CHAPTER 13

Substantive procedures – key financial statement figures

Learning objectives

Tick off

- Understand the nature of tests on balances carried out by assurance providers and the objectives of those tests ☐
- Identify suitable tests in a given business scenario ☐
- Understand when a matter should be referred to a senior member of staff ☐

Specific syllabus references for this chapter are: 3f, i.

Syllabus links

The results of the tests outlined here will be the basis for the drawing conclusions part of your Audit and Assurance paper.

Examination context

Questions about assurance evidence could be set in the context of any balances outlined in this chapter.

In the assessment, candidates may be required to:

- Select appropriate audit procedures for a given financial statement assertion
- Identify the features of external confirmation requests
- Identify why the results of a physical inventory count may differ from inventory records
- Identify the procedures which should be undertaken to confirm the existence of cash at bank
- Evaluate the results of audit work and identify issues that should be referred to a senior colleague

1 Non-current assets

Section overview

- Key areas when testing tangible non-current assets are:
  - Confirmation of ownership (rights and obligations)
  - Inspection of non-current assets (existence and valuation)
  - Valuation, preferably by third parties (valuation)
  - Adequacy of depreciation rates (valuation)
- Key areas when testing intangible non-current assets are:
  - Confirmation that 'assets' exist
  - Confirmation of appropriate valuation
- Key areas when testing investments are:
  - Confirmation of existence
  - Confirmation of ownership

1.1 Tangible non-current assets

You should be aware of the major classes of tangible non-current assets from your Accounting studies. Examples of tangible non-current assets include land, buildings, plant, vehicles, fittings and equipment.

The major risks of the tangible non-current asset balances in the financial statements being misstated are due to:

- The company not actually owning the assets (rights and obligations assertion)
- The assets not actually existing or having been sold by the company (existence assertion)
- Omission of assets owned by the company (completeness assertion)
- The assets being overvalued, either by inflating cost or valuation, or by undercharging depreciation (valuation assertion)
- The assets being undervalued, by not including an appropriate revaluation in a policy of revaluation or by overcharging depreciation (valuation assertion)
- The assets being incorrectly presented in the financial statements (presentation and disclosure assertion)

The objective of assurance tests in respect of non-current assets is therefore to prove that these assertions about the assets are correct. There are several sources of information about non-current assets that can be used (you should consider the strengths and weaknesses of all the sources of evidence listed in this chapter according to the criteria we set out in Chapter 11):

- The non-current asset register (which many companies maintain as a control over the assets they own)
- Purchase invoices for assets purchased within the year
- Sales invoices for assets sold within the year
- Registration documents or other documents of title such as title deeds for property
- Valuations carried out by employees or third party valuers
- Leases or hire purchase documentation in respect of assets
- Physical inspection of the assets themselves by the auditor
- Depreciation records or calculations (these are often kept with the asset register)

Worked example: Non-current asset assurance engagement

Peter is carrying out a non-current asset assurance engagement at Manufacturing Company Limited (MCL). MCL owns the property from which it operates. It has a lot of fixed plant, which it replaced three years ago, and owns several industrial vehicles for moving inventory between locations at its premises. It also owns a number of cars, which its staff have as company cars, and a great deal of office furniture, fittings and computers in the office complex attached to the factory.

Peter is concerned with concluding that the non-current assets declared in the financial statements are complete, exist, are owned by the company and are valued appropriately.

Completeness

Peter will:

- Obtain a schedule of non-current assets from the client
- Agree the figures per the schedule to the financial statements and accounting records (nominal ledger)
- Compare the schedule to the asset register to ensure that the schedule reflects all the assets owned by the company
- Select a number of assets physically present on site and ensure that they are contained in the asset register
- Confirm the additions on the schedule are correct

Existence

Peter will:

- Select a sample of assets contained in the asset register and verify that they are physically present on site

Rights and obligations

Peter will:

- Select a sample of assets in the asset register and vouch them to the registration documents available for those assets (vehicles – registration documents (although these indicate who is the 'registered keeper', who is not necessarily the owner), building – title deeds, plant and fixtures – purchase invoice, ensuring that it is not a lease)
- Review sales invoices for sold assets to ensure that ownership has been transferred

Valuation

Peter will:

- Confirm the cost or valuation of a sample of assets to purchase invoices or valuation certificates
- Confirm the brought forward depreciation levels of those assets (if relevant) to prior year audit files or by reviewing the brought forward asset register files
- Confirm the annual depreciation in respect of those assets is appropriate (by reference to the accounting policy on depreciation published in the financial statements), and correctly calculated (by recalculation or by using analytical procedures)
- Review to ensure that depreciation has been correctly calculated on disposed assets, and recalculate profit or loss on sale of those assets

Presentation and disclosure

- Peter will review the financial statements to ensure that the disclosure requirements relating to non-current assets have been met

Other matters

- Peter is likely to focus asset testing on asset additions, as these will comprise a large proportion of the cost of non-current assets as they will have been depreciated the least
- Peter will use sampling on some classes of assets and not others. For example, in this instance, property is likely to be a material balance and therefore will be vouched 100%. Other classes of assets are likely to be sampled as the overall total contains a large number of assets

Worked example: Self-constructed assets

Katie is working on the audit of Quickshop plc, a large supermarket chain. She has been allocated the audit of non-current assets. One aspect of this audit is the fact that the company has built four new superstores during the year, which have been capitalised into non-current assets. The key objectives she is working on are that all the relevant costs have been capitalised (completeness) and that the self-built stores are valued correctly at cost (valuation).

