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COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE**



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Preface

Auditing financial statements and its sub sections include; cash and marketable securities, accounts receivable and sales, inventories and cost of goods sold, current liabilities, fixed assets, debt and equity capital. Understanding and Practicing audit is vital to the organizations, to make a decision for investors, for the academicians and for the government at large.

Hence, this module builds on the knowledge gained in Auditing II and it covers an in depth practical aspects of topics introduced in Auditing principles and practice II and brings in new concepts as well. The technical application of auditing programs and procedures for balance sheet and income statement accounts in an audit undertaking are the foremost subject matters of the module. This module includes detail about sampling in auditing, rationale for and methods of audit sampling, audit of cash and marketable Securities, receivable and sales audit , inventory and cost of goods sold audit, fixed assets audit including (property, plant & equipment), audit of current liabilities including (accounts payable & notes payable), debt and equity capital .

The general objective of the module is to equip and acquaint students the skills needed to render depth practical aspects of topics introduced in Auditing II 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.

And also to provide an opinion on the reasonableness of financial statements audit with respect to applicable criterias. And specifically, Apply knowledge of sampling methods in auditing, rationale for auditing, standards, techniques and procedures to practical situations commonly encountered relative to an opinion audit; be acquainted the principles that underlie audit of Balance Sheet and Income Statement accounts; to acquire the knowledge about the audit program and procedures of fixed asset like property, plant and equipment, depreciation, accounts payable and other liabilities(debt) and equity capital; develop audit program and procures for the audit of major accounts; and comprehend the significance of professional competence, independence, and mental integrity in the practice of accountancy; to grasp the

knowledge about internal, operational and compliance audit, audit of different organizations and to solve the real audit cases of different organizations and be committed to bringing about a prevalence of good reporting practice and contribute to the pursuit of social justice and fairness.

*To sum up, this module is written in a clear and understandable manner comprising a number of activities and self- test exercises at the end of each chapter. The activities and self -test exercises are intended to make you not to jump a topic without fully understanding it and make sure that you have done them entirely. Answer all the self- test exercises and check your progress by referring the **answers given at the back of the module** after completing each chapter*

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CHAPTER ONE

AUDIT IN SAMPLING

Definition:

Audit sampling is the application of audit procedures to less than 100% of the total population and all the items in the population have the same chance to be selected.

Sampling is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of all the items within the balance or class of transactions.

This is to ensure that the items selected represent the total population which enables the auditor to draw auditors to draw their conclusion and express their opinion based on their predetermined objective.

Audit sampling is really important because it doesn't only help auditors to gather sufficient and appropriate audit evidence to draw the audit's opinion, but also plays a very important part in the audit's work's efficiency and effectiveness. That means auditor is not required to check 100% of object or items to let them express their opinion.

To ensure that the selected items could represent the total population, the selection process and methods should not involve too much from human judgments and should be avoiding bias from auditors. They only perform their review and verification on the selected items and then express their opinion on the entire population. In general, audit sampling can be performed in two different types.

HISTORY

The Department has used sampling in its audit procedures for many years. That sampling, for the most part, has been block sampling. That is, taking a period of time and testing 100% of the records during that time. Until 1990, the Department's policy on sampling was to take 100% samples from three test months per year selected for being the high, low and average months of the year. From 1990 forward the Department has adopted other systematic or random sampling techniques.

Random sampling techniques are both convenient and accurate when performed properly, for these reasons sampling is the rule rather than the exception in most audits performed by the Department. The convenience and accuracy extends to taxpayers as well. Audits based on sampling have been challenged. When challenged we have allowed the taxpayer to present detailed information to refute the results of the sample.

PURPOSE OF AUDIT SAMPLING

Sampling is performed because it is more efficient than testing 100% of a population. In tax audits, if the taxpayer and the Department can agree on a representative sample, it can save both parties time and money. By definition, any procedure that does not examine 100% of the items in question is a sampling procedure.

Objectives of audit sampling

Audit sampling is very important part of audit works. No matter it is a financial audit, internal audit, and other kind of audit, audit sampling still needs to be used by the auditors. Audit sampling also part of the audit standards requirements and it could help auditors to meet their objective with less effort.

The following are the objectives of audit sampling:

- ❖ To gather audit evidence in order to conclude audit opinion
- ❖ To reduce the works yet audit yet still help audit to reach its conclusion
- ❖ To detect any kind of error or fraud that could happen in the company as well as financial statements.
- ❖ To provide the basis for the auditor to conclusion audit opinion.
- ❖ To prove auditors have done their jobs based on the required auditing standards.
- ❖ Use as a tool for investigations.

Two types of auditing sampling:

Statistical audit sampling:

Statistical audit sampling is the sampling approach where auditor uses random sampling to select the items from the total population use the probability technique to measure the result of the testing and make a conclusion.

Using statistical sampling is very important to help the auditor to manage and control the audit's risk. This is because statistics, we use data and probabilities to select the items from the total population and those data are not prejudged and unbiased by auditors.

This statistical sampling normally performs where the total population is more than 100 items. Based on experiences, there are many different tools available in the market that we use could use to perform audit sampling. And, if you don't have the tool, you can use the function in excel instead of software.

In statistical sampling, you can consider select 10 items from the total population randomly or you can set interval every item that reaches the interval set. That means every item among 100

items has the same chance to be selected for verification. Once you completed your testing, and got the result and then make a conclusion base on the result.

So, this is how statistical sampling looks like and how it is using. The two important things you need to remember about statistical sampling are the items are selected randomly and the conclusion is made based on the result of testing. If either of these two things is not meet, then the sampling is called non-probability sampling.

Non-statistical audit sampling:

Non-statistical sampling is different from statistical sampling. Based on the theory from ISA, any methods that not mean the criteria of the statistic are non-statistic. That means you have to be very clear and understand well about statistic audit sampling. There are two important things that can use to identify whether the sampling is systematic or not.

The fist one is selection of data or items are not random. That means the selections are based on judgment. Second, the result from testing from that selections is not using to conclude for the entire population.

The auditor might not use statistical audit sampling to select items for testing. Instead, they might select the items based on:

- ❖ Value of items, for example, the top ten highest values.
- ❖ Select the items that higher than a certain amount or value. For example any items higher than 200,000 USD.
- ❖ Items that contain information or data they want to assess. For example, any purchasing transactions from supplier name dalata.ltd.

These methods of sampling are called non-statistic.

Five methods of audit sampling

- 1) Random selection: it is the type of sampling that provides equal opportunities to all items or units in the total population. This kind of selection could use in excel or other generating tools.
- 2) Systematic selection: involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection, auditors must ensure that the population dos not structure in such a manner that the sampling interval corresponding with a particular pattern in the population.
- 3) Haphazard: selection may be an alternative to the random selection provided auditors satisfy that the sample is representative of entire population. This method requires care to guard against making a selection that is biased, for example towards items that are easily

selected, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.

- 4) Block selection: maybe use to check whether certain items have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year. Block sampling may; however, produce samples that are not representative of the population as a whole, particularly if errors only occurred during certain part of the period, and hence the errors found cannot be projected onto the rest of the population.
- 5) Monetary unit sampling: it is type of value-weighted selection in which sampling size, selection, and the evaluation result in the conclusion in monetary amounts. Monetary unit sampling is a kind of systematic audit sampling.

WHEN NOT TO SAMPLE

There are many audit procedures which do not involve sampling.

Inquiry and Observation:

- Reviewing records for the method of accounting and other information.
- Observing accounting procedures.
- Discussing methods of accounting and reporting with taxpayer.
- Scanning documents for possible issues.

Analytical Review Procedures:

- Comparing records reports and other information.
- Recomputing or estimating amounts. Reviewing trends in reporting.
- Comparing similar businesses.

One-Hundred Percent Examination:

- Reviewing all fixed asset purchases, where appropriate.
- Examining all contracts, where there are a small number.
- Reconciling each years gross receipts to CIT A sales factors or Schedule C receipts.

