

f. Time clocks for recording time worked.

Principle 5: Independent Internal Verification

Independent internal verification involves the review, comparison, and reconciliation of data prepared by employees.

a. Verification should be made periodically or on a surprise basis.

b. Verification should be done by an employee independent of the personnel responsible for the information.

c. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.

d. In large companies, independent internal verification is often assigned to internal auditors.

Principle 6: Other Controls

a. Bonding of employees who handle cash.

b. Rotating employees' duties and requiring employees to take vacations.

2.2.2 Applications of Internal Control to Cash Receipts

Cash receipts may result from sales of goods and services on cash; collections from customers on account; the receipt of interest, rents, and dividends; investments by owners; bank loans and sale of bonds; and proceeds from the sale of non-current assets.

The following internal control principles explained earlier apply to cash receipts transactions:

1. ***Establishment of responsibility***- Only designated personnel (cashiers) is authorized to handle cash receipts.
2. ***Segregation of duties***- Separate cash receipt from recordkeeping. Different individuals receive cash, record cash receipts, and hold the cash.
3. ***Documentation procedures***- Use remittance advice (mail receipts), cash register tapes, and deposit slips.
4. ***Physical, mechanical, and electronic controls***- Store cash in safes and bank vaults; limit access to storage areas; and use cash registers.

5. ***Independent internal verification***- Do not permit any one employee to handle a transaction from beginning to end. For example, supervisors count cash receipts daily; treasurer compares total receipts to bank deposits daily.
6. **Other controls**.
    - Bond personnel who handle cash.
    - Require vacations and rotation of employees.
    - Deposit all cash receipts in bank daily.

2.2.3 Applications of Internal Control to Cash Disbursements

1. Cash is disbursed to pay expenses and liabilities or to purchase assets.

- **a.** Internal control over cash disbursements is more effective when payments are made by check, rather than by cash, except for incidental amounts that are paid out of petty cash.
- **b.** Cash payments are generally made only after specific control procedures have been followed.
- **c.** The paid check provides proof of payment.
- **d.** The principles of internal control applicable to cash disbursements include:
    - ***Establishment of responsibility*** - Only designated personnel (treasurer) are authorized to sign checks. Make all disbursements by check or electronic fund transfer, with the exception of small expenditures from petty cash.
    - ***Segregation of duties*** - Different individuals approve and make payments; check signors do not record disbursements.
    - ***Documentation procedures*** - Use pre-numbered checks and account for them in sequence; each check must have approved invoice.
    - ***Physical, mechanical, and electronic controls*** - Store blank checks in safes with limited access; print check amounts by machine with indelible (permanent) ink.
    - ***Independent internal verification*** - Compare checks to invoices; reconcile bank statement monthly. Have monthly bank reconciliation prepared by employees not responsible for the issuance of checks or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official
    - ***Other controls*** - Stamp invoices PAID.

2. Methods of disbursing and/or safeguarding Cash:

a. **Electronic Funds Transfer (EFT) System**: A new approach developed to transfer funds among parties without the use of paper (deposit tickets, checks, etc.). The approach, called electronic funds transfers (EFT), uses wire, telephone, telegraph, or computer to transfer cash from one location to another.

b. **Petty Cash Fund** - A cash fund used to pay relatively small amounts.

c. **Use of a Bank**. First it contributes significantly to good internal control over cash by creating a separate set of records (bank and books). Second the asset account Cash maintained by the company is the "flip-side" of the bank's liability account for that company. It should be possible to reconcile these accounts at any time. Each month the company receives a bank statement showing its bank transactions and balances. For example, some transactions and balances shown include:
   - Checks paid and other debits that reduce the balance in the depositor's account.
   - Deposits and other credits that increase the balance in the depositor's account.
   - The account balance after each day's transactions.

d. **Minimize** the amount of cash that must be kept on hand

Summary

Important Internal Controls for Cash Disbursements are summarized below:

1. Segregate duties. The foundation of a good internal control system is segregation of duties. The duties of authorization (signing a check or releasing a wire transfer), custody (having access to the blank check stock or the ability to establish a wire transfer), and recordkeeping (ability to record the transaction in the accounting system) should be separated so that one individual cannot complete a transaction from start to finish. The concept behind segregation of duties is that in order to misappropriate cash, individuals would have to collude, rather than one individual acting alone.

For many businesses, proper segregation of duties can be difficult to achieve. In these instances, company owners may want to consider the bank statements delivered to them unopened. The owners should then review the bank statements and the check images for any

transactions that appear unusual, and follow up on these transactions to obtain an understanding of them. This process alone has uncovered many situations.

2. Review authorized signors. Carefully consider who your authorized signors are (authorization of the transaction). Those individuals should not have access to the blank check stock (custody of the asset) nor the ability to enter the transaction into the accounting system (recording of the transaction). The use of a signature stamp, although efficient, may be problematic in that you must have separate controls to ensure that the stamp is not readily available for inappropriate use.

3. Consider requiring dual signatures. Your company may also want to consider the use of dual signatures. A dual signature policy includes the establishment of a dollar threshold over which checks require two signatures. The utilization of dual signatures establishes an element of segregation of duties for disbursements over a specified threshold in that these disbursements require more than one individual to authorize the transaction.

4. Remember the wire transfers. The use of wire transfers has increased significantly over the years, and segregation of duties around wire transfers is paramount. The responsibilities for establishing a wire transfer should be segregated from the responsibility of releasing the wire transfer. If this segregation is not possible, consideration should be given to using a call-back procedure, in which the financial institution will call a specified individual when a wire transfer is initiated. Most important, the call back cannot go to any individual who is able to initiate a wire transfer.

5. Reconcile bank accounts in a timely manner. The bank reconciliation should be completed in a timely manner by someone who is independent of the cash disbursement process. The bank reconciliation should also include a review of the bank statement and the check images that are returned with the bank statement for unusual transactions. Any unusual items should be investigated and evaluated when necessary.

2.3 Guidelines for Internal Control over Cash

Auditors need to determine whether following general guidelines for internal control over cash have been followed by the client.

1. Do not permit any one employee to handle a transaction from start to finish.
2. Separate cash handling from recordkeeping.
3. Centralize receiving of cash to the extent practical.
4. Record cash receipts on a timely basis.
5. Encourage customers to obtain receipts and observe cash register totals.
6. Deposit cash receipts daily.
7. Make all disbursements by check or electronic funds transfer (EFT), with the exception of small expenditures from petty cash.
8. Have monthly bank reconciliations prepared by employees not responsible for the issuance of checks or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official.
9. Monitor cash receipts and disbursements by comparing recorded amounts to forecasted amounts.

2.4 Internal Control Weaknesses

Weak internal control procedures lead to or create opportunity for fraud and/or **defalcation**. Thus it is important that the auditor should investigate client's internal control procedures to see if defalcation techniques are practiced. Some of the defalcation techniques are discussed as follows.

1. **Withholding of Cash Receipts (Skimming)**: Proceeds from cash sales are withheld at point of sales recording and receiving of cash. Skimming means to take cash before recording it. For example, a cash register clerk can fail to register sales, or under-register amounts, pocketing full or partial amounts, if the customer does not wait for the receipt and changes or check amounts charged, registered and paid. The clerk could record an amount less than received or record no sales at all to pocket the amount.

2. **Lapping**: Cash collected on account from credit customers can be withheld and entry postponed for the collection of receivables. This is usually practiced as temporary borrowing, but in the long run may lead to cover up by more elaborate means. Lapping is basically a way to conceal an unauthorized loan taken from the company. For example, a clerk takes money

paid by Mr. Assefa, which he intends to pay back eventually. The next day, when Mr. Berhanu's payment arrives, he posts it to Mr. Assefa's account. The next day, Ms. Konjit's money comes in, and the clerk posts it to Mr. Berhanu's account, and so on. Sometimes the employee manages to repay the loan, otherwise he may try to write off the amounts as bad debts.

Of course, this is possible if the cashier-accountant receives cash and keeps accounts receivables records at the same time.

Audit procedures to detect Skimming/Lapping

If the cashier is not smart enough to try and cover up skimming, it may be found by a) counting cash on hand tracing from prelisting cash register tapes /receipt carbon copies /remittance advices to cash receipts journal, bank records and the A/R master file. If the control is present, the auditor may compare the records of the cashier to see if they all match.

The auditor should examine all voided receipts and ensure the numerical continuity of receipts. This prevents the cashier from stealing money, and later destroying the carbon copy of the receipt.

The auditor should compare names, dates, and amounts on remittance advices with cash receipts entries and deposit slip. If the dates, names and amounts in the remittance advice and cash receipt entries and deposit slips are not the same, this is an indication of lapping. This procedure is also time - consuming, so it is not done unless lapping is actually suspected.

If the cash receipt is different from the amount owed, the auditor should investigate this to determine why it happened. Most customers pay the exact amount that they owe, for each invoice, so a payment different from the amount owed may mean that the accounting clerk is dividing receipts to maintain the lapping scheme.

Lapping can be prevented by good control, such as segregating receiving and recording duties, or by compulsory vacations for the receipts clerk. The clerk cannot continue to cover his theft if he isn't there, and the new clerk will hopefully post the accounts correctly.

3. **Sales Discount**: Cash can be abstracted from sales discount not taken by customers. That is, when customers pay full amount, only amounts net of discount are recorded to customers and difference pocketed by recording it to discount.

4. **Writing-off Bad Debts**: Accounts receivable could be written-off as bad debts when actually customers' remittance is pocketed. This is used to hide cash shortage that may be apparent by repeated overlapping.

5. **Fictitious Accounts Receivable**: Goods could be taken for private use or stolen by charging fictitious customers and writing-off as bad debts later on.

6. **Check Kiting**: Assume that an enterprise has two bank accounts say in Bank A and Bank B. The enterprise writes a check to withdraw an amount from Bank A account balance and deposit into the account in Bank B. The amount deposited in Bank B is immediately reflected. But because of lag of time for clearance (float) it is not reflected as deduction (withdrawal) from Bank A account soon enough. Consequently, the cash position (current ratio) of the organization is temporarily improved or overstated.

Kiting is practiced to cover up cash shortages, which an auditor might uncover.

Example of Kiting

Assume Tirf Trading House has two bank accounts- one in Dashen Bank and another in Commercial Bank of Ethiopia (CBE). The following scenarios happen in Tirf Trading.

A) Kiting to cover Theft

Account clerk Mr. Atalay "borrows" incoming cash receipt (skimming) of 1,000 Birr. However, he needs to post amounts to individual customer accounts in the A/R subsidiary ledger. Otherwise, they will complain and his theft will be discovered. So he makes a journal entry as follows.

	Dr	Cr
Cash in Bank - Dashen	1,000	
Accounts Receivable		1,000

- **But no deposit was made into the Bank**

Then Mr. Atalay realizes that this incorrect entry will be discovered when the bank account is reconciled. So on the last day of the fiscal year, he writes a check on the CBE account for 1,000 Birr, and deposits it into Dashen Bank. But no entry will be made to decrease the account balance in CBE. CBE does not know it as disbursement. The bank reconciliation will

now balance, because CBE will not debit the check until the next fiscal year. Mr. Atalay assumes that by then he will be able to pay back the "loan".

B) Kiting to Overstate Current Ratio (Management Fraud)

W/ro Akeza is managing director of Tirf Trading. She has applied for a business loan at Dashen Bank. Tirf Trading is having a difficult year, and needs the money very badly to pay suppliers and payroll. She knows well the fundamental principle of banking. So she has to convince Dashen Bank that Tirf Trading is having a good year. She decides to do this by overstating the current ratio on the financial statements, because she knows this is a key area for the loan officer's analysis.

On the last day of the fiscal year, she draws a check for 300,000 Birr from CBE and deposits it to Dashen Bank. She gives the stamped deposit ticket to the accountant with the instructions to make this entry on December 31.

Cash in Bank - Dashen Bank	300,000	
Miscellaneous Income		300,000

CBE of course, will not process the check until next year, and it will not show up on the bank reconciliation until January 31. By that time, W/ro Akeza hopes the loan will have been granted, and a simple correcting journal entry can be made to correct the ledger balance for Cash in Bank - Dashen.

<u>Audit procedures to detect Kiting</u>

The audit test to discover kiting is to prepare and examine a schedule of interbank transfers. There are several things that should be audited on the interbank transfer schedule.

1. The accuracy of the information on the interbank transfer schedule should be verified.
2. The interbank transfer must be recorded in both the receiving and disbursing banks. If Birr 10,000 is transferred from bank A to B but only disbursement (in A) is reduced, this is an evidence of an attempt to conceal a cash theft (kiting).
3. The date of recording of the disbursement and receipts for each transfer must be in the same year. If a cash receipt was recorded in the current fiscal year and disbursement in the subsequent year, it may be an attempt to cover cash shortage.
4. Disbursements on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliation as outstanding checks. An outstanding check (CK) for the first bank is an outstanding deposit for the second bank.

Understating outstanding CKs on the bank reconciliation indicates the possibility of kiting. The dates in disbursement books and dates of disbursement in bank must be in the same year. If there are CKs recorded in book but not in bank, they must be included as outstanding CKs in the preparation of bank reconciliation. ***But if there are checks that are not included as outstanding CKs, this is an indication of kiting***.