Completeness

Katie will:

- Obtain architect's certificates for the stores, certifying that the work is complete
- Obtain a schedule of all the costs capitalised into the stores; this is also likely to have been verified by the contractor, giving comfort that the costs are complete

Valuation

Katie will:

- Vouch a sample of costs to appropriate sources of evidence, for example, labour costs to payroll records or contractor bills, materials costs to purchase invoices or contractor bills, finance costs to statements from lenders (for example, bank statements)
- In respect of finance costs, Katie will review bank statements to ensure that all relevant finance costs have been included

Interactive question 1: Non-current assets

Which **three** of the following might an auditor vouch when testing the rights and obligations of a company in respect of a vehicle?

- [ ] A purchase invoice
- [ ] A registration document
- [ ] A hire-purchase agreement
- [ ] An asset register

See **Answer** at the end of this chapter.

1.2 Intangible non-current assets

Examples of intangible assets include licences, development costs and purchased brands.

The major risks of misstatement of the intangible non-current asset balances in the financial statements are due to:

- Expenses being capitalised as non-current assets inappropriately (existence assertion)
- Intangible assets being carried at the wrong cost or valuation due to inflating the cost or valuation (valuation assertion)
- Intangible assets being carried at the wrong cost or valuation due to charging inappropriate amortisation, wrongly amortising or not amortising (valuation assertion)
- Intangible assets being carried at the wrong cost or valuation due to impairment reviews not being carried out appropriately (valuation assertion)

The objective of tests in respect of intangible non-current assets is therefore to prove that these assertions about the assets are correct. The following sources of information can be used:

- Accounting standards/auditor's knowledge of accounting standards for what constitutes an intangible asset
- Purchase invoices or documentation (particularly for, say, purchased intangibles)
- Client calculations and schedules
- Specialist valuations
- Auditor understanding of the entity for signs of impairment factors

2 Inventory

Section overview

- Key areas when testing inventory are:
  - Attending an inventory count (existence)
  - Valuation at the lower of cost and net realisable value (valuation)
  - In some cases, confirmation of ownership (rights and obligations)

The major risks of misstatement of the inventory balance in the financial statements are due to:

- Inventory that does not exist being included in the financial statements (existence)
- Not all inventory that exists being included in the financial statements (completeness)
- Inventory being included in the financial statements at full value when it is obsolete or damaged (valuation)
- Inventory being included in the financial statements at the wrong value, whether due to miscalculation of cost or the fact that cost has been used although net realisable value is lower than cost (valuation)
- Inventory that actually belongs to third parties being included in the financial statements (rights and obligations)
- Inventory which has actually been sold is included in the financial statements (cut-off)

The objective of assurance tests in respect of inventory is therefore to prove that these assertions about the assets are correct. The following sources of information can be used:

- The company's controls over inventory counting
- The auditors' attendance at the annual inventory count
- Confirmations with third parties holding inventory or having inventory stored for them by the company
- Purchase invoices for inventory
- Work-in-progress records for inventory
- Post-year-end sales invoices for inventory
- Post-year-end price lists for inventory
- Post-year-end sales orders

Inventory may lend itself to analytical review as there is a relationship between inventory, revenue and purchases.

2.1 Inventory count

Attendance at an inventory count can be very important. In order to confirm the amount of inventory in existence, rather than undertake a count itself, assurance providers usually rely on the controls that a company has in operation over its inventory or its annual inventory count.

It is important that the assurance provider is satisfied that controls are such that it can be concluded that the count, or the overall inventory controls, are capable of ensuring the correct amount of inventory is reflected in the financial statements.

In terms of inventory counts, the assurance provider will be looking for the following sorts of controls.

Review of inventory count instructions	
Organisation of count	**Supervision** by senior staff, including senior staff not normally involved with inventory
	Tidying and **marking** inventory to help counting
	Restriction and **control** of the production process and inventory movements during the count
	Identification of damaged, obsolete, slow-moving, third party and **returnable** inventory
Counting	**Systematic counting** to ensure all inventory is counted
	Teams of **two counters,** with one counting and the other checking, or two **independent counts**
Recording	**Serial numbering, control** and **return** of all inventory sheets
	Inventory sheets being **completed** in **ink** and **signed**
	Information to be recorded on the **count records** (location and identity, count units, quantity counted, conditions of items, stage reached in production process)
	Recording of **quantity, conditions** and **stage of production** of **work-in-progress**
	Recording of last numbers of **goods inwards** and **outwards** records and of internal transfer records
	Reconciliation with **inventory records** and **investigation** and correction of any **differences**

Some companies have better day-to-day controls over inventories than others and many have complex systems of perpetual counting rendering an annual year-end count unnecessary. In order to rely on such

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a system of perpetual counting, the assurance provider needs to confirm that the controls over this system are strong.

If perpetual inventory counting is used, assurance providers will check that management:

(a) Ensures that all inventory lines are counted at least once a year.

(b) Maintains **adequate inventory records** that are kept up-to-date. Assurance providers may compare sales and purchase transactions with inventory movements, and carry out other tests on the inventory records, for example checking casts and classification of inventory.

(c) Has **satisfactory procedures** for **inventory counts** and **test-counting**. Assurance providers should confirm the inventory count arrangements and instructions are as rigorous as those for a year-end inventory count by reviewing instructions and observing counts. Assurance providers will be particularly concerned with **cut-off**; that there are no inventory movements whilst the count is taking place, and inventory records are updated up until the time of the inventory counts.

(d) **Investigates** and **corrects** all **material differences**. Reasons for differences should be recorded and any necessary corrective action taken. All corrections to inventory movements should be **authorised** by a manager who has not been involved in the detailed work; these procedures are necessary to guard against the possibility that inventory records may be adjusted to conceal shortages.