Zero Percent Examination

- This occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested

Note: Even though 100% examination may be done where appropriate. It is not mandatory for any particular taxpayers or tax programs. Sampling procedures discussed below may be more cost effective.

SAMPLING RISK

Overall tax audit risk is made up of the risk of inaccurate records and the risk of misapplication of the tax law. Both of these risks are made up of two components as well.

1. Risk that there are errors (inherent risk).
2. Risk that procedures will not find errors (audit risk).

Audit risk, in turn is made up of two components, the risk that a procedure is not effective and sampling risk. Sampling risk is the probability that the sample results are not representative of the entire population. In general, factors that may lessen sampling risk include:

1. Taking larger size samples
2. Using random sample selection methods
3. Stratifying the sample
4. Properly defining the test objective
5. Properly defining a deviation
6. Exclusion of non-recurring, non-systematic errors.
7. Properly evaluating errors.

DESIGNING A SAMPLING APPLICATION

There are several steps in designing a sampling application for an audit or investigation. The steps are discussed in detail in the next pages.

1. Define the objectives of the test
2. Determine the type of test to be performed
 - a. Variables Sampling
 - b. Attribute Sampling
3. Define the deviation conditions
4. Define the population

- a. Decide what period will be covered by the test
 - b. Define the sampling unit
 - c. Consider the completeness of the population
 - d. Consider how the error rate will be extrapolated
5. Determine the method of selecting the sample
- a. Random-Number sampling
 - b. Systematic sampling
 - c. Other sampling
6. Determine the sample size
- a. Variables Sampling
 - b. Attribute Sampling
7. Perform the sample
- a. Compare the sample to the population before completing the sample
8. Evaluate the sample results
- a. Interpret results
 - b. Extrapolate results
 - C. Consider the qualitative aspects of the deviations
 - d. Reaching an overall conclusion about the population
9. Document the sampling procedure

CHAPTER TWO

AUDIT FOR CASH AND MARKETABLE SECURITIES

2.0. Learning objectives

At the end of this chapter, learners should be able to:

- ❖ Show the relationship of cash in the bank to the various transaction cycles.
- ❖ Identify the major types of cash accounts maintained by business entities.
- ❖ Design and perform audit tests of the general cash account.
- ❖ Recognize when to extend audit tests of the general cash account to test further for material fraud.
- ❖ Design and perform audit tests of the imprest payroll bank account.
- ❖ Design and perform audit tests of imprest petty cash.
- ❖ Explain the nature of cash receipts and disbursements.
- ❖ Explain the fundamental internal controls over each receipts and cash disbursement.
- ❖ Describe the nature of appropriate procedures to accomplish the objectives of cash audit.

2.1. Introduction

Dear Learners! At this point it is important to know that cash is the only account included in every cycle except inventory and warehousing. It makes sense to study this audit area last because the evidence accumulated for cash balances depends heavily on the results of the tests in other cycles. For example, if the auditors' understanding of internal control and tests of controls and substantive tests of transactions in the acquisition and payment cycle cause them to believe that it is appropriate to reduce assessed control risk to low, they can reduce detailed tests of the ending balance in cash. If, however, auditors conclude that assessed control risk should be higher, extensive year-end testing may be necessary.

Cash is important because of its susceptibility to theft, and cash can also be significantly misstated. This chapter highlights the linkage of cash in the bank to transaction cycles and describes substantive tests of the cash balance. Thus, in this chapter we are going to examine the

audit of cash. For the audit of cash much reliance is placed on third party confirmation of cash balance.

You should bear in mind that the control of cash is of prime importance in any business. The overall objective of the audit of cash is to determine that cash is fairly presented in conformity with generally accepted accounting principles. In most audits, the primary assertions that generate audit risk for ***cash are existence, completeness, right and obligation, and presentation and disclosure.***

2.2. Cash in the bank and transaction cycles

The item cash reported in the financial statements represents currency on hand and cash on deposit in Bank accounts, including certificate of deposit, time deposits, and saving accounts. Certain “cash equivalents” are combined with cash for presentation in the financial statements. FASB statement of financial accounting standards No 95, statement of cash flow”, defines cash equivalents as short – term, highly liquid investments that are readily convertible to cash or so near to their maturity that there is little risk of change in their value. Examples of such type include Treasury bills, commercial paper and money market funds.

Cash is affected in one or another, by all of the entity’s transaction cycles. Although the main source of cash is revenue, other sources of cash include (1) the sale of property, plant, and equipment and (2) the proceeds from issuing long – term debt or capital stock - the main source of disbursements are the purchasing and payroll.

A brief discussion of 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.
2. It aids in further understanding the integration of the different transaction cycles.

Since every transaction involves cash, we can say that the focal point being the general cash account (“Cash in bank”). By examining the involvement of cash in every transaction, it is apparent why the general cash account is considered significant in almost all audits, even when

the ending balance is immaterial. The amount of cash **flowing** into and out of the cash account is often larger than that for any other account in the financial statements. Furthermore, the susceptibility of cash to embezzlement is greater than for other types of assets because most other assets must be converted to cash to make them usable.

In the audit of cash, auditors must distinguish between verifying the client's reconciliation of the balance on the bank statement to the balance in the general ledger, and verifying whether recorded cash in the general ledger correctly reflects all cash transactions that took place during the year. It is relatively easy to verify the client's reconciliation of the balance in the bank account to the general ledger, but a significant part of the total audit of a company involves verifying whether cash transactions are correctly recorded. For example, each of the following misstatements ultimately results in the improper payment of or the failure to receive cash, but none will normally be discovered as a part of the audit of the bank reconciliation:

- ❖ Failure to bill a customer
- ❖ An embezzlement of cash by intercepting cash receipts from customers before they are recorded, with the account charged off as a bad debt
- ❖ Duplicate payment of a vendor's invoice
- ❖ Improper payments of officers' personal expenditures
- ❖ Payment for raw materials that were not received
- ❖ Payment to an employee for more hours than he or she worked
- ❖ Payment of interest to a related party for an amount in excess of the going rate

Entirely different types of misstatements are normally discovered as a part of the tests of the bank reconciliation. These include:

- ❖ Failure to include a check that has not cleared the bank on the outstanding check list, even though it has been recorded in the cash disbursements journal
- ❖ Cash received by the client subsequent to the balance sheet date but recorded as cash receipts in the current year
- ❖ Deposits recorded as cash receipts near the end of the year, deposited in the bank in the same month, and included in the bank reconciliation as a deposit in transit
- ❖ Payments on notes payable debited directly to the bank balance by the bank but not entered in the client's records

QUICK CHECK

1. Discuss different types of misstatements that are normally discovered as a part of the tests of the bank reconciliation.

2.3. The auditors' objectives in examination of cash

The auditors have five objectives in the audit of cash:

- 1 Consider internal control over cash transactions.
- 2 Determine the existence of recorded cash and the client's ownership of this asset.
- 3 Establish the completeness of recorded cash.
- 4 Establish the clerical accuracy of cash schedules.
- 5 Determine that the statement presentation of cash is appropriate.

The overall objective of the audit of cash is to determine that cash is fairly presented in conformity with generally accepted accounting principles. The detail being:

- ✚ Establish available cash i.e. see the cash that is to be there
- ✚ Prove the cash that ought to be there
- ✚ Prove the cash on hand is needed or not
- ✚ Check independent accountability for cash transactions
- ✚ Prove disbursements authorization
- ✚ Prove handling of receipts
- ✚ Prove cash protection
- ✚ Establish management reporting methods and timely monitoring

2.4. Internal control over cash

Control objectives

The central control objectives are that:

- ❖ All sums are received and subsequently accounted for.
- ❖ All payments are made which should not be made.
- ❖ All receipts and payments are promptly and accurately recorded.