5. Receipts on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as deposit in transit. Compare receipt dates as per book and per bank. Any deposit recorded in book but not in bank should be reflected as outstanding deposit in bank reconciliation. ***But if there are receipts recorded as outstanding deposits whose amount is not recorded in cash receipt journal, it is an indication of kiting***.

7. **Window-Dressing**: Cash shortage or cash position can be improved by holding the cashbook open beyond closing date to include subsequent receipts. This may be encouraged by management to improve current period sales.

8. **Cash Disbursements**: Cash from petty cash could be misused for personal or other unauthorized expenses by producing false voucher expenses, or voucher charges, or overstating vouchers submitted for reimbursements or changing dates of previous vouchers.

9. **Checks Payable to Self**: Checks could be prepared for amounts made payable to self, forging signatures and destroying returned checks or over footing cash disbursements.

10. **Checks Payable to Others**: Checks are prepared in payment of forged endorsements or fictitious or previously used invoices, or over-invoiced vendors' invoices, or padding payrolls.

It should be noted that all of the above defalcations are performed only in absence of proper segregation of duties or when there is collusion among employees.

2.5 Audit Program for Cash

Audit program is a detailed listing of the specific audit procedures to be performed in the course of audit engagement. The following audit program indicates the general pattern of work performed by the auditors in the verification of cash.

2.5.1 Consider internal control over cash

Test of controls provide auditors with evidence as to whether prescribed controls are in use and operating effectively. The result of these tests assists the auditor in evaluating the likelihood of material misstatements having occurred. This implies that the auditor should assure that the above internal control over cash receipts and cash disbursements are in place. This can be achieved by preparing an internal control questionnaire for cash receipts and cash disbursement. Some of the specific activities include:

1. Obtain an understanding of internal control over cash
2. Assess control risk and design additional tests of controls for cash
3. Perform additional tests of controls for those controls which the auditors plan to consider to support their planned assessed level of control risks, such as
    a. Test the account records and reconciliations made by re-performance.
    b. Compare the details of a sample of cash receipts listing to the cash receipts journal, A/R posting, and authenticated deposit slips.
    c. Compare the details of a sample of recorded disbursements in the cash payment journals to A/P postings, and purchase orders, receiving reports, invoices, and paid checks.
4. Reassess control risk and modify substantive tests for cash.

2.5.2 Perform Substantive test of cash transactions and balances

Substantive tests are designed to detect material misstatement if they exist in the financial statements. The amount of substantive testing done by the auditor is greatly influenced by their assessment of the likelihood that misstatement exists. The auditor undertakes the following activities in relation to the substantive test of cash transactions and balances.

1. Obtain analysis of cash balances and reconcile to the general ledger.
2. Send standard confirmation forms to financial institutions to verify amounts on deposit.

3. Obtain or prepare reconciliation of bank accounts as of the balance sheet date and consider need to reconcile bank activity for additional month.
4. Obtain a cut-off bank statement containing transactions of at least seven business days subsequent to balance sheet date.
5. Count cash list on hand.
6. Verify the client's cutoff of cash receipts and cash disbursements.
7. Analyze bank transfers for the last week of audit year and first week of following year to disclose kitting.
8. Investigate any checks representing large or unusual payments to related parties.
9. Evaluate proper balance sheet presentation and disclosure of cash.

⇨ Brief discussion on some of the substantive audit procedures is presented below.

1. Obtain analysis of cash balances and reconcile to the general ledger

The auditor will prepare or obtain a schedule that lists the entire client's cash account. For example for cash in bank account, this schedule will typically list the bank, the bank account number, account type (checking a/c or saving a/c), and the year-end balance per book. The auditors will trace and reconcile all accounts to the general ledger as necessary.

2. Send standard confirmation forms to financial institutions to verify amounts on deposit

Auditors usually obtain a direct receipt of a confirmation from every bank or other financial institution with which the client does business. The main objective of this confirmation letter is to corroborate (confirm) the existence of the amounts of cash recorded on the balance sheet of the client. Ask banks if the amount of cash indicated in balance sheet as 'cash in bank' really exists in the bank account.

After auditors receive the completed bank confirmation, the balance in the bank account confirmed by the bank should be traced to the amount stated on the bank reconciliation. Similarly, all other information on the reconciliation should be traced to the relevant audit schedules. If the bank confirmation does not agree with the audit schedules, auditors must investigate the difference.

3. Obtain or prepare reconciliation of bank accounts as of the balance sheet date

In order to ascertain the appropriateness a company's cash position at the close of the period, the auditor should reconcile the balance per bank statement at that date with the balance per company's accounting records.

A monthly **bank reconciliation** of the general bank account on a timely basis by someone independent of the handling or recording of cash receipts and disbursements is an essential control over the ending cash balance. Companies with significant cash balances and large volumes of cash transactions may reconcile cash on a daily basis to online banking records. The reconciliation ensures that the accounting records reflect the same cash balance as the actual amount of cash in the bank after considering reconciling items. More important, the *independent* reconciliation provides an opportunity for an internal verification of cash receipts and disbursements transactions.

If the client has already prepared bank reconciliation, there is no need for duplicating the work. However, the auditors should examine/inspect the reconciliation in detail to satisfy themselves that it has been properly prepared. Auditors test the bank reconciliation to determine whether client personnel have carefully prepared the bank reconciliation and to verify whether the client's recorded bank balance is the same amount as the actual cash in the bank except for deposits in transit, outstanding checks, and other reconciling items. In verifying the reconciliation, the auditor uses information in the cutoff bank statement to verify the appropriateness of reconciling items.

4. Obtain a cut-off bank statement

A **cut-off bank statement** is a partial-period bank statement and the related copies of cancelled checks, duplicate deposit slips, and other documents included in bank statements, mailed by the bank directly to the auditor's (CPA firm's) office. The purpose of the cut-off bank statement is to verify the accuracy of reconciling items on the client's year-end bank reconciliation with evidence that is not accessible to the client. To fulfil this purpose, the auditor requests the client to have the bank send the statement for 7 to 10 days subsequent to the balance sheet date directly to the auditor. It allows the auditors to examine the checks listed as outstanding and the details of deposits in transit on the company's reconciliation.

With respect to checks that were shown as outstanding at the year-end, the auditors should determine the dates on which the bank paid these checks. By noting the dates of payment of these checks, the auditors can determine whether the time intervals between the dates of the check and the time of payment by bank were unreasonably long. Unreasonable delay in the presentation of these checks for payment constitutes a strong implication that ***the checks were not mailed by the client until sometime after the close of the year.***

In examining the cut-off bank statement, the auditors will also watch for any paid checks issued on or before the balance sheet date but not listed as outstanding on the client's year-end bank reconciliation. Thus, the cut-off bank statement provides assurance that the amount of cash shown on the balance sheet was not overstated by omission of one or more checks from listing of checks outstanding.

5. Count cash list on hand

The auditors should physically count the cash on hand, which may include cash receipts, change funds and petty cash, to verify its existence. This is normally done at the close of business on the last day of the fiscal period under audit. The auditor should take at least two precautions in performing the count of cash.

- The cash count should be made simultaneously with the inspection of investments and negotiable instruments. This requirement prevents the auditor from double counting these assets. Furthermore, all cash should be controlled throughout the time of the cash count to avoid the possibility of the auditor again being misled into counting a specified amount of cash more than once. A common way of achieving this control is to seal each container of cash immediately after it has been counted. After the count has been completed, the auditor should retrace the counting cycle to certify that the individual seals were not broken after the cash in them was counted.
- The count should always be made in the presence of the custodian of each of the funds, and he or she should be asked to sign a receipt for the return of cash after the count has been completed.

6. Analyze bank transfers for the last week of audit year and first week of following year

Embezzlers occasionally cover a theft of cash by a practice known as kiting: transferring money from one bank to another and incorrectly recording the transaction. The purpose of analyzing bank transfer is to disclose overstatement of cash balances resulting from kiting. Kiting is a fraudulent scheme that seeks to take advantage of "float". Float refers to the timing difference between the day a check is credited to an account in one bank, and debited to an account in another bank.

Example of Inter-bank Transfer Schedule

Bank Account				Date of Disbursement		Date of Receipt	
Check No.	**From**	**To**	**Amount**	**Books**	**Bank**	**Books**	**Bank**
5897	General	Payroll	$30,620	12/28	1/3	12/28	12/28
6006	General	Branch 4	24,018	½	¼	12/30	12/30
6029	Branch 2	General	10,000	1/3	1/5	1/3	12/31

Disclosure of Kiting: By comparing the dates on the schedule of bank transfers, auditors can determine whether any manipulation of the cash balance has taken place. The increase in one bank account and decrease in the other bank account should be recorded in the cash journals in the same accounting period. Notice that Check No. 6006 in the transfer schedule was recorded in the cash journals as a receipt on December 30 and a disbursement on January 2. As a result of recording the debit and credit parts of the transaction in different accounting periods, cash is overstated on December 31. For the cash receipts journal to remain in balance, some accounts must have been credited on December 30 to offset the debit to Cash. If a revenue account was credited, the results of operations were overstated along with cash.

A bank transfer schedule should disclose this type of kiting because the transfer deposit appears on the general account bank statement in December, while the transaction was not recorded in the cash journals until January. Check No. 6029 in the transfers schedule illustrates this discrepancy.

These illustrations suggest the following rules for determining when it is likely that a cash transfer has misstated the cash balance:

1. The dates of recording the transfer *per the books* (from the cash disbursements and cash receipts journals, respectively) are from different statement period, or
2. The date the check was recorded *by the bank* (either the disbursement or the receipt, but not both) is from the financial statement period prior to when it is recorded on the books.

7. Evaluate proper balance sheet presentation and disclosure of cash

Cash must be properly classified, described and disclosures need to be appropriate. Take the following in to consideration:

1. Inquire of management. See management representation letter.
2. Evaluate restrictions on cash.
3. Assess cash flow statement.
    a. evaluate presentation (direct or indirect method).
    b. reconcile information with income statement and balance sheet.
4. Read financial statement notes.

2.6 Audit of Marketable securities

2.6.1 Definition of marketable Securities

Companies often invest excess cash accumulated during certain parts of the operating cycle that will be needed in the reasonably near future in short-term, highly liquid cash equivalents. These may include time deposits, certificates of deposit, and money market funds.

Marketable securities (Short-term investments) are financial investments which are convertible into cash within one year or one operating cycle. They are listed at their current market value. Marketable securities are shown on the balance sheet as "**Short-term Investments**".

E.g. Commercial paper, marketable equity securities, and marketable debt securities

Cash equivalents, which can be highly material, are included in the financial statements as a part of the cash account only if they are short-term investments that are readily convertible to known amounts of cash, and there is insignificant risk of a change of value from interest rate changes.

2.6.2 Nature of marketable Securities

Companies group investments in debt and equity securities into three separate portfolios for valuation and reporting purposes as:

- Held-to-maturity,
- Trading, and
- Available-for-sale securities.

2.6.3 Potential Misstatements of Marketable securities

- o Misstatement of recorded value of Securities
- o Unauthorized Security transactions
- o Incomplete recording of Securities
- o Inadequate disclosure of the nature of Security activities

2.6.4 Controls over Marketable Securities

- ✓ Establishment of formal security policies
- ✓ Review and approval of security activities by the security committee of the board of directors
- ✓ Separation of duties among employees
  - Authorizing purchases and sales

  - Having custody of the securities
  - Maintaining records
- ✓ Detailed records of all securities owned
- ✓ Registration in the name of the company
- ✓ Periodic physical inspection of securities
- ✓ Determination of accounting for complex securities by competent personnel

2.6.5 Objectives for the Audit of Marketable Securities

- ➢ To consider the *inherent risks,* including fraud risks.
- ➢ To consider *internal control* over marketable securities.
- ➢ To determine the *existence* of recorded marketable securities and that the client has *rights* to the securities.
- ➢ To establish the *completeness* of recorded marketable securities.
- ➢ To determine that the *valuation* of marketable securities is in accordance with GAAP.
- ➢ To establish the *clerical accuracy* of schedules of securities.
- ➢ To determine that the *presentation and disclosure* of marketable securities are appropriate.

2.6.6 Substantive Audit Procedures: Marketable Securities

- Client prepares schedule of marketable securities activity including
  - Marketable securities held at year-end
  - Audit period transactions - purchases and disposals
- The schedule is footed to determine mathematical accuracy
- Auditor verifies cost or sales price by examining broker's advices
- Auditor recalculates gains/losses on disposal of securities
- Existence of securities owned at year-end is verified by physically examining securities held by the client, or confirmation with client's broker for securities held by the broker
- Current market values are verified by referring to market sources
- Auditor asks management about any changes in the expected holding period, and any restrictions on securities

End of Chapter Notes!

CHAPTER 3

3. AUDIT OF RECEIVABLES AND SALES

Chapter Outline

- Meaning, Sources and Nature of Receivables
- Internal Control over Receivables/Sales
- Objectives for the Audit of Receivables and Revenue
- Audit Program for Receivable/Sales (Receivables Audit Steps)

Introduction

The overall objective of the audit of accounts receivable and sales is to determine if they are fairly presented in the context of the financial statements as a whole. The sales account is closely tied to accounts receivable; therefore, evidence supporting accounts receivable tends to support sales. For example, having determined that an account receivable is valid, the auditor has thereby supported the validity of the sale. Analytical procedures can often be used to test the sales account. An unusual relationship detected in the audit of receivables and inventory may reflect a problem for the reported sales figure as well.