Audit plan: Perpetual inventory count
Attend one of the inventory counts (to observe and confirm that instructions are being adhered to)
Follow up the **inventory counts attended** to compare quantities counted by the assurance providers with the inventory records, obtaining and verifying explanations for any differences, and checking that the client has reconciled count records with book records
Review the **year's counts** to confirm the extent of counting, the treatment of discrepancies and the overall accuracy of records (if matters are not satisfactory, assurance providers will only be able to gain sufficient assurance by a full count at the year-end)
Assuming a full count is not necessary at the year-end, **compare** the **listing of inventory with the detailed inventory records**, and carry out other procedures (**cut-off, analytical review**) to gain further comfort

2.2 Cost vs NRV

Management should **compare cost and net realisable value** for each item of inventory. Where this is impracticable, the comparison may be done by group or category.

Net realisable value is likely to be less than cost when there has been:

- An **increase in costs** or a fall in selling price
- **Physical deterioration**
- **Obsolescence** of products
- A **marketing decision** to manufacture and sell products at a loss
- **Errors in production or purchasing**

For work in progress, the **ultimate selling price** should be **compared** with the **carrying value** at the year-end plus **costs** to be **incurred** after the year-end to bring work in progress to a finished state. The example below shows the test carried out to identify whether NRV is lower than cost.

Worked example: Audit of inventory

Rajeev is carrying out the audit of inventory at Icket Ltd. Icket produces various lines of tableware on behalf of high street stores. It also sells tableware to wholesalers and has a small retail outlet. Icket is not entitled to sell branded products to wholesalers and it makes approximately 10% more inventory of branded products than ordered to ensure it meets quality control standards of the stores. This 10% is therefore obsolete once sales of a line to a store are finished. Each high street store has an allocated sales manager at Icket who keeps records of what sales have been made of each line and when the line is coming to an end. One high street store customer, Argus, maintains a store of approved inventory at Icket's premises, which it calls off as required. Icket carried out an annual inventory count at the year-end.

The key issues for Rajeev when auditing inventory are:

- To ensure that obsolete inventory is not included at full cost in the financial statements
- To ascertain that inventory included in the financial statements exists and that all existing and valuable inventory is included, including the inventory held at the retail outlet
- To ensure that inventory belonging to Argus is not included in the financial statements
- To ensure that inventory is held at the appropriate value in the financial statements

Existence

Rajeev will:

- Obtain a copy of the count instructions issued to employees of Icket and review them to assess whether controls over the count appear strong enough to ensure that the correct amount of inventory will be reflected in the financial statements
- Assess the key issues arising at the count; for instance, what the high value inventory is, what the risks are (outlined above), or whether there are any specific issues that will make counting complex (not in this case)
- Plan his count attendance, including sample sizes and target inventory lines
- Attend the inventory count, at which he will carry out sample counts to ensure that the counters are counting properly, the instructions are being adhered to, procedures for obsolete and damaged inventory are being followed, Argus inventory is properly separated and noted, and to gain an overall impression of the level and state of the inventories and conclude whether the count has been carried out properly
- Trace a sample of items on the final inventory sheets back to original count documents and ensure all count documents are reflected in the final sheets

Completeness

Rajeev will:

- Follow up items sampled at the inventory count to ensure that they are included in the final inventory sheets, and therefore the financial statements
- Follow up Argus items sampled at the inventory count to ensure that they are not included in the final inventory sheets, and therefore the financial statements
- Carry out a 'cut-off' test, ensuring that year-end deliveries and sales have not been double counted or not counted (for example, by including an item in inventory and in sales, or by excluding a consignment of goods received from inventory and purchases). This will be done by selecting the goods inwards and outwards notes on either side of the year-end and tracing them to invoices, ledgers and inventory sheets to ensure they are recorded correctly

Rights and obligations

Rajeev will:

- Send a confirmation letter to Argus, asking them to confirm the level of inventory held at Icket on the year-end date
- Compare the answer to this letter to Icket's records, and, if necessary, reconcile any differences, liaising with Icket's Argus sales manager. If there are any substantial differences, this could indicate a problem with controls over this area of which Rajeev should inform a senior audit team member

Valuation

Rajeev will:

- Check that the calculations of valuation on the final inventory sheets have been made correctly
- Select samples of raw materials, work in progress and finished goods from Icket's final inventory sheets
- Ascertain the accounting policy for inventory cost from the financial statements (for example, FIFO) and confirm it is reasonable and appropriate
- Trace the cost of the raw materials sample to purchase invoices to ensure cost has been recorded correctly and on the right basis
- In addition, for work in progress and finished goods samples, ensure that an appropriate level of raw material has been costed, by reviewing production records
- Confirm labour costs allocated to work in progress and finished goods by reference to production records and payroll
- Review Icket's overhead allocation to ensure only appropriate costs are included (for example, not idle time) and perform analytical procedures comparing overhead allocation to previous years
- Compare valuation of cost for finished goods sample to post-year end selling prices, by reference to sales orders or invoices, to ensure inventory is held at the lower of cost and NRV
- Follow up items noted as obsolete or damaged at the inventory count to ensure that valuation has been appropriately adjusted to reflect NRV
- For branded goods in excess of customer requirements, ensure that valuation has been entered as zero (these goods should be identifiable from sales manager's records)

Interactive question 2: Inventory

Which **one** of the following procedures should be undertaken to confirm the existence of inventory?

☐ Attendance at inventory count
☐ Follow up of inventory count sheets to final inventory sheets
☐ Trace items of inventory to purchase invoices
☐ Cast the final inventory sheets

See **Answer** at the end of this chapter.

3 Receivables

Section overview

- Key areas when testing receivables are:
  - Confirming debt owed by customers with customers (existence, rights and obligations)
  - Confirming debt is still likely to be collected (valuation)

The major risks of misstatement of the receivables balance in the financial statements are due to:

- Debts being uncollectable (valuation)
- Debts being contested by customers (existence, rights and obligations)

The objective of assurance tests in respect of receivables is therefore to prove that these assertions about the assets are correct. The following sources of information can be used:

- Receivables ledger information
- Confirmations from customers
- Cash payments received after the year end

If the company makes a similar number of sales annually to a fairly established customer base then analytical procedures may give good results.