Control procedures

A detailed study of the operating routines of the individual business is necessary in developing the most efficient control procedures. These universal rules for achieving internal control over cash may be summarized as follows:

- 1 Do not permit any one employee to handle transaction from beginning to end.
- 2 Separate cash handling from record keeping.
- 3 Centralize receiving of cash as much as possible.
- 4 Record cash receipts immediately.
- 5 Encourage customers to obtain receipts and observe cash register totals.
- 6 Deposit each day's cash receipts intact.
- 7 Make all disbursements by cheques with the exception of small from petty cash.
- 8 Have monthly bank Reconciliation prepared by employees not responsible for the issuance or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official.
- 9 Forecast expected cash receipts and disbursements and investigate variances from forecasted amounts.

QUICK CHECK

2. List the auditor's objectives in examination of cash.

2.4.1. Internal control over cash receipts

Cash receipts resulted from a variety of activities. For example, cash is received from revenue transactions, short and long term borrowings, the issuance of stock, and the sale of marketable securities, long term investments, and other assets. The scope of this section is limited to cash receipts from cash sale and collection from customers on credit sales. The basic internal controls over cash receipts include the following:

- ❖ Authority to collect cash should be clearly defined.
- ❖ Collections should be recorded when received.

- ❖ The collector's cash receipts should be reconciled to the eventual banking.
- ❖ Receipts should be banked immediately.
- ❖ Each day's receipts should be recorded promptly in the cashbook.
- ❖ Sales ledger account should have no access to the cash.

The processing of receipts from cash and credit sales involves the following cash receipts functions:

- ❖ Receiving cash receipts.
- ❖ Depositing cash in bank.
- ❖ Recording the receipts.

Segregation of duties in performing these functions is an important internal control activity.

Receiving cash receipts: A major risk in processing cash receipts transactions is the possible theft of cash before and after a record of cash is made. Thus, control procedures should provide reasonable assurance that documentation establishing accountability is created at the moment cash is received and that the cash is subsequently safeguarded.

Depositing cash in bank: Proper physical controls over cash require that all cash receipts be deposited intact daily. Intact means all receipts should be deposited; that is cash disbursements should not be made out of un-deposited receipts.

Recording the cash receipts: This function involves journalizing over the counter and mail receipts and posting mail receipts to customer accounts. Controls should ensure that only valid receipts are entered and that all actual receipts entered at the correct amount. To ensure that only valid transactions are entered, physical access to the accounting records or computer terminals used in recording should be restricted to authorized personnel.

The Internal control objectives for cash receipts can be summarized as follows:

- ❖ **Occurrence:** Trace a sample of entries in the cash receipts journal to remittance advices, daily deposit slips, and bank statement.
- ❖ **Completeness:** Trace a sample of remittance advices to cash receipts journal and, if necessary, to deposit slips.
- ❖ **Authorization:** For a sample of days, examine the signature on the deposit slip and the check endorsements for proper authorization.

- ❖ **Accuracy:** For a sample of daily deposits, foot the remittance advices and entries on the deposit slip and agree to the cash receipts journal and bank statement. For a sample of weeks, foot the cash receipts journal and agree posting to the general ledger.
- ❖ **Cutoff:** Compare the dates for recording a sample of cash receipts transactions in the cash receipts journal with the dates the cash was deposited in the bank (note any significant delays). Observe cash on hand for the last day of the year, and trace deposits to cash receipts journal and cutoff bank statement.
- ❖ **Classification:** Examine a sample of remittance advices for proper account classification.

Table 2.1. Summary of Assertions, Possible Misstatements, Control Activities, and Tests of Controls for Cash Receipts Transactions

Assertion	Possible Misstatement	Control Activity	Test of Controls
Occurrence	Cash receipts recorded but not received or deposited	Segregation of duties. Use of lockbox system. Monthly bank reconciliations prepared and independently reviewed.	Observation and evaluation of proper segregation of duties. Inquiry of management about lockbox policy. Review of monthly bank reconciliation for indication of independent review.
Completeness	Cash receipts stolen or lost before recording	Same control procedures as above. Checks restrictively endorsed when received and daily cash list prepared. Daily cash receipts reconciled with posting to accounts receivable subsidiary ledger. Customer statements prepared on a regular basis; complaints handled independently.	Same tests of controls as above. Observation of the endorsement of checks. Testing of the reconciliation of daily cash receipts with posting to accounts receivable subsidiary ledger. Inquiry of client personnel about handling of monthly statements and examination of resolution of complaints.

Authorization	Cash discounts not properly Taken	Procedures specifying policies for cash discounts	Testing of a sample of cash receipts transactions for proper cash discounts.
Accuracy	Cash receipts recorded at incorrect amount	Daily remittance report reconciled to control listing of remittance advices. Monthly bank statement reconciled and independently reviewed.	Review and testing of reconciliation. Examination of monthly bank reconciliation for independent review.
Cutoff	Cash receipts recorded in wrong period	Use of a lockbox system or a control procedure to deposit cash receipts daily	Examination of cash receipts for daily deposit.
Classification	Cash receipts posted to wrong customer account Cash receipts not properly posted to general ledger accounts Cash receipts recorded in wrong financial statement account	Daily remittance report reconciled daily with postings to cash receipts journal and accounts receivable subsidiary ledger Monthly customer statements with independent review of complaints Monthly cash receipts journal agreed to general ledger posting Accounts receivable subsidiary ledger reconciled to general ledger control account Chart of accounts	Review and testing of reconciliation; if IT application, testing of application controls for posting. Review and testing of client procedures for mailing statements and handling complaints from customers. Review of posting from cash receipts journal to the general ledger. Examination of reconciliation of accounts receivable subsidiary ledger to general ledger control account. Tracing of cash receipts from listing to cash receipts journal for proper classification. Review of cash receipts journal for unusual items.

QUICK CHECK

3. Discuss the internal control objectives for cash receipts.

1.4.2. Internal control over cash disbursements

There are two cash disbursements functions as follows:

- 1 Paying the liability
- 2 Recording the cash disbursements.

These functions should not be performed by the same department or individual. The basic internal controls over cash disbursements include:

- ❖ Unused checks should be held in a secure place.
- ❖ The person who prepares checks should have no responsibility over purchase ledger or sales ledger.
- ❖ Checks should be signed only when evidence of a properly approved transaction is available.
- ❖ These checks should be evidenced by signing the supporting documents.
- ❖ Check signatories should be restricted to the minimum practical number.
- ❖ Two signatories at least should be required except perhaps for checks of small amounts.
- ❖ Checks should be crossed before being signed.
- ❖ Supporting documents should be cancelled as paid to prevent their use to support further check payments.
- ❖ Checks should preferably dispatch immediately.

The Internal control objectives for cash disbursements can be summarized as follows:

- ❖ **Validity** - It refers that segregation of duties must be made to check possible misstatements such as cash disbursement recorded may not be made (occurred).
- ❖ **Completeness** – It refers that all transactions of the given period which are made or occurred must be included or recorded in records. However, there might be cash

disbursements made or occurred but not recorded or included. Auditors have to check numerical sequence of checks; daily cash disbursements reconciled to postings to accounts payable subsidiary records.

- ❖ **Timeliness** – It refers that all disbursement transactions must be recorded in proper time then, the internal control objective helps to prevent cash disbursements not to be recorded in a wrong period. In control procedure, there would be daily reconciliation of checks issued with postings to cash disbursements journal and accounts payable subsidiary records.
- ❖ **Authorization** – It refers that there must be appropriate authorization of disbursement transactions by concerned personnel. Control procedure to insure this objective is segregation of duties; checks must be prepared only after all source documents have been independently approved.
- ❖ **Valuation** – It refers that cash disbursements must be properly determined. The balances of cash disbursements must be determined accurately. There might be incorrect amount of cash disbursed and recorded in journal; therefore, there must be a control procedure to check this misstatement. Daily cash disbursements report must be reconciled to checks issued; vendor statements must be reconciled to accounts payable records, and independently reviewed, monthly bank statements must be reconciled and independently reviewed.
- ❖ **Classification** - The cash disbursements must be properly classified to in accordance with chart of accounts. Therefore, there might be cash disbursements charged to wrong account. The control procedure includes that there must be well – prepared chart of accounts, independent approval and review of general ledger account on voucher packet. Examine a sample of canceled checks for proper account classification
- ❖ **Posting and summarization** – It refers that all cash disbursement transactions must be posted and summarized. There might be cash disbursement posted to the wrong vendor accounts, or cash disbursements journal may not be summarized properly or not properly posted to general ledger accounts. Then, there must be reconciled and independently reviewed, monthly cash disbursements journal agreed must agree to general ledger postings, Accounts payable subsidiary records must be reconciled to general ledger control account.