3.1 Meaning, Sources and Nature of Receivables

- Receivables are all money claims against individuals, organizations or other debtors.
- They are acquired by business enterprises in various types of transactions, common being the *sale* of goods (merchandise) or services on a *credit basis*.
- Receivables that are based on oral agreements are known as *open accounts* (*Accounts receivables*). Receivables that are based on formal (written) instruments are called *promissory notes* (*Notes receivables*).
- Accounts and Notes receivables originating from *sales* transactions are called *Trade Receivables.*
- Receivables are shown on the balance sheet at their ***net realizable value (***I.e. A/R balance less Allowance for uncollectible accounts).

Sources of Receivables: Accounts receivable/Notes receivable include the business organization's:

- ✓ Claims against customers from sale of goods and services

- ✓ Loans given to officers or employees
- ✓ Loans given to subsidiaries
- ✓ Claims for tax refunds
- ✓ Claims against various other refunds
- ✓ Advances to suppliers

Sources of Notes Receivable

- ✓ Written promises to pay certain amounts at future dates
- ✓ Notes for substantial amounts
  - – Sale of industrial machinery, farm equipment
  - – Issuance of capital stock
  - – Loans to officers, employees

Audit Risk: Audit risk is significant in A/R, N/R or Sales accounts because:

- – Many incidences of fraud have involved overstatement of receivables and revenue.
- – Revenue recognition may be based on complex accounting rules.
- – Receivables and revenues are usually subject to valuation using significant accounting estimates.

3.2 Internal Control over Receivables/Sales

The auditor, in evaluating the internal control system, is concerned to determine the extent to which the common characteristics of control are present within the system. Because the specific placement of responsibility, compliance and qualified personnel characteristics all apply in the same way to all subsystems, we shall concentrate our attention on the others as they relate specifically to the revenue system.

The internal controls with regard to accounts receivable include the following:

a) Appropriate segregation of responsibilities

1. Persons handling cash receipts do not have access to the accounts receivable records.
2. The billing function should be separated from the handling of cash receipts.
3. Any special discount concessions to customers should be approved by a responsible supervisor.
4. The credit function should be separated from the handling of cash receipts and the record keeping function.

5. The A/R ledger clerk recording sales and cash collections should be someone other than the general bookkeeper.
6. Persons having the authority to originate non-cash credits to receivables should not have access to cash.

b. Documentation approvals and records

1. Sales invoices should be sequentially numbered and procedures should be established to account for the use of the invoice forms.
2. Credit memos should also be sequentially numbered and controlled in the same manner as are sales invoices.
3. Sequentially numbered remittance advice forms should be prepared when cash is received by the company.
   Formal procedures should be established for carrying out the billing function.
4. A/R records should indicate both control account and a subsidiary ledger.
5. Formal procedures should be established for authorizing and approving the acceptance of notes receivable

c. Safeguarding Assets and records

1. All cash receipts should be deposited intact daily.
2. Appropriately protected storage facilities for undeposited cash receipts.
3. The accounts receivable records should be stored in a safe or vault designed to protect those records from damage or alteration when they are not being used.

Internal control components (Internal Control over A/R and Revenue)

1. Control Environment

- Important because of risk of intentional misstatement of revenue
- Independence of audit committee
- Management establishes tone at the top
- Commitment to competence
- Management's philosophy and operating style
- Human resource policies and practices

2. Risk Assessment

- Risk of misstatement of revenue

3. Control Activities

- **Division of duties**

- Prepare sales order
- Approve credit
- Issue merchandise from stock
- Shipment
- Billing
- Invoice verification
- Maintenance of control accounts
- Maintenance of customers' ledgers
- Approval of sales returns and allowances
- Authorization of write-offs of uncollectible accounts

Revenue cycle and relevant control

The account data in the revenue system include sales or other trade revenues, sales returns and allowances, sales discounts, the allowance for doubtful accounts, bad debts expense, receivables and cash receipts from cash sales and collection accounts. Because of the perceived inclination of management to overstate assets, the auditor is most concerned with verifying that the receivables element of the system and the offsetting credits to sales are not overstated.

Revenue Cycle---Documents

- Customer purchase order
- Sales order
- Bill of lading
- Invoice
- Control listing
- Credit memo

Revenue Cycle Controls

The revenue cycle controls include:

- Segregation of duties--sales and collections
- Matching of sales invoices and shipping documents
- Clerical accuracy checks on invoices
- Credit approval for sales transactions
- Mailing of monthly statements
- Reconciliation of bank accounts
- Use of control listing of cash receipts
- Use of budgets and analysis of variances
- Control over shipping and billing documents
- Use of authorized credit memoranda
- Use of chart of accounts and review of account coding

3.3. Objectives for the Audit of Receivables and Revenue

The auditors strive for attaining following objectives for the audit of receivables and revenues.

1. Use the understanding of the client and its environment to consider *inherent risk*, including fraud risks, related to receivables and revenues.
2. Obtain an understanding of *internal control* over receivables and revenues.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that:
    a. Substantiate the **existence** of receivables and the **occurrence** of revenue transactions.
    b. Establish the **completeness** of receivables and revenue transactions.
    c. Verify the **cutoff** of revenue transactions.
    d. Determine that the client has **rights** to recorded receivables.
    e. Establish the proper **valuation** of receivables and the **accuracy** of revenue transactions.
    f. Determine that the **presentation** and **disclosure** of receivables and revenue are appropriate.

Theoretically the audit could depend on a strong system of internal control as a basis for an opinion on the financial statements, assuming that compliance has been proved through transaction validity test.

In designing tests of details of balances for accounts receivable, auditors must satisfy each of the eight balance-related audit objectives first discussed in the introductory part of this course. These eight general objectives are the same for all accounts. Specifically applied to accounts receivable, they are called **accounts receivable balance-related audit objectives** and are as follows:

1. Accounts receivable in the aged trial balance agree with related master file amounts, and the total is correctly added and agrees with the general ledger. **(Test of Valuation and Accuracy)**
2. Recorded accounts receivable exist**. (Existence)**
3. Existing accounts receivable are included. **(Completeness)**
4. Accounts receivable are stated at realizable value**. (Valuation)**
5. Accounts receivable are accurate. **(Accuracy)**
6. Accounts receivable are correctly classified. **(Classification)**
7. Cut-off for accounts receivable is correct**. (Cut-off)**
8. The client has rights to accounts receivable**. (Rights)**

Brief discussions about these points follow**.**

1. **Accounts Receivable are correctly added and agree with the master file and the general Ledger**

The auditor should verify that the sum of receivable subsidiary ledgers is equal to the total of the general ledger of Receivables. For this purpose the auditor prepares aged trial balance of receivables. The auditor should verify that Account Receivables in the aged trial balance equal the total of the Account Receivables master file, and the total in both is correctly added and agree with the general ledger. The individual accounts must be summarized correctly into the General Ledger. The auditor will use the aged trial balance for this test. The total of the aged trial balance must agree with the general ledger balance and also the total of the Account Receivables subsidiary ledger. Each of the columns in the aged trial balance must be footed, then cross footed, comparing the total to the general ledger balance.

2. Verification of Existence of Receivable balance

The actual existence of a receivable as an asset depends on the clients having a valid claim for the amount shown in the account. Confirmation is the primary auditing procedure in verifying existence of receivables. This procedure is judged to be so important that it is required by generally accepted auditing standards, unless it is impossible or impractical to perform. Confirmation helps us answer the question: Do the A/R really exist? It also provides evidence related to *valuation/allocation*. Acknowledgement of the debt by the customer is some evidence that it may be collected. Also, it helps to determine whether there was proper **cut-off** of the accounts.

- Confirmations provide reliable external evidence about the:
  - Existence of recorded accounts receivable, and
  - Completeness of cash collections, sales discounts, and sales returns and allowances,
- Confirmations are required by GAAS unless one of the following is present:
  - Receivables are not material
  - Use of confirmations would be ineffective (the auditor considers that response rates are likely to be inadequate or unreliable)
  - Environment risk is assessed as low and sufficient evidence is available from using other substantive tests (inherent and control risk are low, meaning that other evidence can be regarded as sufficient)

Of course, confirmations are so widely used in auditing that the auditor must be very sure that he/she can defend his action in court if accounts receivable are not confirmed.

Types of Confirmations

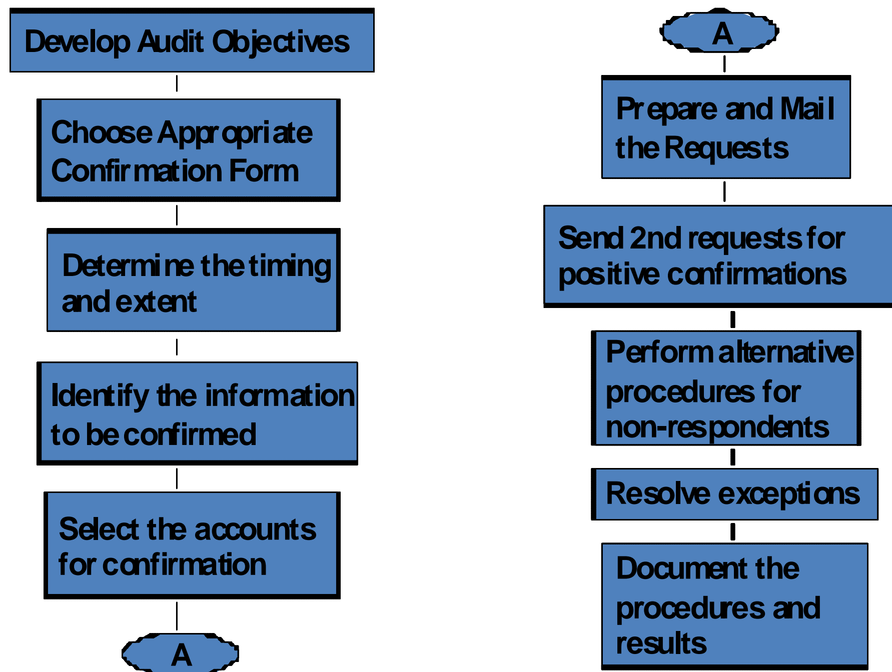
Two methods in which the client makes the formal request are:

1. **Positive confirmation** – requests addressed to the debtor asking for a reply.
   - Basically, **positive confirmation** is letter sent to debtors asking them to confirm **directly to the auditor** the amount of the balances in their respective accounts.
   - Customers are asked to agree the amount on the confirmation with their accounting records and to respond directly to the auditor whether they agree with the amount or not.
   - The auditor wants a response regardless of whether the customer ***agrees or disagrees*** with the stated balance.
   - Positive confirmation requires a response.

- If customer does not respond, auditor must use alternative procedures.
- As a practical matter, the auditor will often send *positive* confirmation to accounts with *large* balance.
- Positive confirmations are more reliable, partly because the auditor will follow-up confirmations which are not returned.

2. **Negative confirmation** – asks debtors to advise the auditors only if the balance shown is incorrect (asks for a response only if the debtor **disagrees** with recorded amount).

   - Customers are asked to respond only if they disagree with the balance (non-response is assumed to mean agreement).
   - Negative confirmation requests are often simply stamped or glued into the client's regular monthly statement to the customer before it is sent out.
   - If a negative confirmation is not returned, the auditor assumes it is because the debtor agrees with the balance. Since negative confirmations are often simply ignored by the recipient, that assumption may not be correct.
   - Negative confirmations are less reliable, but are cheaper to send. It is less expensive since there are no additional procedures if customer does not respond.
   - A formal letter is not required, and no time is spent following up. Therefore, confirmations that are more negative can be sent for the same cost.
   - May be used when all of the following are present
     - Confirming a large number of small customer balances.
     - Environment risk for receivables is assessed as low.



3. Existing accounts receivable are included

The objective of this test is to verify that all transactions affecting receivables occurred in the period are recorded, that is, the auditor examines if there is no unrecorded transaction (sales on account that increases accounts receivable). The understatement of sales and accounts receivable is best uncovered by substantive tests of transactions for shipments made but not recorded (completeness objective for tests of sales transactions) and by analytical procedures. The auditor will want to be aware of the possibility of understatement in examining the aged TB when doing accuracy test, in case a problem exists that was not uncovered in the audit of sales. If a balance is left off aged TB, the aged TB should be different from the general ledger control account. If all sales to a particular customer are omitted from the A/R, then this probably won't be discovered through confirmation (Customers aren't likely to respond to a zero balance - rather they rejoice at their good fortune!). Such an omission may also be found by analytical procedures.

4. Verification of Valuation of Receivable balance

Accounting standards require that companies state accounts receivable at the amount that will ultimately be collected. The **realizable value of accounts receivable** is equal to gross accounts receivable less the *allowance for uncollectible accounts*. Under GAAP, short term receivables are reported at ***net realizable value***. Therefore, auditing procedures to meet this objective are directed towards determining whether or not the client's provision for uncollectible accounts and notes is adequate.

Valuation/allocation: It is important for the auditor to verify that transactions have been ***appropriately cut-off at the end of each period***. A lager claim against the goods purchased is established generally at the point where title passes. The title passage, in turn, is determined by the FOB point. These tests try to make sure that current period transactions are not recorded in a subsequent period, and the subsequent period transactions are not recorded in the current period. They are most relevant for cash receipts and sales. The reason is that if large subsequent period sales are recorded in the current period, they can materially overstate sales. If sales are materially overstated, net income and assets are overstated, hence two financial statements are affected.