3.1 Confirmations from customers

When it is reasonable to expect customers to respond, the assurance providers should ordinarily plan to obtain direct confirmation of receivables to individual entries in an account balance. Direct confirmation of receivables in an audit is covered by ISA (UK) 505 *External Confirmations*. External confirmations are not compulsory in an audit of financial statements.

The verification of trade receivables by external confirmation is a means of providing relevant and reliable audit evidence to satisfy the objective of checking whether customers exist and owe *bona fide* amounts to the company (**existence** and **rights and obligations**).

Confirmation should take place immediately after the year end and hence cover the year end balances to be included in the statement of financial position. If this is not possible it may be acceptable to carry out the confirmation **prior to the year end** provided that the auditor obtains further evidence relating to the remainder of the period.

Confirmation is essentially an act of the **client**, who alone can authorise third parties to divulge information to the auditor. If the client refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to management's reasons for the refusal and evaluate the implications on the auditor's risk assessment. Alternative audit procedures must be performed. If these do not generate relevant and reliable audit evidence or the auditor concludes that management's refusal is unreasonable, the auditor must communicate with those charged with governance and determine the implications for the auditor's opinion.

When confirmation is undertaken the method of requesting information from the customer may be either 'positive' or 'negative'.

- Under the **positive** method the customer is requested to give the balance or to confirm the accuracy of the balance shown or state in what respect he is in disagreement.

- Under the **negative** method the customer is requested to reply only if the amount stated is disputed. This method generally provides less reliable audit evidence than the positive method as a lack of response could mean that the customer does not dispute the balance, or it could mean that the customer did not receive the confirmation request, or ignored it.

The positive method is generally preferable as it is designed to encourage definite replies from those contacted. The risk that customers might reply without actually confirming the balance can be mitigated by not providing the balance for confirmation and requesting that the customer fills the balance in. However, this approach can lead to a lower response rate as it involves more work on the part of the customer. The negative method should only be used when:

- Assessed risk of material misstatement is low
- The relevant controls are operating effectively
- A large number of small balances is involved
- A substantial number of errors is not expected
- The auditor has no reason to believe that customers will disregard the request

The statements will normally be prepared by the client's staff, from which point the assurance providers, as a safeguard against the possibility of fraudulent manipulation, must maintain strict control over the checking and despatch of the statements.

Precautions must also be taken to ensure that undelivered items are returned, not to the client, but to the assurance providers' own office for follow up by them.

Worked example: Positive request for confirmation with balance provided

MANUFACTURING CO LIMITED

15 South Street

London

Date

Messrs (customer)

In accordance with the request of our auditors, Messrs Arthur Daley & Co, we ask that you kindly confirm to them directly your indebtedness to us at (insert date) which, according to our records, amounted to £.......... as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter direct to our auditors in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors directly of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully,

For Manufacturing Co Limited

Reference No: ....

....

(Tear off slip)

The amount shown above is/is not * in agreement with our records as at (insert date)

Account No .... Signature ....

Date .... Title or position ....

* The position according to our records is shown overleaf.

Notes

- The letter is on the client's paper, signed by the client.
- A copy of the statement is attached (although that will not always be the case).
- The reply is sent directly to the auditor in a pre-paid envelope.

Assurance providers will normally only contact a sample of customers although it must be based upon a complete list of all customers. In addition, when constructing the sample, the following classes of account should receive special attention:

- **Old unpaid accounts**
- **Accounts written off** during the period under review
- **Accounts with credit balances**
- **Accounts settled by round sum payments**

Similarly, the following should not be overlooked:

- **Accounts with nil balances**
- **Accounts** that have been **paid** by the date of the examination

Assurance providers will have to carry out further work in relation to those receivables who:

- **Disagree** with the **balance stated** (positive and negative confirmation)
- **Do not respond** (positive confirmation only)

In the case of disagreements, where the customer balance was stated, the customer response should have identified specific amounts that are disputed.

Reasons for disagreements
There is a **dispute** between the client and the customer. The reasons for the dispute would have to be identified, and specific allowances for receivables made if appropriate against the debt.
Cut-off problems exist, because the client records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year. Cut-off testing may have to be extended.
The customer may have sent the **monies before** the year-end, but the monies were **not recorded** by the client as receipts until **after** the year-end. Detailed cut-off work may be required on receipts.
Monies received may have been posted to the **wrong account** or a cash-in-transit account. Assurance providers should check if there is evidence of other misposting. If the monies have been posted to a cash-in-transit account, assurance providers should ensure this account has been cleared promptly.
Customers who are also suppliers may **net off balances** owed and owing. Assurance providers should check that this is allowed.
Teeming and lading (**stealing** monies and **incorrectly posting** other receipts so that no particular customer is seriously in debt), is a fraud that can arise in this area. If assurance providers suspect teeming and lading has occurred, detailed testing will be required on cash receipts, particularly on prompt posting of cash receipts.

When the positive request method is used the assurance providers must follow up by all practicable means those customers who **fail to respond**. Second requests should be sent out in the event of no reply being received within two or three weeks and if necessary this may be followed by telephoning the customer, with the client's permission.

After two, or even three, attempts to obtain confirmation, a list of the outstanding items will normally be passed to a responsible company official, preferably independent of the sales accounting department, who will arrange for them to be investigated.

Where their confirmation is carried out before the year end, assurance providers will have to reconcile the balance agreed to the year-end balance by reviewing ledger records, invoices and receipts.