Table 2.2. Summary of Assertions, Possible Misstatements, Control Activities, and Tests of Controls for Cash Disbursement Transactions

Assertion	Possible Misstatement	Control Activity	Test of Controls
Occurrence	Cash disbursement recorded but not made	Segregation of duties Vendor statements independently reviewed and reconciled to accounts payable records Monthly bank reconciliations prepared and reviewed	Observe and evaluate proper segregation of duties. Review client's procedures for reconciling vendor statements. Review monthly bank reconciliations for indication of independent review.
Completeness	Cash disbursement made but not recorded	Same as above Accounting for the numerical sequence of checks Daily cash disbursements reconciled to postings to accounts payable subsidiary records	Same as above Review and test client's procedures for numerical sequence of checks; if IT application, test application controls. Review procedures for reconciling daily cash disbursements with postings to accounts payable subsidiary records; if IT application, test application controls.
Authorization	Cash disbursement not Authorized	Segregation of duties Checks prepared only after all source documents have been independently approved	Evaluate segregation of duties. Examine indication of approval on voucher packet.
Cutoff	Cash disbursement recorded in wrong period	Daily reconciliation of checks issued with postings to the cash disbursements journal and accounts payable subsidiary records	Review daily reconciliations.
Accuracy	Cash disbursement recorded at incorrect amount Cash disbursement posted to the wrong vendor account Cash disbursements journal not summarized	Daily cash disbursements report reconciled to checks issued Vendor statements reconciled to accounts payable records and independently reviewed Monthly bank statements reconciled and independently reviewed	Review reconciliation. Review reconciliation. Review monthly bank reconciliations. Review reconciliation. Review postings from cash disbursements journal to the general ledger. Review reconciliation.

	properly or not properly posted to general ledger accounts	Accounts payable subsidiary records reconciled to general ledger control account	
Classification	Cash disbursement charged to wrong account	Chart of accounts Independent approval and review of general ledger account on voucher packet	Review cash disbursements journal for reasonableness of account distribution. Review general ledger account code on voucher packet for reasonableness.

QUICK CHECK

4. Discuss the internal control objectives for cash receipts.

1.5. Balance-Related Assertions

The major audit procedures for each cash account involve tests of the bank reconciliation. The approach to auditing bank reconciliation is basically the same regardless of the type of bank account being examined. However, the type and extent of the audit work are more detailed for the general cash account because it normally represents a material amount and because of the large amount of activity in the account.

Table 2.3. Examples of Tests of Details of Balances for Cash

Assertions about Account Balances at Period End	Tests of Details Account Balances
Existence Completeness Valuation and Allocation	Test bank reconciliation for each account: • Foot the reconciliation and the outstanding check listing. • Trace balances per book to the general ledger. • Obtain standard bank confirmation and trace balance per bank to the bank reconciliation. • Obtain cutoff bank statement. • Trace deposits in transit, outstanding checks, and other reconciling items to cutoff bank statement.
	If control risk is high or if fraud is suspected: • Perform extended bank reconciliation procedures. • Perform a proof of cash. • Test for kiting.

2.6. Types of cash accounts

Before dealing with audit tests of the client's bank reconciliation, it is helpful to discuss the types of cash accounts commonly used by most companies, because the auditing approach to each varies. Auditors are likely to learn about the various types of cash balances when they obtain an understanding of the client's business. In spite of the sophisticated nature of cash management, the entity's management must still be concerned with the control and safekeeping of cash. The use of different types of bank accounts aids in controlling the entity's cash. The following types of bank accounts are typically used:

1. General cash account
2. Imprest cash accounts and
3. Branch accounts

General cash account

The **general cash account** is the focal point of cash for most organizations because virtually all cash receipts and disbursements flow through this account. For example, the disbursements for the acquisition and payment cycle are normally paid from this account, while the receipts of cash in the sales and collection cycle are deposited in the account.

Impress cash account

Impress cash account contains a stipulated amount of money, and the account is used for limited purposes. This account is usually used for disbursing of payroll checks and the account contains a minimum balance.

Disbursement may be by check or direct deposit. Prior to the disbursement of payroll, a check is drawn or a cash transfer is made from the general cash account to the payroll account for the amount of the net payroll. The payroll is then drawn on this imprest account. Thus, the payroll account serves as a clearing account for payroll payments and facilitates the disbursement of cash while also maintaining adequate control over cash. Use of imprest accounts also minimizes the time required to reconcile the general cash account.

Branch bank accounts

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. The branch account in this instance is much like a general account, but at the branch level.

Imprest petty cash fund

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 checks. An imprest cash account is set up on the same basis as an imprest branch bank account, but the expenditures are normally for much smaller amounts. Typical expenses include minor office supplies, stamps, and employee meals. A petty cash account usually does not exceed a few hundred dollars and is often reimbursed only once or twice each month.

Many organizations use pre-approved purchase cards (known as P-cards) to make miscellaneous purchases instead of maintaining a petty cash fund. These purchase cards function much like a credit card, but contain numerous restrictions on the nature and amount of purchases that can be made.

QUICK CHECK

1. What is meant by an imprest bank account for a branch operation? Explain the purpose of using this type of bank account.

2.7. Audit of the general cash account

It is important to note that all cycles, except inventory and warehousing, affect cash in the bank. In testing the year-end balance in the general cash account, the auditor must accumulate

sufficient appropriate evidence to evaluate whether cash, as stated on the balance sheet, is fairly stated and properly disclosed in accordance with five of the eight balance-related audit objectives used for all tests of details of balances (existence, completeness, accuracy, cutoff, and detail tie-in). Rights to general cash and its classification on the balance sheet are generally not of concern, and the realizable value of cash is not applicable.

The methodology for auditing year-end cash is essentially the same as that for all other balance sheet accounts and discussed in detail next which comprises the following points:

Identify Client Business Risks Affecting Cash

Most companies are unlikely to have significant client business risks affecting cash balances. However, client business risk may arise from inappropriate cash management policies or handling of funds held in trust for others. Client business risk is more likely to arise from cash equivalents and other types of investments. Several financial services firms have suffered large trading losses from the activities of individual traders that were hidden by misstating investment and cash balances. The auditor should understand the risks from the client's investment policies and strategies, as well as management controls that mitigate these risks.

Set Tolerable Misstatement and Assess Inherent Risk

The cash balance is not material on many audits, but cash transactions affecting the balance are almost always extremely material. Therefore, the potential often exists for material misstatement of cash. Because cash is more susceptible to theft than other assets, there is high inherent risk for the existence, completeness, and accuracy objectives. These objectives are usually the focus in auditing cash balances. Typically, inherent risk is low for all other objectives.

Assess Control Risk

Internal controls over year-end cash balances in the general account can be divided into two categories:

1. Controls over the transaction cycles affecting the recording of cash receipts and disbursements
2. Independent bank reconciliations

In preceding section, we discussed controls affecting the recording of cash transactions, which are essential in assessing control risk for cash. On the other hand, 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.

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 bank statements are received unopened by the reconciler, and physical control is maintained over the statements until the reconciliations are complete, copies of cancelled checks, duplicate deposit slips, and other documents included in the statement can be examined without concern for the possibility of alterations, deletions, or additions.