The auditor must decide whether the allowance is reasonable, given the available facts. Four factors should be weighed by the auditor in determining the correct amount - economic conditions, sales volume, credit policy, and collection history.

Many questions will be asked by the auditor in determining the *reasonableness* of the allowance. Is the balance of the allowance account reasonable compared to previous years, compared to current year write - offs, compared to the age of accounts receivable, and in light of general economic conditions? The age and amount of current past due accounts should be compared with those of previous years, and the percentage of total A/R in each age category should be calculated. Generally, the longer a receivable is outstanding, the less likely it is to be collected. The auditor should also review *correspondence* with customers, and interview the credit manager regarding specific accounts. Before an account is to be written off, there is often a strong letter to the customer demanding payment. When the auditor is satisfied with the balance of the allowance account, Bad Debt Expense for the year can be easily calculated.

5. Accounts receivable are correctly classified

Statement presentation is mainly giving precise and sufficient disclosure about the accounts to the users of the information. This has to do with whether the Account Receivables are correctly classified and presented on the balance sheets, and any related disclosures appear in the notes to the financial statements, according to GAAP. If Account Receivables are not

properly classified, this probably is best found by scanning the aged TB. Examples of amounts sometimes improperly classified as Accounts Receivable include longer-term notes receivable, and large credit balance in Account Receivables. If the amount of credit balance of Accounts Receivable is significant, this type of balance should be reclassified to A/P.

Specific circumstances which require disclosure are receivables from related parties and receivables which have been pledged as collateral. In presenting receivables in the balance sheet, it is important to verify that an appropriate distinction has been made between current and non-current receivables and that appropriate disclosures have been made related to any contingent claims against receivables.

6. Verification of Rights/Ownership of Receivables

The existence of typical documentary support in the form of sales invoices, shipping documents, notes, etc provides evidence of existence of receivables. However, the auditor is always concerned with contingencies that may cloud the ownership rights of the client. Examples are, ***receivables may be pledged or Notes might have been discounted.*** A careful review of the board meeting minutes, discussions with the client, or the bank's confirmation letter are more likely to reveal this situation-whether receivable are pledged or not. The auditor will also request a ***representation letter*** from the client that all such contingent claims against receivables have been disclosed in the financial statements. Due to the matching principle associated with the financial reporting process, it is important for the auditor to verify transactions that have been appropriately cut-off at the end of each period.

7. Cut-off for Accounts Receivable Is Correct

Cut-off misstatements exist when current period transactions are recorded in the subsequent period or vice versa. The objective of cut-off tests, regardless of the type of transaction, is to verify whether transactions near the end of the accounting period are recorded in the proper period. Cut-off misstatements can occur for sales, sales returns and allowances, and cash receipts.

a. **Sales Cut-off**: Check that sales of the period are recorded in the period/year in which title to the sold goods is transferred (point of sale method).

- An auditor can easily test this by comparing recorded sales with the related shipping documents for the last few days of the current period and the first few days of the subsequent period.

b. ***Sales Returns and Allowances Cut-off***. Accounting standards require that sales returns and allowances be *matched with related sales* if the amounts are material. For

example, if current period shipments are returned in the subsequent period, the sales return should appear in the current period (the returned goods should be treated as current period inventory).

3.4 Audit Program for Receivable/Sales (Receivables Audit Steps)

(I) Internal Control considerations- Tests of Controls

Perform following **tests of controls**.

a. Examine significant aspects of a sample of sales transactions.

b. Compare a sample of shipping documents to related sales invoices.

c. Review the use and authorization of credit memoranda.

d. Reconcile selected cash register tapes and sales tickets with sales journals.

e. Test IT application controls.

f. Examine evidence of review and approval of revenue estimates.

(II)Substantive Audit Procedures for Receivable/Sales

Perform following major **Substantive procedures** for receivables and revenue.

1. Obtain an aged trial balance of trade accounts receivable and analyses of other accounts receivable and reconcile to ledgers.
2. Obtain analyses of notes receivable and related interest.
3. Inspect notes on hand and confirm those with holders.
4. Confirm receivables with debtors.
5. Review the year-end cutoff of sales transactions.
6. Perform analytical procedures for accounts receivable, notes receivable, and revenue.
7. Review significant year-end sales contracts for unusual terms.
8. Test the valuation of notes receivable, computation of interest income, interest receivable, and amortization of discount or premium.
9. Evaluate the propriety of the client's accounting methods for receivables and revenue.
10. Evaluate accounting estimates related to revenue.
11. Determine the adequacy of the client's allowance for uncollectible accounts.
12. Ascertain whether any receivables have been pledged.
13. Investigate any transactions with or receivables from related parties.
14. Evaluate the business purpose of significant and unusual sales transactions.
15. Evaluate financial statement presentation and disclosures of receivables and revenue.

FIGURE 11.2 **Objectives of Major Substantive Procedures for Receivables and Revenue**

Substantive Procedures	Primary Audit Objectives
Obtain aged listing of receivables and reconcile to ledgers. Obtain analyses of notes receivable and related interest.	*Valuation* and *accuracy*
Inspect notes on hand and confirm those not on hand.	*Existence*, *occurrence*, and *rights*
Confirm receivables with debtors.	*Existence*, *occurrence*, and *rights* *Valuation* and *accuracy*
Review the year-end cutoff of sales transactions.	*Existence*, *occurrence*, and *rights* *Completeness* *Cutoff*
Perform analytical procedures. Review significant year-end sales contracts.	*Existence*, *occurrence*, and *rights* *Completeness* *Valuation* and *accuracy*
Verify interest earned on notes receivable.	*Existence*, *occurrence*, and *rights* *Completeness*
Evaluate the propriety of client's accounting for transactions. Evaluate accounting estimates related to revenues.	*Valuation* and *accuracy*
Determine adequacy of allowance for uncollectible accounts.	*Valuation*
Ascertain the existence of pledged receivables. Investigate receivables from related parties.	*Presentation* and *disclosure*
Evaluate the business purpose of significant and unusual sales transactions.	*Valuation* and *accuracy* *Presentation* and *disclosure*
Evaluate financial statement presentation and disclosure.	*Presentation* and *disclosure*

End of Chapter Notes!

CHAPTER 4

4. AUDIT OF INVENTORIES AND COST OF SALES

Chapter Outline

- Meaning of Inventories and the Significance of Audit of Inventories
- Functions making up the Inventory and Warehousing Cycle
- Audit objectives for Inventories/Cost of Sales
- Audit Program for Inventories/Cost of Sales
- Verification of Inventories

4.1 Meaning of Inventories and the Significance of Audit of Inventories

Inventories are goods held for resale in the ordinary course of business or goods that will be used or consumed in the production of goods to be sold. They are mainly divided into two major categories:

- ✓ Inventories of merchandising businesses
- ✓ Inventories of manufacturing businesses

Source of Inventories

Inventories include:

- ✓ Goods on hand ready for sale.
- ✓ Goods in the process of production.
- ✓ Goods to be consumed directly or indirectly in production such as raw materials, purchased parts, and supplies.

In auditing the purchases, cost of sales and cash disbursements system and related balances, the auditor must be concerned with verification of transaction validity, existence, ownership, cutoff, valuation and appropriate statement presentation. The primary asset accounts associated with the cost of sales system are inventories.

Audit of cost of goods sold can be directly tied to the audit of inventory. If beginning and ending inventories have been verified and acquisitions have been tested, cost of goods sold

can be directly calculated. Auditor should also apply analytic to cost of goods sold to see if there are any significant variations - either overall or by product line.

Special significance of Audit of Inventories

The audit of inventory is quite complex and time consuming part for the following reasons:

1. Inventory is generally a major item on the balance sheet and it is often the largest item making up the accounts included in the working capital. I.e., inventories often represent the largest current asset of a company.
2. The inventory may be in different locations, which makes physical counting difficult. I.e., determining the quantities of inventories may require specialized techniques.
3. The diversity of items in inventory creates another difficulty for auditors.
4. The valuation of inventory is also difficult due to such factors as obsolescence and the need to allocated manufacturing costs to inventories. I.e., the valuation of goods on hand and in process often presents complex and difficult issues.
5. There are several acceptable inventory valuation methods but any given client must apply a method consistently from year to year.
6. Misstatements of inventories directly affect cost of goods sold and, therefore, net income.
7. Management fraud has often involved the fraudulent overstatement of inventories.

Risks of Material Misstatements

i. Inventories constitute a large asset and are very susceptible to major errors and fraud.
ii. The accounting profession allows numerous alternative methods for valuation of inventories, and different methods may be used for various classes of inventories.
iii. The determination of inventory value directly affects the cost of goods sold and has a major impact on net income for the year.
iv. The determination of inventory quality, condition, and value is inherently a more complex and difficult task than is the case with most other elements of financial position.

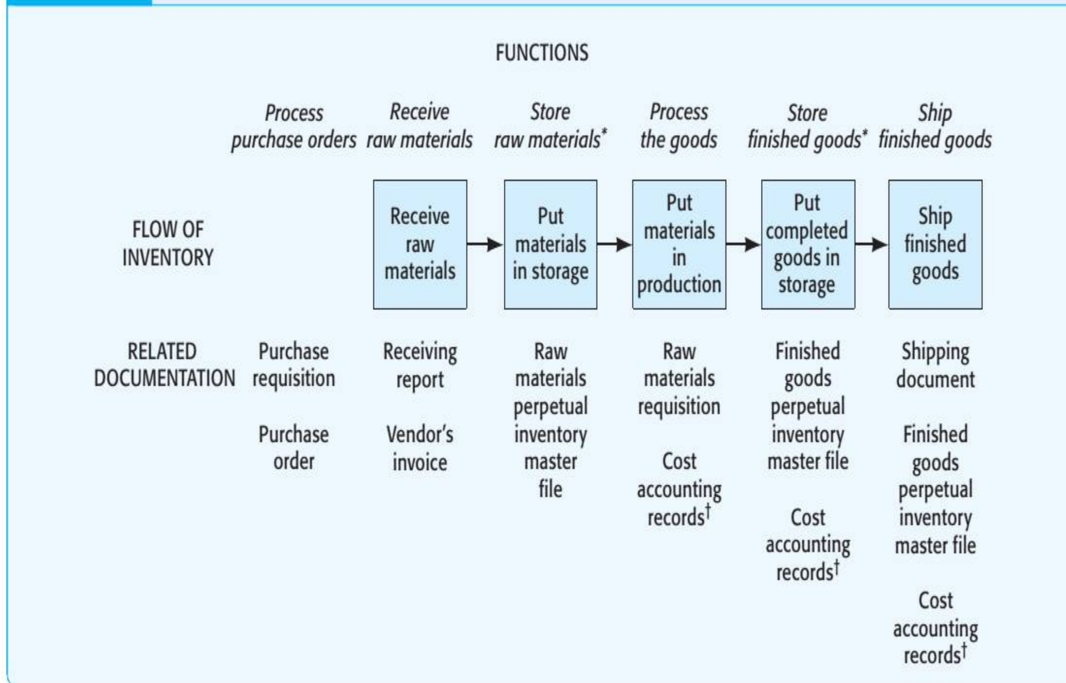
4.2 Functions making up the Inventory and Warehousing Cycle

Inventory takes many different forms, depending on the nature of the business. For retail or wholesale businesses, the largest account in the financial statements is often merchandise inventory available for sale. To study the inventory and warehousing cycle, we will use an example of a manufacturing company, whose inventory may include raw materials, purchased parts and supplies for use in production, goods in the process of being manufactured, and finished goods available for sale. Still, most of the principles discussed apply to other types of businesses as well.

The inventory and warehousing cycle can be thought of as comprising two separate but closely related systems, one involving the *physical flow of goods* and the other the *related costs*. Six functions make up the inventory and warehousing cycle. Each of these is discussed next.

1. ***Process Purchase Orders***
2. ***Receive Raw Materials***
3. ***Store Raw Materials***
4. ***Process the Goods***
5. ***Store Finished Goods***
6. ***Ship Finished Goods***

The following figure shows the above six functions in the inventory and warehousing cycle and below the figure brief discussions have been made for each function.



*Inventory counts are taken and compared with perpetual and book amounts at any stage of the cycle. The auditor must determine that cutoff for recording documents corresponds to the physical location of the items. A count must ordinarily be taken once a year. If the perpetual inventory system is operating well, this can be done on a cycle basis throughout the year.
†Includes cost information for materials, direct labor, and overhead.

1. Process Purchase Orders

The inventory and warehousing cycle begins with the acquisition of raw materials for production. Adequate controls over purchasing must be maintained whether inventory purchases are raw materials for a manufacturer or finished goods for a retailer. Purchase requisitions are forms used to request the purchasing department to order inventory. These requisitions may be initiated by stockroom personnel as raw materials are needed, by automated computer software when raw materials reach a predetermined level, by orders placed for the materials required to produce a customer order, or by orders initiated on the basis of a periodic raw materials count.