All confirmations, regardless of timing, must be properly recorded and evaluated. All **balance disagreements** and **non replies** must be **followed up** and their effect on total receivables evaluated.

Differences arising that merely represent **invoices** or **cash in transit** (normal timing differences) generally do not require adjustment, but disputed amounts, and errors by the client, may indicate that further substantive work is necessary to determine whether material adjustments are required.

3.2 Alternative procedures to verify existence/rights and obligations

If it proves impossible to get confirmations from individual customers, alternative procedures must be performed which may include the following.

Plan: Receivables – alternative procedures
Check receipt of cash after date
Verify valid purchase orders, although these will not necessarily have led to an invoice
Examine the account to see if the balance outstanding represents specific invoices and **confirm** their **validity** to despatch notes
Obtain explanations for **invoices remaining unpaid** after subsequent ones have been paid
Check if the **balance** on the account is **growing**, and if so, why
Test company's control over the issue of **credit notes** and the **write-off of irrecoverable receivables**

3.3 Irrecoverable receivables

A significant test of irrecoverable receivables will be reviewing the **cash received after** date. This will provide evidence of collectability of debts (and hence **valuation**). It also provides some evidence of correctness of title (**rights and obligations**), although ideally it should be carried out as well as a receivables confirmation (the main test on rights and obligations as outlined above).

3.4 Other receivables

A company may also have other receivables, such as royalties. It should be possible to verify such items to third party evidence, such as correspondence from the relevant partner, or by cash received after date.

Worked example: Audit of receivables

Sajeeda is working on the audit of General Stationery plc (GSP), a company that sells a large range of standard stationery items to businesses by mail order. GSP has a large receivables ledger. Although GSP has many established clients, it also receives a number of one-off or short-term customers, as some companies tend to shop around for the best deals on stationery at the time. GSP's controls over new customers and sales orders are good in principle, but controls testing has revealed weaknesses in their operation. In addition, some problems with goods despatch and invoicing were also discovered during controls testing. It has been concluded that substantial tests of detail are required in this area with quite a large sample of customer accounts being taken.

The major risks of misstatement of GSP's receivables balance arise from:

- Customers disputing the balances due to requested credits and general problems with recording sales on customer accounts
- There being a high instance of irrecoverable receivables

Completeness

Sajeeda will:

- Obtain a listing of receivables, and ensure that it casts correctly and agrees with the receivables balance in the financial statements and the sales ledger control account total in the nominal ledger
- Check a sample of customers on the list against the individual sales ledger accounts

Rights and obligations/existence

Sajeeda will:

- Select a sample of receivables balances and carry out confirmation procedures at the year end, using the positive approach, providing a statement of the customer's account
- Follow up replies appropriately depending on their content

Valuation

Sajeeda will:

- Obtain an analysis of aged debt at the year end from receivables ledger records and review it for debt in excess of GSP's published credit terms
- Carry out an analysis of after-date receipts to observe whether any old debt remains outstanding at audit date
- If so, collate a list of old debt as yet unpaid and compare the results of any confirmation replies that are covered by the list
- Cross-refer her list to any list of debt written off in the financial statements
- Discuss old debts not written off with the credit controller to see what steps GSP has taken to recover the debt

- Consider whether any of the debt requires writing off in the financial statements. This amount should be entered on a list of potential adjustments. If material, it should be referred to senior audit team members

It is the middle of the final audit visit to GSP. Sajeeda has received 54 out of 56 replies to her confirmation requests. Of these replies, 30 agree the balance stated and 24 dispute the balance. Customers who have not yet replied have been sent three reminders each.

Sajeeda will:

- Pass the two outstanding requests to a senior official unconnected with sales for further follow up
- Perform reconciliations on the 24 disputed balances, using the information given on the reply and the information available in the sales and receipts records of GSP

Of the 24 disputes, Sajeeda finds that 10 relate to timing differences with regard to receipts. She confirms that all of these receipts clear GSP's bank within reasonable time after the year end by checking the paying in records and bank statements. She can conclude that these 10 accounts are fairly stated.

The remaining 14 have differences resulting from requested credits, for damaged goods (some going back over six months), for invoices in relation to which there were no goods delivered and for invoices relating to different customers.

Sajeeda will:

- Discuss the requested credits with the appropriate sales manager to determine why credits have not been issued and form an opinion as to whether these debts and related sales may need writing off
- Trace invoices disputed due to lack of goods delivered, try and trace back to despatch notes to ascertain whether GSP states the goods were delivered and form an opinion as to whether these debts and related sales may need writing off
- Consider the implications in terms of inventory movements if goods are being invoiced but not delivered – is inventory overstated; is a fraud being carried out where goods are being stolen?
- Refer to copy invoices to confirm whether invoices were in fact sent to the wrong customers. These errors, while indicating a lack of control over invoicing, do not affect the overall total of receivables, as they are genuine sales to other customers

Sajeeda should:

- Highlight to senior audit team members that substantive testing has confirmed conclusions that controls in the area have been ineffective and proved that there is a problem with the receivables balance, and that the sample may have to be extended and further substantive tests carried out in this area

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Interactive question 3: Audit of receivables

Which one of the following procedures should be undertaken to confirm the rights and obligations of trade receivables?

☐ Review of cash received after date
☐ Tests of controls over ordering
☐ Receivables external confirmation
☐ Recalculation of specific allowance for doubtful debts

See **Answer** at the end of this chapter.