A careful bank reconciliation by competent client personnel includes the following actions:

- ❖ Compare cancelled checks or electronic bank records of payment with the cash disbursements records for date, payee, and amount
- ❖ Examine cancelled checks or electronic bank records of payment for signature, endorsement, and cancellation
- ❖ Compare deposits in the bank with recorded cash receipts for date, customer, and amount
- ❖ Account for the numerical sequence of checks, and investigate missing ones
- ❖ Reconcile all items causing a difference between the book and bank balance and verify their appropriateness for the client's business
- ❖ Reconcile total debits on the bank statement with the totals in the cash disbursements records
- ❖ Reconcile total credits on the bank statement with the totals in the cash receipts records
- ❖ Review month-end interbank transfers for appropriateness and proper recording
- ❖ Follow up on outstanding checks and stop-payment notices

Design and Perform Tests of Controls and Substantive Tests of Transactions

Because the cash balance is affected by all other cycles except inventory and warehousing, an extremely large number of transactions affect cash. Cash transactions are audited through all other cycles except inventory and warehousing transaction cycle tests.

Design and Perform Analytical Procedures

In many audits, the year-end bank reconciliation is extensively audited. Using analytical procedures to test the reasonableness of the cash balance is therefore less important than it is for most other audit areas. Auditors commonly compare the ending balance on the bank reconciliation, deposits in transit, outstanding checks, and other reconciling items with the prior-year reconciliation. Similarly, auditors normally compare the ending balance in cash with previous months' balances. These analytical procedures may uncover misstatements in cash.

Design Tests of Details of Cash Balance

The starting point for the verification of the balance in the general bank account is to obtain a bank reconciliation from the client for inclusion in the auditor's documentation. To audit cash in the bank, the auditor verifies whether the bank reconciliation received from the client is correct. The most important objectives are existence, completeness, and accuracy. Therefore, they receive the greatest attention. In addition to these balance-related objectives, the auditor also performs tests related to the four presentation and disclosure objectives, such as review of minutes and loan agreements to determine if there are restrictions on cash that must be disclosed. As in all other audit areas, the actual audit procedures depend on materiality and the risks in cash that the auditor has identified in other parts of the audit.

The following three procedures merit additional discussion because of their importance and complexity: receipt of a bank confirmation, receipt of a cutoff bank statement, and tests of the bank reconciliation.

- ✚ **Receipts of a Bank Confirmation** - Bank confirmations are not required for audits of non-public entities or under international auditing standards. However, auditors usually obtain a direct receipt of a confirmation from every bank or other financial institution with which the client does business, except when there is an unusually large number of inactive accounts. If the bank does not respond to a confirmation request, the auditor

should send a second request or ask the client to communicate with the bank to ask them to complete and return the confirmation to the auditor.

 **Receipt of a Cutoff Bank Statement** - A cutoff 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 CPA firm's office. The purpose of the cutoff bank statement is to verify the reconciling items on the client's year-end bank reconciliation with evidence that is not accessible to the client. To fulfill 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.

Many auditors verify the subsequent period bank statement if a cutoff statement is not received directly from the bank. The purpose is to test whether the client's employees have omitted, added, or altered any of the documents accompanying the statement. Obviously, this tests for intentional misstatements. The auditor performs the following verification in the month subsequent to the balance sheet date:

- ✓ Foot the lists of all cancelled checks, debit memos, deposits, and credit memos
- ✓ Verify that the bank statement balances when the footed totals are used
- ✓ Review the items included in the footings to make sure that they were cancelled by the bank in the proper period and do not include any erasures or alterations

 **Tests of the Bank Reconciliation** - A well-prepared independent bank reconciliation is an essential internal control over cash. 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. The auditor's verification of the reconciliation involves several procedures:

- ✓ Verify that the client's bank reconciliation is mathematically accurate.
- ✓ Trace the balance on the bank confirmation and/or the beginning balance on the cutoff statement to the balance per bank on the bank reconciliation to ensure they are the same.

- ✓ Trace checks written and recorded before year-end and included with the cutoff bank statement to the list of outstanding checks on the bank reconciliation and to the cash disbursements journal in the period or periods prior to the balance sheet date. All checks that cleared the bank after the balance sheet date and were included in the cash disbursements journal should also be included on the outstanding check list. If a check was included in the cash disbursements journal, it should be included as an outstanding check if it did not clear before the balance sheet date. Similarly, if a check cleared the bank before the balance sheet date, it should not be on the bank reconciliation.
- ✓ Investigate all significant checks included on the outstanding check list that have not cleared the bank on the cutoff statement. The first step in the investigation should be to trace the amount of any items not clearing to the cash disbursements journal. The reason for the check not being cashed should be discussed with the client, and if the auditor is concerned about the possibility of fraud, the vendor's accounts payable balance should be confirmed to determine whether the vendor has recognized the receipt of the cash in its records. In addition, a copy of the cancelled check should be examined before the last day of the audit if it becomes available.
- ✓ Trace deposits in transit to the cutoff bank statement. All cash receipts not deposited in the bank at the end of the year should be traced to the cutoff bank statement to make sure that they were deposited shortly after the beginning of the new year.
- ✓ Account for other reconciling items on the bank statement and bank reconciliation. These include such items as bank service charges, bank errors and corrections, and unrecorded transactions debited or credited directly to the bank account by the bank. These reconciling items should be investigated to be sure that they have been treated properly by the client.

QUICK CHECK

2. Why is the monthly reconciliation of bank accounts by an independent person an important internal control over cash balances? Which individuals will generally not be considered independent for this responsibility?

a material fraud when there are inadequate internal controls, especially the improper segregation of duties between the handling of cash and the recording of cash transactions in the accounting records and the lack of independently prepared monthly bank reconciliation.

In designing procedures for uncovering fraud, auditors should carefully consider the nature of the deficiencies in internal control, the type of fraud that is likely to result from the deficiencies, the potential materiality of the fraud, and the audit procedures that are most effective in uncovering the fraud.

When auditors are specifically testing for fraud, they should keep in mind that audit procedures other than tests of details of cash balances can also be useful. Procedures that may uncover fraud in the cash receipts area include:

- ☞ Confirmation of accounts receivable
- ☞ Tests performed to detect lapping
- ☞ Review of the general ledger entries in the cash account for unusual items
- ☞ Comparison of customer orders to sales and subsequent cash receipts
- ☞ Examination of approvals and supporting documentation for bad debts and sales returns and allowances

Similar tests can be used for testing for the possibility of fraudulent cash disbursements.

Extended Tests of the Bank Reconciliation

When the auditor believes that the year-end bank reconciliation may be intentionally misstated, it is appropriate to perform extended tests of the year-end bank reconciliation. The extended procedures verify whether all transactions included in the journals for the last month of the year were correctly included in or excluded from the bank reconciliation and verify whether all items in the bank reconciliation were correctly included. Let's assume that there are material internal control weaknesses and the client's year-end is December 31. Using a common approach, auditors:

1. Start with the bank reconciliation for November and compare all reconciling items with cancelled checks and other documents in the December bank statement.
2. Compare all remaining cancelled checks and deposit slips in the December bank statement with the December cash disbursements and receipts journals.

3. Trace all uncleared items in the November bank reconciliation and the December cash disbursements and receipts journals to the client's December 31 bank reconciliation to make sure they are included.
4. Verify that all reconciling items in the December 31 bank reconciliation represent items from the November bank reconciliation and December's journals that have not yet cleared the bank.

In addition to these four tests, the auditor must carry out procedures subsequent to the end of the year with the use of the bank cutoff statement.

Proof of Cash

A proof of cash is used to reconcile the cash receipts and disbursements recorded on the client's books with the cash deposited into and disbursed from the client's bank account for a specific time period. Because the proof contains four columns, a proof of cash is commonly referred to as a ***four-column proof of cash***.

Auditors sometimes prepare a proof of cash when the client has material internal control weaknesses in cash. The auditor uses a proof of cash to determine whether the following were done:

- ❖ All recorded cash receipts were deposited
- ❖ All deposits in the bank were recorded in the accounting records
- ❖ All recorded cash disbursements were paid by the bank
- ❖ All amounts that were paid by the bank were recorded

A proof of cash includes the following four reconciliation tasks:

- 1 Reconcile the balance on the bank statement with the general ledger balance at the beginning of the proof-of-cash period.
- 2 Reconcile cash receipts deposited per the bank with receipts recorded in the cash receipts journal for a given period.
- 3 Reconcile electronic payments and cancelled checks clearing the bank with those recorded in the cash disbursements journal for a given period.