2. Receive Raw Materials

Receipt of the ordered materials, which is also part of the acquisition and payment cycle, involves the inspection of material received for quantity and quality. The receiving department prepares a receiving report that becomes a part of the documentation before payment is made. After inspection, the material is sent to the storeroom and copies of the receiving documents, or electronic notifications of the receipt of goods, are typically sent to

purchasing, the storeroom, and accounts payable. Control and accountability are necessary for all transfers.

3. **Store Raw Materials**

Once received, materials are normally stored in a storeroom. When another department needs materials for production, personnel submit a properly approved materials requisition, work order, or similar document or electronic notice that indicates the type and quantity of materials needed. This requisition document is used to update the perpetual inventory master files and record transfers from raw materials to work in process accounts. These updates occur automatically in organizations with integrated inventory management and accounting software systems.

4. **Process the Goods**

Processing inventory varies greatly from company to company. Companies determine the finished goods items and quantities they will produce based on specific orders from customers, sales forecasts, predetermined finished goods inventory levels, and economical production runs. A separate production control department is often responsible for determining the type and quantities to produce.

An adequate cost accounting system is an important part of the processing of goods function for all manufacturing companies. The system shows the relative profitability of the products for management planning and control and values inventories for preparing financial statements. Two primary types of cost systems exist: job cost systems and process cost systems, but there are many variations and combinations of these systems.

Cost accounting records consist of master files, spreadsheets, and reports that accumulate material, labour, and overhead costs by job or process as those costs are incurred. When jobs or products are completed, the related costs are transferred from work-in-process to finished goods based on production department reports.

5. **Store Finished Goods**

When finished goods are completed, they are placed in the stockroom to await shipment. In companies with good internal controls, finished goods are kept under physical control in a separate, limited-access area. The control of finished goods is often considered part of the sales and collection cycle.

6. **Ship Finished Goods**

Shipping completed goods is part of the sales and collection cycle. The actual shipment of goods to customers in exchange for cash or other assets, such as accounts receivable, creates

the exchange of assets necessary for meeting revenue recognition criteria. For most sales transactions, the actual shipment becomes the trigger for recognizing the related accounts receivable and sales in the accounting system. Thus, shipments of finished goods must be authorized by a properly approved shipping document.

4.3 Audit objectives for Inventories/Cost of Sales

1. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to inventories and cost of goods sold.
2. Obtain an understanding of internal control over inventories and cost of goods sold.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that:
   a. Substantiate the ***existence*** of inventories and the ***occurrence*** of transactions affecting cost of goods sold.
   b. Establish the ***completeness*** of recorded inventories.
   c. Verify the ***cutoff*** of transactions affecting cost of goods sold.
   d. Determine that the client has ***rights*** to the recorded inventories.
   e. Establish the proper ***valuation*** of inventories and the ***accuracy*** of transactions affecting cost of goods sold.
   f. Determine that the ***presentation*** and ***disclosure*** of information about inventories and cost of goods sold are appropriate, including disclosure of the classification of inventories, accounting methods used, and inventories **pledged** as **collatera**l for debt.

4.4 Audit Program for Inventories/Cost of Sales

The auditor needs to design an appropriate audit program for inventories/cost of sales as follows.

(I) Internal Control Consideration- Tests of Controls (Verification of Transaction validity)

The primary objective of an auditor is to verify effectiveness of internal of the client to enhance efficient and effective utilization of inventory. The auditor depends primarily on the reliability of the system of internal control in judging whether inventory, cost of sales and cash disbursement transactions have been appropriately recorded, classified and accumulated in the accounting records.

During the preliminary study and evaluation of the system of internal controls, the reliability of the system can be evaluated in general by verifying the extent to which it included the desirable internal control characteristics. If selected controls are found to be weak, related substantive tests over inventory and related accounts should be expanded.

Internal Control over inventory includes

- Documentation of authorization and approval procedures
- Appropriate separation of responsibilities
- Safeguarding assets and records: Inventory Balances

a. Documentation of authorization and approval procedures

The more important procedures for inventory and cost of sales require that:

1. A properly approved purchase requisition be originated as the first document in support of materials acquisition.
2. Purchase orders, originated in response to properly approved purchase requisitions, be sequentially numbered and a procedure be established to account for the use of each of the purchase order forms.
3. Debit memos, issued in connection with purchase returns and allowances, be sequentially numbered and controlled in the same manner as are purchase orders.
4. Sequentially numbered vouchers be prepared and properly approved in support of all cash disbursements. When a check is issued against a properly approved voucher, the voucher should be cancelled by being stamped "paid" and should be initialed by the person signing the check in payment of it.
5. A voucher register be maintained to record all approved vouchers.
6. Properly controlled, sequentially numbered receiving report forms be used to acknowledge receipt of goods from vendors.
7. Job order cost sheets or cost of production reports be used to account for goods in the process of being manufactured.
8. Subsidiary perpetual inventory records be maintained for raw materials and finished goods.
9. Bills of material or raw material requisitions be used to account for materials issued into production.
10. Properly controlled, sequentially numbered paychecks be used to pay all employees.

b. Appropriate separation of responsibilities

The appropriate separation of responsibilities should be checked by making inquiries, observing procedures, and examining policy and procedures manuals. This requires that many functions be assigned to different employees to protect resources and provide reliable financial data, as follows:

1. Persons preparing and approving the vouchers for payment should have no other responsibilities relating to cash payments.
2. The person authorized to sign checks should have no responsibilities relating to the preparation of vouchers and should have no access to cash receipts or the cash records.
3. The authority to borrow should be separated from the cash handling transactions.
4. The stores ledger clerk should not have access to the store room or to the handling of inventory items.
5. The various authorization and approval functions associated with payments of accounts should be divided among a number of different persons.
6. Persons having a responsibility for the purchase of goods or services should have no access to cash.

c. Safeguarding assets and records: Inventory Balances

All assets and records associated with the cost of sales system should be appropriately protected from physical loss or alteration. This requires that:

1. All payments be made by use of pre-numbered checks.
2. The inventory storage areas should be fitted to the goods stored in them.
3. Inventory records should be stored so as to protect them from damage or alteration.

(II) Substantive Audit Procedures for Inventories/Cost of Sales

Perform following **Substantive procedures** for inventories/cost of goods sold.

1. Obtain listings of inventory and reconcile to ledgers.
2. Evaluate the client's planning of physical inventory.
3. Observe the taking of physical inventory and make test counts.
4. Review the year-end cutoff of purchases and sales transactions.
5. Obtain a copy of the completed physical inventory, test its clerical accuracy, and trace test counts.
6. Evaluate the bases and methods of inventory pricing.

7. Test the pricing of inventories.
8. Perform analytical procedures.
9. Determine whether any inventories have been pledged and review purchase and sales commitments.
10. Evaluate financial statement presentation of inventories and cost of goods sold, including the adequacy of disclosure.

Summary of Major Substantive Tests of Inventories

Substantive Test	Preliminary Audit Objectives
Obtain listings of inventory and reconcile to ledgers	Clerical Accuracy
Evaluate the client's planning of physical inventory Observe the taking of the physical inventory	Existence and rights Completeness Valuation
Review the year end cut-off of purchase and sales transactions Obtain a copy of the completed physical inventory and test its accuracy	Existence and rights Completeness Clerical accuracy
Evaluate the bases and methods of inventory pricing	Valuation
Determine whether any inventories have been pledged and review commitments	Valuation Presentation and disclosure
Evaluate financial statement presentation and disclosure	Presentation and disclosure

4.5 Verification of Inventories

1. Verification of Existence: Inventory Balance

Auditors must observe the client taking a physical inventory count to determine whether recorded inventory actually exists at the balance sheet date and is correctly counted by the client. ***Physical examination is an essential type of evidence used to verify the existence and count of inventory***

When inventories exist and are material to the financial statements taken as a whole the auditor must generally be present to observe and to take some test counts when the client physically counts the inventory.

Observation of inventory ordinarily begins with an inspection of the client's physical inventory instructions. To making this inspection, the auditor should be alert for weaknesses that could allow particular elements of the inventory to be counted twice or possibly be omitted during the inventory taking process.

In some situations it may be impossible or impracticable for the auditor to observe and test count inventories at the balance sheet date. In these situations, if the client has maintained proper perpetual records, the auditor may still be able to verify the existence of year-end inventories by the use of alternative procedures. These procedures must be performed as soon as possible after the balance sheet date and include the following:

1. Review of client inventory instructions.
2. Inquiry of the client as to how counts were made.
3. Inspection of physical inventory records, noting that the proper procedures were performed and adjustment were made where necessary.
4. Test counting of selected items, tracing the movement of inventories back through the perpetual records by use of issue slips and receiving reports, and then reconciling the resultant calculations with amounts shown on the perpetual records as of the balance sheet date.

2. Verification of Valuation: Inventory Balance

The verification of inventory valuation generally begins when the auditor investigates the valuation method used by the client. The auditor must then determine whether that method produces, within the limits of materiality, a valuation that is in accordance either with one of the generally accepted cost-flow assumptions or with the lower of cost or market valuation procedures.

Specifically, the investigation of inventory valuation (pricing) often will emphasize the following questions:

i. What method of pricing (costing) does the client use? Inventories should be priced in accordance either with one of the generally accepted cost-flow assumptions (FIFO, LIFO, and Weighted Average) or with the lower of cost or market valuation (LCM) procedures.
ii. Is the method of pricing the same as that used in prior years?
iii. Has the method selected by the client been applied consistently and accurately in practice?

The auditor will then, on a test basis, inspect the values assigned to various inventory items. The cost assigned to inventories should be the invoice cost less cash discounts taken. In verifying the valuation of work in process and finished goods inventories, it is important for the auditor to inspect the supporting records found within the cost accounting subsystem.

If the client is a retail store, the valuation involves vouching not only the unit cost of goods but also the retail price. During the observation of inventory it is important for the auditor to give special attention to inventory items that may be damaged, shopworn or obsolete. Slow moving (obsolete) items are most likely to be discovered by examining the perpetual inventory records.

3. Verification of Ownership of inventory: Inventory Balance

The verification of ownership requires the auditor to inspect, on test basis, the documents underlying to the acquisition of individual inventory items including ***purchase orders, receiving reports and vender invoices.*** With respect to consigned goods, the auditor should inquire about them and secure an ***inventory representation letter stating that such goods have been excluded from the inventory accounts.*** He or she can then examine the final inventory listing to verify that such goods have, in fact, been excluded from inventories.

4. Verification of cut off (Periodicity): Inventory Balance

Cut off errors occur near the beginning or end of the audit period when entries involving the acquisition or disposal of merchandise are included as transactions in the wrong period. In verifying proper cutoff the auditor must inspect the underlying documents relating to both purchases and sales made near the end of the period under audit and during the first few days of the succeeding period. This procedure is performed to determine that the transaction has been recorded in the proper period and that he client held legal title to the goods as of the balance sheet date. Ordinarily, merchandise acquisitions should be recorded at the date the title to the goods passes to the purchaser, i.e., the FOB shipping point.

5. Verification of Statement Presentation

The verification of statement presentation primarily involves seeing that the disclosure requirement relating to inventory has been met. The auditor must inquire of the client as to whether any part of the inventory has been pledged as security against creditor claims. If so, the auditor must ascertain that the amount of the pledged inventory has been appropriately disclosed in the balance sheet. It is also necessary for the financial statement to disclose the method used in valuing the inventory. Furthermore, in case of manufacturing firm, appropriate distinction should be made between inventories of raw materials, work in process and finished goods.

End of Chapter Notes!

CHAPTER 5

5. AUDIT OF PROPERTY, PLANT AND EQUIPMENT

Chapter Outline

- Comparison of Audit of Fixed Assets with Audit of Current Assets
- Objectives for the Audit of Property, Plant and Equipment
- Internal Control over Fixed Assets
- Audit Program for Property, Plant and Equipment and Related Accounts
- Tests in the Audit of Fixed Assets

Introduction

Property, plant and equipment are tangible assets with a service life of more than one year that are used in the operation of the business and are not acquired for the purpose of resale. The primary accounting record for property, plant, and equipment accounts is generally a fixed asset master file.

Property, plant and equipment are also known as plant assets, fixed assets or tangible assets. Three major subgroups of property, plant and equipment are:

- ✓ Land
- ✓ Buildings, machinery, equipment and land improvements
- ✓ Natural resources

5.1 Comparison of Audit of Fixed Assets with Audit of Current Assets

In many companies (especially in industrial firms), the investment in plant, property and equipment amounts to 50 percent or more of the total assets. However, the audit required to verify these properties is usually a ***much smaller proportion of the total audit time spent on the engagement***. Auditors verify equipment differently from current asset accounts for three reasons:

1. There are usually fewer current period acquisitions of equipment (little change in property and equipment account from year to year), especially in manufacturing firms. The equipment is likely to be kept and maintained in the accounting records for several years.
    - For example, the Land account often remains unchanged for a long span of years. The durable nature of building and equipment also tend to hold

accounting activity to a minimum for these accounts. In contrast, such current assets as accounts receivable and inventory may have a complete turnover several times a year.

2. The amount of any given acquisitions is often material.

- A typical unit of property and equipment has a high dollar value, and few transactions may lie behind a large balance sheet amounts.

3. Year-end Cut-off transaction in fixed assets is less.

- For current assets the year end cut-off is a critical issue. However, it is almost non-existent for plant assets. An error in the cut-off of a $50,000 purchases or sales transaction may cause a $50,000 error in year –end pre-tax income. For plant assets, on the other hand, a year end cut-off error in recording an acquisition or retirement ordinarily will not affect net income for the year.