4 Bank

Section overview

- Key areas when testing the statement of financial position bank figure are:
  - Confirming bank balances directly with the bank (existence, valuation, rights and obligations)
  - Confirming reconciling differences calculated by the client are reasonable (completeness, valuation)
  - Confirming any material cash balances held at the client are correctly stated (valuation)

The major risks of misstatement of the bank and cash balance in the financial statements are due to:

- Not all bank balances owned by the client being disclosed (rights and obligations/existence)
- Reconciliation differences between bank balance and cash book balance being misstated (valuation)
- Material cash floats being omitted or misstated (completeness/existence)

The objective of tests in respect of bank is therefore to prove that these assertions about the assets are correct. The following sources of information can be used:

- Cash book
- Confirmation from the bank
- Bank statements
- Bank reconciliation carried out by the client

4.1 Direct confirmation with bank

Testing of bank balances will need to cover **completeness, existence, rights and obligations and valuation.** All of these elements can be tested directly through the device of obtaining third party confirmations from the client's banks and reconciling these with the accounting records, having regard to cut off. The assurance providers should update details of bank accounts held.

The form and content of a confirmation request letter (bank letter) will depend on the purpose for which it is required and on local practices.

The most commonly requested information is in respect of balances due to or from the client entity on **current, deposit, loan and other accounts.** The request letter should provide the account description number and the type of currency for the account.

It may also be advisable to request information about **nil balances** on accounts, and accounts which were closed in the twelve months prior to the chosen confirmation date. The client entity may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

The client entity and its assurance providers are likely to request confirmation of **contingent liabilities,** such as those arising on guarantees, comfort letters, bills and so on.

Banks often hold **securities** and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the confirming bank.

The procedure is simple but important.

(a) The banks will require **explicit written authority** from their client to disclose the information requested.

(b) The **assurance providers' request** must **refer** to the **client's letter** of authority and the date thereof. Alternatively it may be countersigned by the client or it may be accompanied by a specific letter of authority.

(c) In the case of joint accounts, **letters of authority** signed by all **parties** will be necessary.

(d) Such **letters** of **authority** may either **give permission** to the bank to disclose information for a specific request or grant permission for an indeterminate length of time.

(e) The request should **reach** the **branch manager** at least **two weeks in advance** of the client's **year-end** and should state both that year-end date and the previous year-end date.

(f) The **assurance providers** should themselves **check** that the bank response covers all the information in the standard and other responses.

4.2 Bank reconciliation

Care must be taken to ensure that there is no **window dressing**, by checking **cut off** carefully. Window dressing in this context is usually manifested as an attempt to overstate the liquidity of the company by:

(a) Keeping the cash book open to take credit for **remittances actually received** after the year-end, thus enhancing the balance at bank and reducing receivables, as cash is more liquid than debt.

(b) **Recording cheques paid** in the period under review which are not actually despatched until after the year-end, thus decreasing the balance at bank and reducing payables. This can contrive to present an artificially healthy looking current ratio.

With the possibility of (a) above in mind, where lodgements have not been cleared by the bank until the new period, the **assurance providers** should **examine the paying in slip** to ensure that the amounts were actually paid into the bank on or before the end of the reporting period.

As regards (b) above, where there appears to be a particularly **large number of outstanding cheques** at the year-end, the **assurance providers** should check whether these were **cleared within** a **reasonable time** in the new period. If not, this may indicate that despatch occurred after the year-end.

4.3 Cash count

Planning is an essential element of cash counts, for it is an important principle that all cash balances are counted at the same time as far as possible. Cash in this context may include unbanked cheques received, IOUs and credit card slips, in addition to notes and coins. Often such cash balances are unlikely to be material, but in certain businesses they may be.

As part of their planning procedures the **assurance providers** will hence need to determine the **locations** where cash is held and which of these locations (if any) warrant a count.

Planning decisions will need to be recorded on the current audit file including:

- The **precise time** of the count(s) and location(s)
- The **names** of the **audit staff** conducting the counts
- The **names** of the **client staff** intending to be present at each location

Where a location is not visited it may be expedient to obtain a letter from the client confirming the balance.

The following matters apply to the count itself.

- All cash/petty **cash books** should be **written up** to date in ink (or other permanent form) at the time of the count.
- All **balances** must be **counted** at the **same time.**
- At **no time** should the **assurance providers** be left **alone** with the cash and negotiable securities.
- **All cash counted** must be **recorded** on working papers subsequently filed on the current audit file. Reconciliations should be prepared where applicable (for example imprest petty cash float).

Worked example: Audit of bank

Tracey is working on the audit of the bank reconciliation at IT Limited (ITL), a computer systems company. She has obtained the following bank reconciliation.

BANK RECONCILIATION AT 31 DECEMBER 20X6

	£	£
Balance per bank statement		79,938
Less unpresented cheques		
Cheque number		
13539	(24,933)	
13540	(54,388)	
13542	(64,420)	
13543	(3,492)	
13544	(1,849)	
13545	(53,944)	
13546	(940)	
		(203,966)
		(124,028)
Bal c/f		(124,028)
Add outstanding lodgements		
Date in cash book		
27.12	355	
28.12	103,344	
31.12	39,455	
31.12	5,301	
		148,455
Balance per financial statements		24,427

The bank letter confirmed the balance per bank given in the bank reconciliation.

Tracey will:

- Trace unpresented cheques to bank statements after the year end to confirm what date they cleared the bank
- Review paying in books and bank statements in respect of the lodgements, to see what date they were paid into the bank
- Enquire why a substantial lodgement remained unbanked for three days prior to the year end

Interactive question 4: Bank balance

Which **one** of the following will be confirmed by obtaining a bank letter from a specific bank?

☐ That the bank balance stated on the bank reconciliation is correct.
☐ That the unpresented cheques listed on the bank reconciliation were sent out pre year-end.
☐ That the company possesses only the bank accounts it declares.
☐ That the cash floats of the company are fairly stated.

See **Answer** at the end of this chapter.