- 4 Reconcile the balance on the bank statement with the general ledger balance at the end of the proof-of-cash period.

Tests of Interbank Transfers

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. Near the balance sheet date, a check is drawn on one bank account and immediately deposited in a second account for credit before the end of the accounting period. In making this transfer, the embezzler is careful to make sure that the check is deposited at a late enough date so that it does not clear the first bank until after the end of the period. If the interbank transfer is not recorded until after the balance sheet date, the amount of the transfer is recorded as an asset in both banks. Although there are other ways to commit this fraud, each involves increasing the bank balance to cover a shortage by the use of interbank transfers.

To test for kiting, as well as for unintentional errors in recording interbank transfers, auditors can list all interbank transfers made a few days before and after the balance sheet date and trace each to the accounting records for proper recording. There are several things that should be audited on the interbank transfer schedule which includes:

- ❖ The accuracy of the information on the interbank transfer schedule should be verified.
- ❖ The interbank transfers must be recorded in both the receiving and disbursing banks.
- ❖ The date of the recording of the disbursements and receipts for each transfer must be in the same fiscal year.
- ❖ Disbursements on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as outstanding checks.
- ❖ Receipts on the interbank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as deposits in transit.

QUICK CHECK

1. Explain the purpose of a four-column proof of cash. List two types of misstatements it is meant to uncover.
2. Define the term kiting. Describe audit procedures that can be used to uncover each.

2.9. Auditing a Payroll or Branch Imprest Account

The audit of any imprest cash account such as payroll or a branch account follows the same basic audit steps discussed under the audit of the general cash account. The auditor obtains bank reconciliation, along with a standard bank confirmation and a cutoff bank statement. However, the audit testing is less extensive for two reasons.

- ❖ First, the imprest balance in the account is generally not material. For example, an imprest payroll or branch account may contain a balance of only \$1,000 except for the short time after a payroll deposit and before the related payroll disbursements have cleared.
- ❖ Second, the types of disbursements from the account are homogeneous. The checks are for similar types of transactions and for relatively small amounts. For example, there may be a limit on the size of an individual payroll check.

2.10. Audit of imprest petty cash

Petty cash is a unique account. Although it is often immaterial in amount, many auditors verify petty cash primarily because of the potential for embezzlement and the client's expectation that auditors will examine the account, even when the amount is immaterial.

Internal Controls over Petty Cash

The most important internal control for petty cash is the use of an imprest fund that is the responsibility of *one individual*. In addition, petty cash funds should not be mingled with other receipts, and the fund should be kept separate from all other activities. There should also be limits on the amount of any expenditure from petty cash, as well as on the total amount of the fund. The types of expenditures that can be made from petty cash transactions should be well defined by company policy.

When a disbursement is made from petty cash, adequate internal controls require a responsible official's approval on a pre-numbered petty cash form. The total of the actual cash and checks in

the fund, plus the total unreimbursed petty cash forms that represent expenditures, should equal the total amount of the petty cash fund stated in the general ledger.

When the petty cash balance runs low, a check payable to the petty cash custodian should be written on the general cash account for the reimbursement of petty cash. The check should be for the exact amount of the pre-numbered vouchers that are submitted as evidence of actual expenditures. These vouchers should be verified by the accounts payable clerk and cancelled to prevent their reuse.

Audit Tests for Petty Cash

The emphasis in verifying petty cash should be on testing controls over petty cash transactions rather than the ending balance in the account. Even if the amount of the petty cash fund is small, the potential exists for numerous improper transactions if the fund is frequently reimbursed.

When control risk is assessed as low and few reimbursement payments occur during the year, it is common for auditors not to test petty cash, for reasons of immateriality. When auditors do test petty cash, the two most common procedures are to count the petty cash balance and to carry out detailed tests of one or two reimbursement transactions to determine that they are properly supported.

QUICK CHECK

1. Assume that a client with excellent internal controls uses an imprest payroll bank account. Explain why the verification of the payroll bank reconciliation ordinarily takes less time than the tests of the general bank account, even if the number of disbursements exceeds those for the general account.
2. Distinguish between the verification of petty cash reimbursements and the verification of the balance in the fund. Explain how each is done. Which is more important?

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- ✓ The custody (possessing), recording, and Authorization of cash should be separated. That is, the same person should not be entrusted to perform the two or three activities. The reason is that if the custody and record keeping are done by the same person, that person can steal money and they change the ledger to conceal the theft. If cashier has custody, the bookkeeper makes entries, and the finance head authorizes payments, this is good segregation of duty regarding to petty cash. If the Bank account is reconciled by one who does not have access to cash, then it is good segregation of duties regarding to cash in Bank the store keeper should not fill our receiving reports to control Inventory.
- ✓ The person who authorizes salary for new employee should not be the one paying the salary.
- ✓ The receiving of cash, depositing of the cash in the Bank, recording of cash and general ledger should be segregated.
- ✓ Cash payment preparation, authorizing of cash payment, cash payment, (disbursing), and recording of cash payments in cash disbursement journal and general ledger such as Account payable ledger and cash control ledger should be segregated; that is each activity should be performed by different persons.

2.12. Limitations (weakness) of internal control over cash

Weak internal control procedures would create opportunity for fraud or defalcation /theft/ of cash. The most common defalcation techniques of cash are:

- ❖ **Withholding of cash receipts** – proceeds from cash sales are withheld at point of sales recording and receiving of cash. For example, a cash register clerk can fail to register sales or under register amounts, and pocketing full or partial amounts. If the customer does not wait for his receipts and changes, or check amounts charged, registered, and paid.
- ❖ **Lapping** - refers to cash collection on account from credit customer may be postponed (delayed). This is usually practiced as temporary borrowing, but in the long run they lead to cover up by more elaborate means. This is possible if a single person is responsible to receive cash from charge customers and keep records for accounts receivable at the same time.

- ❖ **Sales discount** – cash can be abstracted from sales discount not taken by customers. i.e when customers pay the full amount, only amount net of discount are recorded to customers and the difference would be pocketed by recording it to discount account.
- ❖ **Writing off bad debts** – Accounts Receivable could be written off as bad debts when actually customers' remittance is pocketed.
- ❖ **Fictions Accounts Receivable** – Goods could be taken for private use or stolen by charging fictions customers and writing off as bad debts later on.
- ❖ **Check – kiting** – It refers to transferring of check from one bank to another when business has two bank accounts say in bank X and Y check is written to withdraw an account from bank X account balance, and deposited into Bank Y account. Because of lag (delay) of time for clearance, the amount deposited in bank Y is immediately reflected, but is not reflected as deduction (withdrawal) from Bank X account soon, Consequently such technique is practiced by cashier to cover up cash shortage which an auditor might uncover.
- ❖ **Window – Dressing** – Cash Shortage or cash position could be improved by holding the cash book open /unclosed) beyond the closing date to include subsequent cash receipts.
- ❖ **Others include** – as cashier payable to self, check payable to others, petty cash vouchers.

QUICK CHECK

1. Discuss the limitations (weakness) of internal control over cash.
1. Discuss the segregation of duties with regard to control over cash.

2.13. Audit program for cash

The following audit program indicates the general pattern of work performed by the auditors in the verification of cash.

- A ***Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.***
- B ***Obtain an understanding of internal control over cash:*** By understanding internal control over cash receipts and cash disbursements helps auditors to observe whether there

is appropriate segregation of duties and to enquire who performed various functions throughout the year.