Audit Approach—Current Accounts Versus Noncurrent Account

Assets	Liabilities & Equity	
Cash Securities Accounts Receivable Inventories	Accrued Liabilities Accounts Payable Short-Term Notes	High turnover accounts Audit approach—audit the balance
Property, Plant & Equipment Intangible Assets	Long-Term Liabilities Owner's Equity Accounts	Low turnover accounts Audit approach—audit the changes in the accounts

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5.2 Objectives for the Audit of Property, Plant and Equipment

1. To use the understanding of the client and its environment to consider *inherent risk*, including fraud risks, related to property, plant, and equipment.
2. To obtain an understanding of *internal control* over property, plant, and equipment.
3. To assess the risks of material misstatement and design tests of controls and substantive procedures that:
   a. Substantiate the **existence** of property, plant, and equipment.
   b. Establish the **completeness** of recorded property, plant, and equipment.

c. Verify the **cutoff** of transactions affecting property, plant, and equipment.
d. Determine that the client has **rights** to recorded property, plant, and equipment.
e. Establish the proper **valuation** or **allocation** of property, plant, and equipment and the **accuracy** of transactions affecting property, plant, and equipment.
f. Determine that the **presentation** and **disclosure** of property, plant, and equipment are appropriate

5.3 Internal Control over Fixed Assets

Importance of fixed assets audit arises from the following facts:

a. The amount of capital investment in fixed assets represents a large portion of total assets (especially in industrial companies).
b. Maintenance and depreciation of these assets are major expense in the income statements.

Therefore, the total expenditure for these assets and related expenses make strong internal control essential to the preparation of reliable financial statements.

- Errors in measurement of income may be material if the distinction between capital and revenue expenditure is not maintained consistently.
- The losses that arise from uncontrolled method of acquisition, and retiring fixed assets are often greater than losses from fraud of cash handling.

Common Internal controls: Companies need to apply the following internal control over fixed assets.

a. Acquisition and retirement of fixed assets must be based on plan/budget.
b. There must be proper recording of acquisition and disposal of fixed assets.
c. Maintain a subsidiary ledger for each unit of fixed asset (e.g. separate ledger for equipment, another for machinery, furniture, etc).
d. Acquisition and disposals of fixed assets must be approved by concerned higher management.
e. Any variance between authorized expenditure and actual costs must be disclosed, reported and analysis for the cause for the variance must be investigated.
f. There must be company policy that distinguishes between capital expenditure and revenue expenditure.
g. Receipt of purchased fixed asset should be made with proper inspection and goods receiving report must be issued to suppliers.

h. Periodic physical inventory must be undertaken in order to ascertain existence, location and condition of all fixed assets.
i. There must be a system of retirement procedure stating reasons for retirement and bearing appropriate approval.

5.4 Audit Program for Property, Plant and Equipment and Related Accounts

The auditor's program for plant asses audit includes the following.

(I) Internal Control consideration—tests of controls

- Obtain an understanding of client's internal control
  - Preliminary review
  - System documentation
  - Transaction walk-through
  - Determine whether controls are potentially reliable in assessing control risk below maximum
- Physically inspect sampled fixed assets
- Review adequacy insurance coverage
- Inquire about the nature of training to a select sample of personnel (Inquiry)
- Observe property management actions in process (Observation)
- Review documentation showing completion of the training (Inspection of documentation)

(II) Substantive Audit Procedures for property, plant, and equipment

1. Obtain a summary analysis of changes in property owned and reconcile to ledgers.
2. Vouch additions to property, plant, and equipment during the year.
3. Make a physical inspection of major acquisitions of plant and equipment.
4. Analyze repair and maintenance expense accounts.
5. Investigate the status of property, plant, and equipment not in current use.
6. Test the client's provision for depreciation.
7. Investigate potential impairments of property, plant, and equipment.
8. Investigate retirements of property, plant, and equipment during the year.
9. Examine evidence of legal ownership of property, plant, and equipment.

10. Review rental revenue from land, buildings, and equipment owned by the client but leased to others.
11. Examine lease agreements on property, plant, and equipment leased to and from others.
12. Perform analytical procedures for property, plant, and equipment.
13. Evaluate financial statement presentation and disclosures for plant assets and for related revenue and expenses.

(III) Audit of Plant Asset Related Accounts

1) Analyze Repairs and Maintenance Expense Accounts

Analyze repairs and maintenance expense accounts to:

   a. Discover items that should have been capitalized
   b. Use company policy to determine consistency in application
   c. Analyze monthly amounts for significant variations from:
      i. Month to month
      ii. Between corresponding months of two years

2) Auditors' Approach for Depreciation

The auditor should audit depreciation because it is an estimate that needs due consideration.

- Client makes
  - Estimate of useful economic life
  - Choice of several depreciation methods
- Audit approach for estimate
  - Review and test management's process of developing the estimate
  - Review subsequent events or transactions bearing on the estimate
  - Independently develop an estimate of the amount to compare to management's estimate

3) Audit Program – Depreciation

- Review the depreciation policies set forth in company manuals or other management directives. Determine whether the methods in use are designed to allocate costs of plant and equipment assets systematically over their service lives.
- Obtain or prepare a summary analysis of accumulated depreciation for the major property classifications as shown by the general ledger control accounts, listing

beginning balances, provisions for depreciation during the year, retirements, and ending balances.

- Test the provisions for depreciation.
- Test deductions from accumulated depreciation for assets retired.
- Perform analytical procedures for depreciation.
- Overall test

5.5 Tests in the Audit of Fixed Assets

Although the approach to verifying equipment differs from that used for current assets, several other asset accounts are verified in much the same manner. These include patents, copyrights, and all property, plant, and equipment accounts. In the audit of equipment and related accounts, it is helpful to separate the tests into the following categories:

1. Perform analytical procedures
2. Verify current year acquisitions
3. Verify current year disposals
4. Verify the ending balance in the asset account
5. Verify depreciation expense
6. Verify the ending balance in accumulated depreciation

Next, let's examine the use of these categories of tests in the audit of equipment, depreciation expense, accumulated depreciation, and gain or loss on disposal accounts.

1. Perform Analytical Procedures

This involves the comparison of relationship among financial and non-financial data. This is used to assess whether account balances or other data appear reasonable.

Examples:

- Compare gross profit margin of this year with last year.
- Compare amount of payable of this year (month) with last year (month).
- Compare current year's repair expense with previous year's repair expense and investigate the cause for any difference.

The purpose of analytical procedure is to investigate the cause for any unusual or unrealistic deviation (difference) among (between) data.

As in all audit areas, the type of analytical procedures depends on the nature of the client's operations. The following Table illustrates analytical procedures often performed for equipment.

Analytical Procedure	Possible Misstatement
Compare depreciation expense divided by gross equipment cost with previous years.	Misstatement in depreciation expense and accumulated depreciation
Compare accumulated depreciation divided by gross equipment cost with previous years.	Misstatement in accumulated depreciation
Compare monthly or annual repairs and maintenance expense, small tools expense, and similar accounts with previous years.	Expensing amounts that should be capitalized
Compare gross manufacturing cost divided by some measure of production with previous years	Idle equipment or equipment that was disposed of but not written off.

As you can see, most of the typical analytical procedures assess the likelihood of material misstatements in depreciation expense and accumulated depreciation.

2. Verify Current Year Acquisitions

Companies must correctly record current year additions because the assets have long-term effects on the financial statements. For example, failure to capitalize a fixed asset (recording fixed asset cost as expenses) affects balance sheet and income statement.

a. Understates assets in the balance sheet.
b. Overstates current period's operating expenses and understates income of the period. On the other hand depreciation expenses of the subsequent years will be understated thereby overstates income of the years.

Because of the importance of current period acquisitions in the audit of equipment, auditors use seven of the eight balance-related audit objectives as a frame of reference for tests of details of balances: ***existence, completeness, accuracy, classification, cut-off, detail tie-in, and rights and obligations (Realizable value is discussed in connection with verifying ending balances.) The balance-related audit objectives and common audit tests are shown in the following table Existence, completeness, accuracy, classification, and rights are usually the major objectives for this part of the audit.***

As in all other audit areas, the actual audit tests and sample size depend heavily on tolerable misstatement, inherent risk, and assessed control risk. Tolerable misstatement is important for verifying current year additions because these transactions vary from immaterial amounts in some years to a large number of significant acquisitions in others.

Balance-Related Audit Objectives and Tests of Details of Balances for Equipment Additions

Balance Related Audit Objective	Common Tests of Details of Balances Procedures	Comments
Current year acquisitions in the acquisitions schedule agree with related master file amounts and the total agrees with the general ledger (detail tie-in).	Foot the acquisitions schedule. Trace the individual acquisitions to the master file for amounts and descriptions. Trace the total to the general ledger.	Footing the acquisitions schedule and tracing individual acquisitions should be limited unless controls are deficient. All increases in the general ledger balance for the year should reconcile to the schedule.
Current year acquisitions as listed exist (existence).	Examine vendors' invoices and receiving reports. Physically examine assets.	It is uncommon to physically examine assets acquired unless controls are deficient or amounts are material.
Existing acquisitions are recorded (completeness).	Examine vendors' invoices of closely related accounts such as repairs and maintenance to uncover items that should be recorded as equipment.	This objective is one of the most important for equipment.
Current year acquisitions as listed are accurate (accuracy).	Examine vendors' invoices.	Extent depends on inherent risk and effectiveness of internal controls.
Current year acquisitions as listed are correctly classified (classification).	Examine vendors' invoices in various equipment accounts to uncover items that should be office equipment, part of the buildings, classified as manufacturing or repairs. Examine vendors' invoices of closely related accounts such as repairs to uncover items that should be recorded as equipment. Examine rent and lease expense for capitalizable leases.	The objective is closely related to tests for completeness. It is done in conjunction with that objective and tests for accuracy.
Current year acquisitions are recorded in the correct period (cutoff).	Review transactions near the balance sheet date for correct period.	Usually done as part of accounts payable cut-off tests.
The client has rights to current year acquisitions (rights).	Examine vendors' invoices.	Ordinarily the main concern is whether equipment is owned or leased. Purchase or lease contracts are examined for equipment and property deeds, abstracts, and tax bills are frequently examined for land or major buildings.

The starting point for the verification of current year acquisitions is normally a schedule obtained from the client of all acquisitions recorded in the general ledger property, plant, and equipment accounts during the year. A typical schedule lists each addition separately and includes the date of the acquisition, vendor, description, notation of whether it is new or used, life of the asset for depreciation purposes, depreciation method, and cost.

Sample Plant Assets Master File (Schedule)

S.No	**Description**	**Date of Acquisition**	**Supplier**	**Estimated Life**	**Cost**	**Method of Dep.**	**Remark (New/ Used)**
1	Equipment						
2	Machinery						

3. Verify Current Year Disposals

Transactions involving the disposal of equipment are often misstated when company internal controls lack a formal method to inform management of the sale, trade-in, abandonment, or theft of recorded machinery and equipment. If the client fails to record disposals, the original cost of the equipment account will be overstated indefinitely, and net book value will be overstated until the asset is fully depreciated.

Formal methods of tracking disposals and provisions for proper authorization of the sale or other disposal of equipment help reduce the risk of misstatement. There should also be adequate internal verification of recorded disposals to make sure that assets are correctly removed from the accounting records.

The auditor's main objectives in the verification of the sale, trade-in, or abandonment of equipment are to gather sufficient appropriate evidence that all disposals are recorded and at the correct amounts. *The starting point for verifying disposals is the client's schedule of recorded disposals.* The schedule typically includes the date when the asset was disposed of, name of the person or firm acquiring the asset, selling price, original cost, acquisition date, and accumulated depreciation.

The nature and adequacy of the controls over disposals affect the extent of the search. The following procedures are often used for verifying disposals:

- Review whether newly acquired assets replace existing assets.
- Analyze gains and losses on the disposal of assets and miscellaneous income for receipts from the disposal of assets.
- Review plant modifications and changes in product line, changes in major costly computer-related equipment, property taxes, or insurance coverage for indications of deletions of equipment.

- Make inquiries of management and production personnel about the possibility of the disposal of assets.

When an asset is sold or disposed of without having been traded in for a replacement asset, the *accuracy* of the transaction can be verified by examining the related sales invoice and property master file. The auditor should compare the cost and accumulated depreciation in the master file with the recorded entry in the general journal and re-compute the gain or loss on the disposal of the asset for comparison with the accounting records. When *trade-in of an asset for a replacement* occurs, the auditor should be sure that the new asset is capitalized and the replaced asset correctly eliminated from the records, considering the book value of the asset traded in and the additional cost of the new asset.

4. Verify Ending Balance of Asset Account

Two of the auditor's objectives when auditing the ending balance in the equipment accounts include determining that:

1. All recorded equipment physically exists on the balance sheet date (existence)
2. All equipment owned is recorded (completeness)

When designing audit tests to meet these objectives, auditors first consider the nature of internal controls over equipment or assess the control risk (Examine the effectiveness of internal control) and following audit programs:

1. Typically, the first audit step concerns the detail tie-in objective-equipment, as listed in the master file, agrees with the general ledger..
2. Based on the auditor's assessment of control risk for the completeness objective, the auditor ***may physically examine*** a sample of major equipment items and trace them to the master file. If a physical inventory is taken, the auditor normally observes the count.
3. The auditor normally does not need to test the accuracy or classification of fixed assets recorded in prior periods because, presumably, they were verified in previous audits at the time they were acquired. But if there is an idle plant asset with material balance, the auditor should evaluate whether they should be written down to net realizable value (realizable value objective) or at least classified separately as "non-operating equipment."