5 Payables

Section overview

- Key areas when testing payables are:
  - Ensuring that all liabilities are included (completeness)
  - Confirming that all liabilities are *bona fide* owed by the company (rights and obligations)

The major risks of misstatements of payables in the financial statements are due to:

- The entity understating its liabilities in the financial statements (completeness)
- Cut-off between goods inward and liability recording being incorrect (cut-off)
- (More rarely) non-existent liabilities being declared (existence, rights and obligations)

The objective of tests in respect of payables is therefore to prove that these assertions about the liabilities are correct. The following sources of information can be used:

- Payables ledger records
- Confirmations from suppliers

Analytical procedures could point to understatement if the account balance is inexplicably reduced from previous years.

5.1 Supplier statements

The most important test when considering **trade payables** is comparison of suppliers' statements with payables ledger balances.

When selecting a sample of payables to test, assurance providers must be careful not just to select suppliers with large year-end balances. Remember, it is errors of **understatement** that assurance providers are primarily interested in when reviewing payables, and errors of understatement could occur equally in payables with low or nil balances as with high.

When comparing **supplier statements** with **year-end payables ledger balances**, assurance providers should include within their sample payables with nil or negative **payables ledger** balances. Assurance providers should be particularly wary of low balances with major suppliers. Remember the client has no incentive to record liabilities before being invoiced. The sample should be selected from the client's list of suppliers, not the payables ledger.

You may be wondering, as we normally carry out a circularisation confirmation of receivables, whether we would also circularise suppliers. The answer is generally no.

The principal reason for this lies in the nature of the purchases cycle: third party evidence in the form of suppliers' invoices and, even more significantly, **suppliers' statements**, are part of the standard documentation of the cycle. The assurance providers will hence concentrate on these documents when designing and conducting their tests.

In the following circumstances the assurance providers may, however, determine that a confirmation is necessary. In these cases confirmation requests should be sent out and processed in a similar way to accounts receivable confirmation requests. 'Positive' replies will be required where:

- **Suppliers' statements** are, for whatever reason, **unavailable** or **incomplete**.
- **Weaknesses in internal control** or the nature of the client's business make possible a material misstatement of liabilities that would not otherwise be picked up.
- It is thought that the **client** is **deliberately** trying to **understate payables**.
- The **accounts** appear to be **irregular** or if the nature or size of balances or transactions is abnormal.

5.2 Other payables/accrued expenses

Companies may have other **payables** and the tests carried out on them will vary according to what the nature of that account is. Remember that you are primarily testing for understatement. Consider whether you can obtain third party evidence about the balance. You may have to think laterally about the specific balance.

An **accrual** is a type of payable, and is made when an expense has been incurred in the current period, but will not be paid for until the next period. Typically, an accrual is made when a company not only has not paid for the item, but has not even received an invoice at the period end. In order to include these expenses the company draws up a list of accruals. Examples of accruals include recurring items, such as utility expenses and bank interest, as well as one-offs such as the audit fee.

The amount of some accruals may be known precisely, but in some cases the amount to accrue has to be **estimated**. In cases where the invoice covers a period straddling the year end, it may be necessary to **prorate** an expense, ie to accrue for only the proportion of the expense which falls before the period end (eg the two months of a three-month phone bill which relates to the reporting period).

The audit of accruals focuses primarily on **cut-off** and **completeness**. Here, cut-off means that the amount accrued relates to the reporting period, eg that two months of the three-month phone bill have been accrued (up to the period end) rather than two and half months, which would be inaccurate. Cut-off can therefore be **tested** by the auditor making her own estimate of the accrual and comparing this with the amount accrued by the entity.

Completeness means that no accruals have been missed. This can be **tested** by reviewing the entity's purchase invoices received after the period end. Any invoices which relate to the reporting period should be accrued for.

Worked example: Audit of payables

Ugo is working on the audit of payables at Seriously Dodgy Limited (SDL). He has carried out analytical procedures on the payables balance, comparing it with prior years, month by month balance owing levels, levels of purchases during the year and the change in inventory levels from beginning to end of the year.

Ugo has enquired about obtaining supplier statements at the year-end, and the **payables ledger** clerk has directed him to a file where they are kept. She tells him that not all the suppliers send statements, so they only reconcile the ones they get. Ugo confirms this with the audit file from the previous year. On examination of the file, however, Ugo notes that at least three suppliers which sent statements last year have apparently not sent statements this year. In addition, SDL has started major accounts with three new suppliers in the year, none of which has sent a statement.

As a result of this, and the results of his analytical procedures, which indicate that there may be a discrepancy between the level of purchases and the published payables at the year end, he suspects that SDL may be trying to understate payables.

Ugo therefore alerts senior audit staff members to his suspicions and makes a recommendation that a supplier circularisation be carried out as a one-off exercise.

Interactive question 5: Audit of payables

Indicate whether the following statements are true or false.

	True	False
(a) Supplier statements are a strong source of evidence as they are third party evidence, however, as the assurance provider receives them through the medium of the client, the assurance provider must treat supplier statements with professional scepticism.	☐	☐
(b) Payables may be tested by cash payments after date as these give an indication that debts were owed and the value of those debts has not been understated.	☐	☐

See **Answer** at the end of this chapter.

6 Long-term liabilities

Section overview

- **Risks include failure to make correct disclosures and miscalculation of interest.**
- **There should be third party evidence from lender.**

We are concerned here with long-term liabilities comprising debentures, loan stock and other loans **repayable** at a date **more than one year after the year-end.** The major risks of misstatement of long-term liabilities are:

- That not all long-term liabilities have been disclosed (completeness)
- That interest payable has not been calculated correctly and included in the correct accounting period (accuracy and cut-off)
- That disclosure is incorrect (presentation and disclosure)

A complication for the assurance provider is that debenture and loan agreements frequently contain conditions with which the company must comply, including restrictions on the company's total borrowings and adherence to specific borrowing ratios.