- C ***Assess control risk and design additional tests of controls for cash:*** After obtaining an understanding of the client's internal control for cash receipts and disbursements, the auditors perform their initial assessment of control risk.
- D ***Perform additional tests of control for those controls, which the auditors plan to consider in their assessment of control risk:*** Tests directed toward the effectiveness of control help to evaluate the client's internal control and determine the extent to which the auditors are justified in reducing the assessed levels of control risk for assertions about the cash account. The following are examples of typical tests of controls.
- ❖ Test the accounting records and reconciliation by re-performance.
 - ❖ Compare the detail of a sample of recorded disbursements in cash payments journal to accounts payable postings, purchase orders, receiving reports, invoices, and paid checks.
 - ❖ Compare the detail of a sample of recorded cash receipts listings to the cash receipts, journal, accounts receivable postings, and authenticated deposit slips.
- E. ***Reassess control risk and design substantive tests for cash:*** When the auditors have completed the procedures described above, they should reassess control risk and design substantive tests of cash transactions and balances.
- F. ***Perform further audit procedures—substantive procedures for cash transactions and balances.***
- 1 Obtain analyses of cash balances and reconcile them to the general ledger.
 - 2 Confirm cash balances with financial institutions.
 - 3 Obtain or prepare reconciliations of bank (financial institution) accounts as of the balance sheet date and consider the need to reconcile bank activity for additional months.
 - 4 Obtain a cutoff bank statement containing transactions of at least seven business days subsequent to balance sheet date.
 - 5 Count and list cash 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 the first week of following year.
- 8 Investigate any checks representing large or unusual payments to related parties.
- 9 Evaluate proper financial statement presentation and disclosure of cash.

G. Substantive tests:

- ❖ Study and evaluate the adequacy of internal controls relating to cash balances on hand.
- ❖ Audit procedures undertaken in connection with the recording of transaction in the cash book concerning sales, purchases, wages etc. form an integral part of the overall audit work undertaken. These procedures have an important bearing on the verification of the completeness of cash balances on hand. The work already undertaken need not repeated.
- ❖ Ascertain cash balances on hand by undertaking physical verification of these balances. It is always advisable to do this without giving any prior information. Surprise cash counts will avoid the possibility of the custodians making up any shortfall in the balances temporarily to satisfy the audit. For the very same reason it would be advisable to undertake and counts at the end of the accounting period and again at a alter date, reconciling the difference during the intervening period by vouching the transactions that took place during intervening period.
- ❖ In case difference cash balances exist, undertake counting all of the simultaneously so as to avoid the possibility of making up any shortfall in one balance by transferring from another one.
- ❖ Scrutinize a sample of cash receipts and payments towards the end of the current accounting period and the beginning of the next accounting period so as to make sure they are included in the correct accounting period.
- ❖ Obtain confirmation from a responsible official independent of the cash department is respect of withdraws slips, IOUs, etc, include din cash balances (e.g. temporary advances paid to the client staff). Ensure that they are debited to the appropriate accounts.

- ❖ Examine documentary evidence in support of cash in transit, cash with branches, and cash with agents, etc. and verify their subsequent receipt.
- ❖ Ensure that any foreign currencies are converted at the appropriate authoritative rates. Check the calculations.

Summary

In this chapter, we have seen that transactions in most cycles affect the cash account. Because of the relationship between transactions in several cycles and the ending cash account balance, the auditor typically waits to audit the ending cash balance until the results of tests of controls and substantive tests of transactions for all cycles are completed and analyzed. Tests of the cash balance normally include tests of the bank reconciliations of key cash accounts, such as the general cash account, imprest payroll account, and imprest petty cash fund. If auditors assess a high likelihood of fraud in cash, they may perform additional tests such as extended bank reconciliation procedures, a proof of cash, or tests of interbank transfers.

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question

1. Which statement is false about Existence of account receivable?
 - A. Recorded accounts receivable exist.
 - B. Existing accounts receivable are included.
 - C. Accounts receivable are accurate.
 - D. Accounts receivable are correctly classified.
 - E. Cutoff for accounts receivable is correct.
 - F. None of the above
2. Proper segregation of functional responsibilities calls for separation of the
 - A. Authorization, approval and execution functions.
 - B. Authorization, execution and payment functions.
 - C. Receiving, shipping and custodial functions.
 - D. Authorization, recording and custodial functions.
 - E. None of the above
3. On receiving the bank cutoff statement, the auditor should trace
 - A. Deposits in transit on the year-end bank reconciliation to deposits in the cash receipts journal.
 - B. Checks dated prior to year-end to the outstanding checks listed on the yearend bank reconciliation.
 - C. Deposits listed on the cutoff statement to deposits in the cash receipts journal.
 - D. Checks dated subsequent to year-end to the outstanding checks listed on the year-end bank reconciliation.
 - E. None of the above

4. Which of the following is the objective of major substantive tests of cash transactions and balance?
 - A. Clerical accuracy.
 - B. Existence and ownership.
 - C. Completeness.
 - D. All of the above.
5. An auditor ordinarily should send a standard confirmation request to all banks with which the client has done business during the year under audit, regardless of the year-end balance, because this procedure
 - A. Provides for confirmation regarding compensating balance arrangements.
 - B. Detects kiting activities that may otherwise not be discovered.
 - C. Seeks information about indebtedness to the bank.
 - D. Verifies securities held by the bank in safekeeping.
 - E. None of the above

Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. Evaluate the necessity of following the practice described by an auditor: "In confirming bank accounts, I insist upon a response from every bank the client has done business with in the past 2 years, even though the account may be closed at the balance sheet date."
2. Describe what is meant by a cutoff bank statement and state its purpose.
3. Why are auditors usually less concerned about the client's cash receipts cutoff than the cutoff for sales? Explain the procedure involved in testing for the cutoff for cash receipts.
4. When the auditor fails to obtain a cutoff bank statement, it is common to verify the entire statement for the month subsequent to the balance sheet date. How is this done and what is its purpose?

5. Explain why, in verifying bank reconciliations, most auditors emphasize the possibility of a nonexistent deposit in transit being included in the reconciliation and an outstanding check being omitted rather than the omission of a deposit in transit and the inclusion of a nonexistent outstanding check.
6. How will a company's bank reconciliation reflect an electronic deposit of cash received by the bank from credit card agencies making payments on behalf of customers purchasing products from the company's online Web site, but not recorded in the company's records?
7. Explain the relationships among the initial assessed control risk, tests of controls and substantive tests of transactions for cash receipts, and the tests of details of cash balances.
8. Explain the relationships among the initial assessed control risk, tests of controls and substantive tests of transactions for cash disbursements, and the tests of details of cash balances. Give one example in which the conclusions reached about internal controls in cash disbursements will affect the tests of cash balances.
9. Evaluate the effectiveness and state the shortcomings of the preparation of a bank reconciliation by the controller in the manner described in the following statement: "When I reconcile the bank account, the first thing I do is review the sorted list of returned checks and find which numbers are missing. Next I determine the amount of the uncleared checks by referring to the cash disbursements journal. If the bank account reconciles at that point, I am all finished with the reconciliation. If it does not, I search for deposits in transit, checks from the beginning outstanding check list that still have not cleared, other reconciling items, and bank errors until it reconciles. In most instances, I can do the reconciliation in 20 minutes."
10. Assume that a client with excellent internal controls uses an imprest payroll bank account. Explain why the verification of the payroll bank reconciliation ordinarily takes less time than the tests of the general bank account, even if the number of disbursements exceeds those for the general account.
11. Distinguish between the verification of petty cash reimbursements and the verification of the balance in the fund. Explain how each is done. Which is more important?

CHAPTER THREE

AUDIT OF RECEIVABLES AND SALES

3.0. Learning objectives

At the end of this chapter, learners should be able to:

- ❖ Explain the nature of sales and collection of receivables.
- ❖ Identify the accounts and the classes of transactions in the sales and collection cycle.
- ❖ Describe the business functions and the related documents and records in the sales and collection cycle.
- ❖ Understand internal control, and design and perform tests of controls and substantive tests of transactions for sales.
- ❖ Describe the auditors' objectives for the audit of receivables and sales.
- ❖ Describe the nature of the audit procedures to accomplish the auditors' objectives for the audit of receivables and sales.

3.1. Introduction

Dear student, this chapter is second chapter for the entire course. It is basically designed to examines the audit of sales/revenue and receivables. You should bear in mind in the audit of receivables that receivables are a product of the sales cycle and therefore the control objectives of the sales cycle are relevant. Receivable is a general term that may refer to many types of receivables whose origin and nature may be different. Because a considerable portion of the audit of transactions in the sales and collection cycle involves documents and records, it is essential to understand the typical documents and records used in the cycle which will be discussed in this chapter.