4. A major consideration in verifying disclosures related to fixed assets is the possibility of *legal encumbrance (impediment)*. Auditors may use several methods to determine whether equipment is encumbered, including:
    a. Read the terms of loan and credit agreements
    b. Mail loan confirmation requests to banks and other lending institutions
    c. Have discussions with the client or send letters to legal counsel
5. The *proper presentation and disclosure* of equipment in the financial statements must be evaluated carefully to make sure that accounting standards are followed. Equipment should include the gross cost and should ordinarily be separated from other fixed assets. Leased property should also be disclosed separately, and all liens on property must be included in the footnotes. Auditors must perform sufficient tests to verify that all presentation and disclosure objectives are met.

5. Verify Depreciation Expense

Depreciation expense is one of the few expense accounts not verified as part of tests of controls and substantive tests of transactions. The recorded amounts are determined by *internal allocations* rather than by exchange transactions with outside parties. When depreciation expense is material, more tests of details of depreciation expense are required than for an account that has already been verified through tests of controls and substantive tests of transactions.

The most important balance-related audit objective for depreciation expense is *accuracy*. Auditors focus on determining whether the client followed a *consistent depreciation policy* from period to period, and the client's *calculations are correct*. In determining the former, auditors must weigh four considerations:

1. The useful life of current period acquisitions
2. The method of depreciation
3. The estimated salvage value
4. The policy of depreciating assets in the year of acquisition and disposition

The client's policies can be determined by discussions with appropriate personnel and comparing their responses with information in the auditor's permanent files. In deciding on the reasonableness of the useful lives assigned to newly acquired assets, the auditor must consider the physical life of the asset, the expected life (taking in to account obsolescence or the company's normal policy of upgrading equipment), and established company policies on trading in equipment.

A useful method of auditing depreciation is an analytical procedures test of reasonableness made by multiplying un-depreciated fixed assets by the depreciation rate for the year. In making these calculations, the auditor must make adjustments for current year additions and disposals, assets with different lengths of life, and assets with different methods of depreciation.

Because accounting standards require footnote disclosures related to fixed asset depreciation, including disclosure of depreciation methods and related useful lives by asset class, auditors perform procedures to obtain evidence that the presentation and disclosure-related audit objectives for depreciation are satisfied. For example, auditors compare information obtained through audit tests of the depreciation expense accounts to information disclosed in footnotes to ensure the information presented is consistent with the actual method and assumptions used to calculate and record depreciation.

6. Verify Ending Balance in Accumulated Depreciation

The debits to accumulated depreciation are normally tested as a part of the audit of disposals of assets, while the credits are verified as a part of depreciation expense. If the auditor traces selected transactions to the accumulated depreciation records in the property master file as a part of these tests, then little additional testing should be required for the ending balance in accumulated depreciation.

Two objectives are usually emphasized in the audit of the ending balance in accumulated depreciation:

1. Accumulated depreciation as stated in the property master file agrees with the general ledger. This objective can be satisfied by test-footing the accumulated depreciation in the property master file and tracing the total to the general ledger.
2. Accumulated depreciation in the master file is accurate.

In some cases, the life of equipment may be significantly reduced because of reductions in customer demands for products, unexpected physical deterioration, a modification in operations, or other changes. Because of these possibilities, auditors must evaluate the adequacy of the allowances for accumulated depreciation each year to make sure that the net book value does not exceed the realizable value of the assets.

End of Chapter Notes!

CHAPTER 6

6. AUDIT OF CURRENT LIABILITIES

Chapter Outline

- ➢ Meaning and Sources of Current liabilities
- ➢ Objectives for the Audit of Accounts Payable and Purchases
- ➢ Important Issues related to the Acquisition and Payment Cycle
- ➢ Audit Program for Accounts Payable
- ➢ Audit Procedures for Other Current liabilities
- ➢ Methodology for test of Controls and Substantive test of transactions
- ➢ Methodology for tests of detail of Balances of Accounts Payable

6.1 Meaning and Sources of Current liabilities

Current liabilities are liabilities or the obligations that a company reasonably expects to liquidate either through the use of current assets or the creation of other current liabilities. This concept includes:

- ✓ Payables resulting from the acquisition of goods and services: accounts payable, wages payable, taxes payable, and so on.
- ✓ Collections received in advance for the delivery of goods or performance of services, such as unearned rent revenue or unearned subscriptions revenue.
- ✓ Other liabilities whose liquidation will take place within the operating cycle, such as the portion of long-term bonds to be paid in the current period or short-term obligations arising from purchase of equipment.

Sources of Accounts Payable

- ➢ Short-term obligations arising from purchase of goods and services in ordinary course of business; examples:
  - – Acquisition of merchandise on credit.
  - – Receipt of services such as advertising, repairs, etc.
- ➢ Invoices and statements from suppliers usually evidence accounts payable
  - ❑ Interest-bearing obligations are not included in accounts payable; they are included as bonds, notes, etc.

Sources of Accrued Liabilities

- ❑ **Accrued liabilities**
  - ✓ Sometimes called **accrued expenses**

- **Examples:** Salaries, interest, rent, etc.
  - ✓ Accumulate over time and management must make accounting estimate at year-end.

- Note that if management does not make such an estimate, no entry will occur since the related transactions (e.g., interest) may have occurred months ago.

6.2 Objectives for the Audit of Accounts Payable and Purchases

1. Use the understanding of the client and its environment to consider ***inherent risk***, including **fraud risks**, related to accounts payable.
2. Obtain an understanding of ***internal control*** over accounts payable.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that:
   a. Substantiate the ***existence*** of accounts payable and the client's ***obligation*** to pay these liabilities and establish the ***occurrence*** of purchase transactions.
   b. Establish the ***completeness*** of recorded accounts payable.
   c. Verify the ***cutoff*** of transactions affecting accounts payable.
   d. Establish the proper ***valuation*** of accounts payable and the ***accuracy*** of purchase transactions.
   e. Determine that the ***presentation and disclosure*** of accounts payable are appropriate.

6.3 Important Issues related to the Acquisition and Payment Cycle

The acquisition of goods and services includes the acquisition of such things as merchandise, raw materials, equipment, supplies, utilities, repairs and maintenance, and research and development. The acquisition and payment cycle involves the decisions and processes necessary for obtaining the goods and services for operating a business. The cycle typically begins with the initiation of a purchase requisition by an authorized employee who needs the goods or services, and it ends with payment on accounts payable.

The objective in the audit of the acquisition and payment cycle is to evaluate whether the accounts affected by the acquisitions of goods and services and the cash disbursements for those acquisitions are fairly presented in accordance with accounting standards

A. Acquisition Cycle Documents

- Purchase order

- Receiving report
- Vendor's invoice
- Vendor's statement

B. Transactions in the Acquisition and Payment Cycle

- Acquisitions of goods and services
- Cash disbursements
- Purchase returns and allowances
- Purchase discounts

C. Business Functions and related Documents

The functions in the acquisition and payment cycle include:

1. Processing Purchase Orders
2. Receiving Goods and Services
3. Recognizing the Liability
4. Processing and Recording Cash Disbursements

Processing Purchase Orders

a. A **purchase requisition** is used to request goods and services by an authorized employee. This may take the form of a request for such acquisitions as materials by production staff or the storeroom supervisor, outside repairs by office or plant personnel, or insurance by the vice president in charge of property and equipment.

b. A **purchase order** is a document used to order goods and services from vendors. It includes the description, quantity, and related information for goods and services the company intends to purchase and is often used to indicate authorization of the acquisition.

Receiving Goods and Services

The receipt by the company of goods or services from the vendor is a critical point in the cycle because it is when most companies first recognize the acquisition and related liability on their records. When goods are received, adequate control requires examination for description, quantity, timely arrival, and condition. A **receiving report** is a paper or electronic document prepared at the time goods are received. It includes a description of the goods, the quantity received, the date received, and other relevant data.

Recognizing the Liability

The proper recognition of the liability for the receipt of goods and services requires *prompt and accurate* recording. The initial recording affects the financial statements and the actual cash disbursement; therefore, companies must take care to include all acquisition transactions, only acquisitions that occurred, and at the correct amounts. Common documents and records include:

a. **Vendor's Invoice:** A **vendor's invoice** is a document received from the vendor and shows the amount owed for an acquisition.
b. **Debit Memo:** A **debit memo** is also a document received from the vendor and indicates a reduction in the amount owed to a vendor because of returned goods or an allowance granted.
c. **Voucher:** A **voucher** is commonly used by organizations to establish a formal means of recording and controlling acquisitions, primarily by enabling each acquisition transaction to be sequentially numbered.
d. **Acquisitions Journal or Listing:** The **acquisitions journal** or listing, often referred to as the purchases journal, is generated from the acquisitions transaction file.
e. **Accounts Payable Master File:** An **accounts payable master file** records acquisitions, cash disbursements, and acquisition returns and allowances transactions for each vendor. The master file is updated from the acquisition, returns and allowances, and cash disbursement computer transaction files. The total of the individual account balances in the master file equals the total balance of accounts payable in the general ledger.
f. **Accounts Payable Trial Balance:** An **accounts payable trial balance** listing includes the amount owed to each vendor or for each invoice or voucher at a point in time. It is prepared directly from the accounts payable master file.

Processing and Recording Cash Disbursements

The payment for goods and services represents a significant activity for all entities. This activity directly reduces balances in liability accounts, particularly accounts payable. Documents associated with the disbursement process that auditors examine include:

a. Check payment Voucher: This document is commonly used to pay for the acquisition when payment is due. Vouches are typically prepared in a multi-copy format, with the

original going to the payee, one copy filed with the vendor's invoice and other supporting documents, and another filed numerically.

b. **Check in response to the approved Check payment voucher**

c. **Cash Disbursements Journal or Listing** This is a listing or report generated from the cash disbursements transaction file that includes all transactions for any time period.

D. Risks of Material Misstatements

- o Subsidiary records not in agreement with general ledger
- o Receiving reports and vouchers used haphazardly
- o Purchase transactions often not recorded until payment is made
- o Many accounts payable long past due
- Risks such as these indicate the need for extensive substantive procedures

E. Controls against misstatements

- o Independent employee reconciles sub ledger to general ledger
- o Serially numbered receiving reports and vouchers are prepared
- o Immediately recorded in accounting records
- o Payments made promptly on due dates

F. Controls over the Acquisition Cycle

- Segregation of duties - purchases and disbursements
- Approval of purchase orders
- Approval of vendors' invoices
- Numerical control of purchase orders and receiving reports
- Matching of details of vendors' invoices to purchase orders and receiving documents
- Use of pre-numbered checks
- Use of budgets and analysis of variances
- Use of chart of accounts and review of account coding
- Reconciliation of details of individual disbursements to controlling accounts
- Reconciliation of vendors' statements to accounts
- Reconciliation of bank accounts

6.4 Audit Program for Accounts Payable

(I) Internal Control consideration- tests of controls

1. Examples of tests of controls.
   i. Verify a sample of postings to the accounts payable control account.
   ii. Vouch to supporting documents a sample of postings in selected accounts of the accounts payable subsidiary ledger.
   iii. Test IT application controls.
2. If necessary, revise the risks of material misstatement based on the results of tests of controls.

(II) Perform further audit procedures - substantive procedures for accounts payable

a. Obtain or prepare a trial balance of accounts payable as of the balance sheet date and reconcile with the general ledger.
b. Vouch balances payable to selected creditors by inspection of supporting documents.
c. Reconcile liabilities with monthly statements from creditors.
d. Confirm accounts payable by direct correspondence with vendors.
e. Perform analytical procedures for accounts payable and related accounts.
f. Search for unrecorded accounts payable.
g. Perform procedures to identify accounts payable to related parties.
h. Evaluate proper balance sheet presentation and disclosure of accounts payable.

6.5 Audit Procedures for Other Current liabilities

a) Amounts Withheld from Employees' pay

These are income taxes withheld from employees' pay but not remitted as of balance sheet date.

- ❖ Trace amounts withheld to payroll summary sheets.
- ❖ Test computations of taxes withheld and accrued.
- ❖ Determine that taxes have been deposited in accordance with law.

b) Sales Tax payable

Companies are required to collect sales tax imposed by state and local governments. The amounts collected are not an expense, but liabilities until remitted.

- ❖ Verify liability by reviewing tax return.

- Test reasonableness of amount.
- Test invoices for correct tax charge.

c) Unclaimed wages/salaries

Unclaimed wages are untaken wages for various reasons. They are subject to misappropriation.

- Concerned with adequacy of internal control
  - ✓ Should not be left for more than a few days.
  - ✓ Prompt deposit in special bank account.
- Analyze unclaimed wages to determine
  - ✓ Credit represents all unclaimed wages after each payroll distribution.
  - ✓ Debit represents authorized payments.

d) Customers' Deposits

Customer deposits refer to deposits on returnable containers or to guarantee payment of bills.