The following sources of information exist:

- Schedule of loans/prior year audit file information
- Statutory books, such as register of debentures, articles of association
- Loan agreements
- Bank letter and direct confirmations from other lenders
- Cash book
- Board minutes
- Client schedules and calculations
- Accounting policies in the financial statements

Plan: Long-term liabilities

Obtain/prepare schedule of loans outstanding at the end of the reporting period showing, for each loan: name of lender, date of loan, maturity date, interest date, interest rate, balance at the end of the period and security

Compare opening balances to previous year's working papers

Test the clerical accuracy of the analysis

Compare balances to the nominal ledger

Plan: Long-term liabilities
Check name of **lender** etc, to **register** of **debenture holders** or equivalent (if kept)
Trace additions and **repayments** to **entries** in the **cash book**
Confirm repayments are in accordance with **loan agreement**
Examine cancelled cheques and **memoranda of satisfaction** for **loans repaid**
Verify that **borrowing limits** imposed either by Articles or by other agreements are **not exceeded**
Examine signed Board minutes relating to **new borrowings/repayments**
Obtain direct confirmation from **lenders** of the amounts outstanding, accrued interest and what security they hold
Verify interest charged for the period and the adequacy of accrued interest
Confirm assets charged have been **entered** in the **register of charges** and **notified** to the **Registrar**
Review restrictive covenants and provisions relating to default: • **Review** any **correspondence** relating to the loan • **Review confirmation** replies for non-compliance • If a **default appears** to exist, **determine** its **effect**, and schedule findings
Review minutes, cash book to **check** if all **loans have been recorded**

7 Income statement items

Section overview

- A key area when testing income statement items is completeness.

7.1 Revenue

It was stated in Chapter 6 that revenue will often be tested by testing controls. Subsequent testing on revenue will usually involve analytical procedures, as revenue is the area of the business the company is most likely to have information and analysis about. In addition, revenue has predictable relationships with other items in the financial statements, notably receivables, about which it is possible to obtain strong third party evidence as outlined above.

Revenue can also be tested by vouching individual transactions. If the major risk with revenue at a particular client is that it is overstated, this would involve selecting individual items of revenue recorded in the nominal ledger and tracing back to source documents, such as sales invoice, then despatch notes.

7.2 Purchases

As noted in Chapter 7, purchases are often tested by testing controls in that area. Additional or alternative substantive procedures will often include the use of analytical procedures due to the strong relationships that purchases has with other items in financial statements, notably inventory and payables.

In addition, individual transactions can be tested, commencing with goods received notes and tracing transactions through the system to ensure completeness.

7.3 Payroll costs

Analytical procedures are often carried out on payroll costs as there are strong relationships between numbers of staff, pay rates and overall costs and also tax/NI rates and pay.

Tests of details to verify if payroll costs might include checking for a sample of payroll records that time worked has been correctly included (to clockcards), employees exist (personnel records) and are being paid at the correct rate (contracts/personnel records) and that the payroll is calculated correctly (by reperforming calculations).

Payments from the payroll to staff and tax authorities can be verified to bank statements. Postings from the payroll to the nominal ledger should also be checked.

7.4 Interest paid/received

Interest paid/received can usually be tested by inspecting bank statements, or confirmations from other lenders.

7.5 Expenses

Other expenses in the income statement can be tested by analytical procedures, and also by vouching specific transactions to purchase invoices.

7.6 Summary of matters which should be reported to more senior staff

The following table applies to any of the areas of the financial statements covered in this chapter, and gives examples of matters which should be reported to more senior staff.

Matters which should be referred to a senior member of staff
Conclusions of audit procedures performed. This is crucial if the conclusion is negative, eg that controls in the area being tested are ineffective.
Exceptional items discovered when performing procedures, eg transactions outside the normal course of business, and transactions above or below market rates.
Any **unusual** accounting entries noticed. These could be misstatements, or may be subject to different reporting requirements, eg related party transactions.
Any **indications of possible money laundering**. It may be necessary for the junior to report the matter to the firm's MLRO rather than to more senior staff.
Issues which need to be **discussed with the client**. Different firms have different norms here; in some it is usual for the junior member of staff to discuss issues with the client staff, but in others this would always be done by a senior member of staff. Junior staff should generally behave in accordance with their firm's expectations, referring matters up to senior staff as appropriate. Where the junior member of staff discusses issues directly with the client staff, the client's responses should be clearly recorded in the audit file. If these responses appear unclear or ambiguous, this should be raised and discussed with a senior member of staff.
Anything which the junior member of staff is **unsure about** or does not understand. It may not be always necessary to raise an exception on the audit file, so the matter should first be discussed with more senior staff. This is important both for the junior's professional development and also because it may be that they do not understand the matter because it contains a misstatement.

Summary

Non-current assets

Key issues:
Existence, rights and obligations, completeness, valuation

Sources of information:
Third party valuations, invoices, auditor inspection (strong)
Client schedules and calculations (not so strong)

Inventory

Key issues:
Existence, valuation

Sources of information:
Auditor attendance at count, invoices, third party confirmations (strong)
Client controls over count, client production schedules (not so strong)

Receivables

Key issues:
Rights and obligations, valuation

Sources of information:
Third party confirmations, cash payments after date (strong)

Payables

Key issue:
Completeness

Sources of information:
Supplier statements (strong, but open to tampering by client)

Bank

Key issues:
Completeness, existence, rights and obligations, valuation

Sources of information:
Confirmation from bank, bank statements (strong)
Client schedules, reconciliations (not so strong)

Long-term liabilities

Key issues:
Completeness, accuracy, disclosure

Sources of information:
Loan documentation, statutory books, confirmations from lenders (strong)
Client schedules, board minutes, client calculations (not so strong)

Income statement

Key issue:
Completeness