- Review procedures followed in accepting and returning deposits.
- Verify list of individual deposits and compare to general ledger account.

e) Accrued Liabilities/Accrued expenses

Accrued liabilities are obligations payable sometime during the succeeding period for services or privileges received before balance sheet date.

- ✓ **Examples:** Interest payable, Accrued property taxes, Accrued Payrolls, Pension Plan Accruals, Post-employment Benefits other than Pensions, Accrued Vacation Pay, Product Warranty Liabilities, Accrued Commission and Bonuses, Income Tax Payable, Accrued Professional Fees, etc.

- Accounting estimates
  - Review and test management's process of developing the estimate
  - Review subsequent events
  - Independently develop estimate to compare

Accrued Liabilities- Basic audit steps:

1. Examine any contracts or other documents on hand that provide the basis for the accrual.
2. Appraise the accuracy of the detailed accounting records maintained for this category of liability.
3. Identify and evaluate the reasonableness of the assumptions made that underlie the computation of the liability.
4. Test the computations made by the client in setting up the accrual.
5. Determine that accrued liabilities have been treated consistently at the beginning and end of the period.
6. Consider the need for accrual of other liabilities not presently considered (that is, test completeness).
7. For significant estimates, perform a retrospective analysis of the prior year's estimates for evidence of management bias.

6.6 Methodology for test of Controls and Substantive test of transactions

In a typical audit, the most time-consuming accounts to verify by substantive tests of details of balances are accounts receivable, inventory, fixed assets, accounts payable, and expense accounts. Notice that four of these five are directly related to the acquisition and payment cycle. If the auditor can reduce tests of details of the account balances by using tests of controls and substantive tests of transactions to verify the effectiveness of internal controls for acquisitions and cash disbursements, the net time saved can be dramatic. Tests of controls and substantive tests of transactions for the acquisition and payment cycle receive a considerable amount of attention, especially when the client has effective internal controls.

The following table summarizes key internal controls, common tests of controls, and common substantive tests of transactions for each transaction-related audit objective. We assume the existence of a separate acquisitions journal or listing for recording all acquisitions. As you examine the table you should:

- Relate each of the internal controls to transaction-related audit objectives
- Relate tests of controls to internal controls
- Relate substantive tests of transactions to transaction-related audit objectives after considering controls and deficiencies in the system.

Table 6.1: Summary of Transaction-Related Audit Objectives, Key Controls, Tests of Controls, and Substantive Tests of Transactions for Acquisitions

Transaction-Related Audit Objectives	Key Internal Controls	Common Tests of Controls	Common Substantive Tests of Transactions
Recorded acquisitions are for goods and services received, consistent with the best interests of the client (**occurrence**).	1. Purchase requisition, purchase order, receiving report and vendor's invoice are attached to the voucher. 2. Acquisitions are approved at the proper level. 3. Vendors' invoices, receiving reports, purchase order and purchase requisitions are internally verified.	1. Examine documents in voucher package for existence. 2. Examine indication of approval. 3. Examine indication of internal verification.	1. Review the acquisitions journal, general ledger, and accounts payable master file for large or unusual amounts. 2. Examine underlying documents for reasonableness and authenticity (vendors' invoices, receiving reports purchase orders, and purchase requisitions). 3. Trace inventory acquisitions to inventory master file.
Existing acquisition transactions are recorded (**completeness**).	1. Purchase orders are pre-numbered and accounted for. 2. Receiving reports are pre-numbered and accounted for. 3. Vouchers are pre-numbered and accounted for.	1. Account for a sequence of purchase orders. 2. Account for a sequence of receiving reports. 3. Account for a sequence of vouchers.	1. Trace from a file of receiving reports to the acquisitions journal. 2. Trace from a file of vendors invoices to the acquisitions journal.
Recorded acquisition transactions are accurate (**accuracy**).	1. Calculations and amounts are internally verified. 2. Acquisitions are approved for prices and discounts.	1. Examine indication of internal verification. 2. Examine indication of approval.	1. Compare recorded transactions in the acquisitions journal with the vendor's invoice receiving report, and other supporting documentation. 2. Re-compute the clerical accuracy on the vendor's invoice, including discounts and freight.

Acquisition transactions are correctly classified (**classification**)	1. An adequate chart of accounts is used. 2. Account classifications are internally verified.	1. Examine procedures manual and chart of accounts, 2. Examine indication of internal verification.	1. Compare classification with chart of accounts by referring to vendors' invoices.
Acquisition transactions are recorded on the correct dates (**timing**).	Procedures require recording transactions as soon as possible after the goods and services have been received. Dates are internally verified.	Examine procedures manual and observe whether unrecorded vendors invoices exist. Examine indication of internal verification.	Compare dates of receiving reports and vendors' invoices with dates in the acquisitions journal.

6.7 Methodology for tests of detail of Balances of Accounts Payable

Because all acquisition and payment cycle transactions typically flow through accounts payable, this account is critical to any audit of the acquisition and payment cycle. Accounts payable are *unpaid obligations* for goods and services received in the ordinary course of business. Accounts payable include obligations for the acquisition of raw materials, equipment, utilities, repairs, and many other types of goods and services that were received before the end of the year. Most accounts payable can also be identified by the existence of vendors' invoices for the obligation. Accounts payable should be distinguished from accrued liabilities and interest bearing obligations.

If tests of controls and related substantive tests of transactions show that controls are operating effectively, and if analytical procedures results are satisfactory, the auditor is likely to reduce tests of details of balances for accounts payable. However, because accounts payable tend to be material for most companies, auditors almost always perform some tests of details of balances. The following table summarizes the balance-related audit objectives and common tests of details of balances procedures for accounts payable. The auditor's actual audit procedures vary considerably depending on the nature of the entity, the materiality of accounts payable, the nature and effectiveness of internal controls, and inherent risk.

As auditors perform test of details of balances for accounts payable and other liability accounts they may also gather evidence about the presentation and disclosure objectives, especially when performing completeness objective tests.

Table 6.2: Balance-Related Audit Objectives and Tests of Details of Balances for Accounts Payable

Balance-Related Audit Objective	Common Tests of Details of Balances Procedures	Comments
1. Accounts payable in the account payable list agree with related master file, and the total is correctly added and agrees with the general ledger (**detail tie-in**).	1. Re-add or use the computer to total the accounts payable list. 2. Trace the total to the general ledger. 3. Trace individual vendors' invoices to master file for names and amounts.	1. All pages need not ordinarily be footed if footing manually. 2. Unless controls are deficient, tracing to master file should be limited.
2. Accounts payable in the accounts payable list exist (**existence**).	1. Trace from accounts payable list to invoices and statements. 2. Confirm accounts payable, emphasizing large and unusual amounts.	Ordinarily receives little attention because the primary concern is with understatements.
3. Existing accounts payable are in the accounts payable list (**completeness**).	Perform out-of-period liability tests.	These are essential audit tests for accounts payable.
4. Accounts payable in the accounts list are accurate (**accuracy**).	Perform same procedures as those used for existence objective and out-of-period liability tests.	Ordinarily, the emphasis in these procedures for accuracy is understatement rather than Omission.
5. Accounts payable in the accounts list are correctly classified (**classification**).	1. Review the list and master file for related parties, notes or other interest-bearing liabilities, long-term payables, and debit balances.	Knowledge of the client's business is essential for these tests.
6. Transactions in the acquisition and payment cycle are recorded in the proper period (**cutoff**).	1. Perform out-of-period liability tests. 2. Perform detailed tests as part of physical observation of inventory. 3. Test for inventory in transit.	These are essential audit tests for accounts payable. These are called *cutoff tests.*
7. The company has an obligation to pay the liabilities included in accounts payable (**obligations**).	Examine vendors' statements and confirm accounts payable.	Normally not a concern in the audit of accounts payable because all accounts payable are obligations

End of Chapter Notes!

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Exercise I-20%

Part I: Multiple choices. (**1 mark each**)

1. _____________ refers to assessing the effectiveness of controls in preventing or detecting material misstatements in financial statement assertions using attribute testing.

A. Tests of control
B. Substantive testing
C. Sampling testing
D. Internal control

2. The risk that the auditor's conclusion, based on a sample, might be different from the conclusion which would be reached if the test were applied in the same way to the entire population.

A. Sampling risk
B. Non-sampling risk
C. Business risk
D. Operating risk

3. Which sampling has an ability to objectively limit the sampling risk to a quantifiable level?

A. Systematic sampling
B. Haphazard sampling
C. Judgmental sampling
D. Statistical sampling

4. Non-probabilistic sample selection methods include:

A. Simple random.
B. Probability proportionate to size.
C. Stratified sample selection.
D. All of these
E. None of these

Part II: Say 'True' if the statement is correct and 'False' if it is otherwise. (**1 mark each**)

1. As acceptable sampling risk increases, sample size increases.
2. Attributes sampling reaches a conclusion regarding rate of occurrence.
3. The risk of incorrect rejection is referred to as alpha risk.
4. As variability in population items increases, sample size increases.
5. Non-sampling risk can be controlled by adjusting sample size.
6. The lower the ARACR, the fewer the tests of detailed balances.

Part III: Essay Questions

1. In one short paragraph, explain why auditors strive for selecting representative sample. (**2 marks**)
2. Differentiate between ''the risk of assessing control risk too high'' and ''the risk of assessing control risk too low''. (**2 marks**)
3. What three phases are there in audit sampling steps? (**2 marks**)

Problem 1

Assume the following data for a hypothetical audit client operating in Adigrat town.

- Population Size = 10,000 accounts
- Book value of accounts= $625,000

Other information:

- Tolerable misstatement = $36,400
- Estimated Standard Deviation= $1.5
- Sampling risk:
  - Incorrect Acceptance = 4.6%
  - Incorrect Rejection = 1.0 %
- MPU Risk Coefficients:

Acceptable Level of Risk (%)	Incorrect Acceptance Coefficient	Incorrect Rejection Coefficient
1.0	2.33	2.58
4.6	1.68	2.00
5.0	1.64	1.96

Required:

Determine sample size. (**4 marks**)

Good luck

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Exercise II-20%

Part I: Multiple choices. (Each question carries 1.5 marks)

1. Audit procedures for cash disbursements include the following, **except**:

A. *Trace cash account totals to general ledger and trial balance*
B. *Trace amounts to signed purchase orders*
C. *Trace amounts to receipt invoices*
D. *None of these*

2. An irregularity whereby an **overstatement** of cash is created by a cash transfer between bank accounts is termed as:

A. *Lapping*
B. *Kiting*
C. *Window dressing*
D. *Skimming*

3. Ordinary and extended procedures designed to produce evidence about the ***effectiveness of the controls over cash*** are best described as:

A. *Internal controls*
B. *Audit of balances*
C. *Substantive procedures*
D. *Test of controls*

4. Identify the assertion which intends to ensure that there is no unrecorded cash during the period under audit.

A. *Existence*
B. *Completeness*
C. *Accuracy*
D. *Cut-off*

Good luck

5. Which of the following statements is **incorrect** regarding a cutoff bank statement?
   A. *It is a statement for a period of time shorter than that of regular month-end statements.*
   B. *It is sent directly to auditor, who uses it to verify reconciling items on client's year-end bank reconciliation.*
   C. *It is used to identify the list of checks returned during few days following the year-end.*
   D. *It is a statement for a period of time equal to that of regular month-end statements.*

6. The negative form of accounts receivable confirmation request is useful except when
   A. *internal control surrounding accounts receivable is considered to be effective.*
   B. *a large number of small balances are involved.*
   C. *the auditor has reason to believe the persons receiving the requests are likely to give them consideration.*
   D. *individual account balances are relatively large.*

7. Select the **incorrect** match from the list given?
   A. *Existence - Marketable securities exist at balance sheet date.*
   B. *Rights - Company has title to Marketable securities accounts as of balance sheet date.*
   C. *Allocation - Properly classifying the securities on balance sheet.*
   D. *Completeness - Securities balances include all securities transactions taken place during the period.*

8. Which of the following would most likely be detected by an auditor's review of the client's sales cutoff?
   A. *excessive goods returned for credit*
   B. *unrecorded sales discount*
   C. *lapping of year-end accounts receivable*
   D. *inflated sales for the year*

<u>Part II: Essay type questions</u>

1. Explain skimming and discuss how it is performed. (**2 marks**)

2. List at least three activities an auditor undertakes in relation to the substantive test of cash transactions and balances. (**3 marks**)

3. What primary audit objectives will be achieved when confirming receivables with debtors? (**3 marks**)

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Assignment on Audit of Debt and Equity Capital

A. Capital Acquisition and Repayment cycle

1. What are the major accounts of the capital acquisition and repayment cycle?
2. Identify the unique characteristics of the capital acquisition and repayment cycle.

B. Debt Capital

1. Mention the primary audit objectives with regard to long-term liability account balances?
2. What are the internal control mechanisms over Interest-bearing Debt.
3. Identify the audit program for Interest-bearing Debt.

B. Equity capital

1. Mention the general audit concerns for Stockholders' Equity
2. What are the internal control mechanisms for Owners' Equity.
3. Identify the major control of capital stock transactions by board of directors.
4. State the audit program for equity accounts.
5. If all other accounts have been audited with satisfactory results, is the audit of retained earnings_necessary? Explain your answer.

END!