3.2. Sources and nature of receivable

The sales and collection cycle including the receiving of orders from customers are delivery and billing of merchandise to customers, and the recording and collection of receivables. Receivables from customers include both accounts receivable and various types of notes

receivable. It is important to differentiate the origin and nature of receivables to ensure their appropriate classification and valuation.

The source of account receivables includes the following:

- ❖ Claims against customers from sale of goods
- ❖ Loans to officers or employees
- ❖ Loans to subsidiaries
- ❖ Claims against various other refunds
- ❖ Claims for tax refunds
- ❖ Advances to suppliers

3.3. Accounts and classes of transactions in the sales and collection cycle

The overall objective in the audit of the sales and collection cycle is to evaluate whether the account balances affected by the cycle are fairly presented in accordance with accounting standards. In general there are five **classes of transactions in the sales and collection cycle**. The nature of the accounts may vary, of course, depending on the industry and client involved. There are differences in the nature and account titles for a service industry, a retail company, and an insurance company, but the key concepts remain the same. To provide a frame of reference for understanding the material in this chapter, let's assume we're dealing with a wholesale merchandising company.

The five classes of transactions in the sales and collection cycle includes the following:

1. Sales (cash and sales on account)
2. Cash receipts
3. Sales returns and allowances
4. Write-off of uncollectible accounts
5. Estimate of bad debt expense

In the above five class of transaction one can understand that, with the exception of cash sales, every transaction and amount is ultimately included in one of two balance sheet accounts, accounts receivable or allowance for uncollectible accounts. For simplicity, we assume that the same internal controls exist for both cash and credit sales.

QUICK CHECK

1. List the source of account receivables.
2. Discuss the five classes of transactions in the sales and collection cycle.

3.4. Business functions in the cycle and related documents and records

The **sales and collection cycle** involves the decisions and processes necessary for the transfer of the ownership of goods and services to customers after they are made available for sale. It begins with a request by a customer and ends with the conversion of material or service into an account receivable, and ultimately into cash.

Table 3.1. Classes of Transactions, Accounts, Business Functions, and Related Documents and Records for the Sales and Collection Cycle

Classes of Transactions	Accounts	Business Functions	Documents and Records
Sales	Sales Accounts receivable	Processing customer orders Granting credit Shipping goods Billing customers and recording sales	Customer order Sales order order or sales order Shipping document and recording sales Sales transaction file Sales journal or listing Accounts receivable master file Accounts receivable trial balance Monthly statement
Cash receipts	Cash in bank (debits from cash receipts) Accounts receivable	Processing and recording cash receipts	Remittance advice Prelisting of cash receipts Cash receipts transaction file Cash receipts journal or listing
Sales returns and allowances	Sales returns and allowances Accounts receivable	Processing and recording sales returns and allowances	Credit memo Sales returns and allowances journal
Write-off of uncollectible accounts	Accounts receivable Allowance for uncollectible accounts	Writing off uncollectible accounts receivable	Uncollectible account authorization form General journal
Bad debt expense	Bad debt expense	Providing for bad	General journal

	Allowance for uncollectible accounts	debts	
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3.5. Control objectives and Test of controls

The following control objectives and Test of controls are applicable in the accounts Receivable and sales (Revenue) Transaction.

- ❖ **Validity** – the validity internal control objectives relates to management’s assertion about existence or occurrence. Auditors are concerned about the validity objective for revenue from actions because clients are more likely to overstate sales than to understate them. The possible misstatement including sells to fictitious customer, and recording of revenue when goods have not been shipped or services have not been performed. The major control for preventing such misstatement is segregation of duties between the shipping function and the order entry and billing function. Requiring an approved customer sales order and shipping document before revenue is recognized also minimizes the recording of fictions sales in client’s records.
- ❖ **Completeness** – the completeness objective relates to the completeness assertion. The major misstatement that concerns both management and Auditor is that goods are shipped or services are performed and no revenue is recognized control procedures that provide assurance that accounting for numerical sequences of shipping documents and sales invoices, matching shipping documents with sales invoices, reconciling the sales invoices to daily sales report, and minting and reviewing the open –order file.
- ❖ **Timeliness** – timeliness internal control objective relates to the completeness assertion. After client does not have adequate controls to ensure that revenue transaction recorded on timely basis, sales may be recorded in the wrong accounting period. The client should require that all shipping documents be forwarded to the billing function daily for processing on a timely basis. The Auditor should test this control by comparing the date on a bill of lading with the date on the respective sales invoice and the date the sales invoice was recorded in the sales journal. All billing must occur with the minimum delay.
- ❖ **Authorization of revenue Transaction** - this internal control objective relates to the valuation assertion’ possible misstatements due to improper authorization include

shipping goods to or performing services for customers who are bad credit risks and making sales at unauthorized prices or terms. Authorized price lists and specified terms of trade, for shipping and credit must be established. The auditor is concerned about authorization at *three key points*:

1. Credit must be properly authorized before a sale takes place.
2. Goods should be shipped only after proper authorization.
3. Prices, including basic terms, freight, and discounts, must be authorized.

The first two controls are meant to prevent the loss of company assets by shipping to fictitious customers or those who will fail to pay for the goods. Price authorization is meant to ensure that the sale is billed at the price set by company policy. Authorization may be done for each individual transaction or general authorization may be given for specific classes of transactions. General authorizations are often done automatically by computer.

- ❖ **Valuation** – This control relates to valuation assertion – Incorrectly valued (determined) amount of Revenue results in misstatements that directly affect amounts reported in financial statements there must be authorized price, terms of trade, type of goods shipped, and a sale invoices should be verified for mathematical accuracy before being sent. To recording.
- ❖ **Adequate Documents and Records** Because each company has a unique system of originating, processing, and recording transactions, auditors may find it difficult to evaluate whether each client's procedures are designed for maximum control. Nevertheless, adequate record-keeping procedures must exist before most of the transaction related audit objectives can be met. Some companies, for example, automatically prepare a multi-copy pre-numbered sales invoice at the time a customer order is received. Copies of this document are used to approve credit, authorize shipment, record the number of units shipped, and bill customers. This system greatly reduces the chance of the failure to bill a customer if all invoices are accounted for periodically, but controls have to exist to ensure the sale isn't recorded until shipment occurs. Under a system in which the sales invoice is prepared only after a shipment has been made, the likelihood of failure to bill a customer is high unless some compensating control exists.

In many organizations, all sales documents are electronic and no paper documents are prepared.

- ❖ **Pre-numbered Documents** - Prenumbering is meant to prevent both the *failure* to bill or record sales and the occurrence of *duplicate* billings and recordings. Of course, it does not do much good to have prenumbered documents unless they are properly accounted for. To use this control effectively, a billing clerk will file a copy of all shipping documents in sequential order after each shipment is billed, while someone else will periodically account for all numbers and investigate the reason for any missing documents.
- ❖ **Monthly Statements** - Sending monthly statements is a useful control because it encourages customers to respond if the balance is incorrectly stated. These statements should be controlled by persons who have no responsibility for handling cash or recording sales or accounts receivable to avoid the intentional failure to send the statements. For maximum effectiveness, all disagreements about the account balance should be directed to a designated person who has no responsibility for handling cash or recording sales or accounts receivable.
- ❖ **Internal Verification Procedures** - Computer programs or independent personnel should check that the processing and recording of sales transactions fulfill each of the six transaction-related audit objectives. Examples include accounting for the numerical sequence of prenumbered documents, checking the accuracy of document preparation, and reviewing reports for unusual or incorrect items.
- ❖ **Classification of Revenue Transaction** - This control objective relates to the presentation and disclosure assertion – the use of chart of accounts and proper codes for recording transactions should provide adequate assurance about the objective. The auditor can review the sales journal and general ledger for proper classification.
- ❖ **Posting and summarization of revenue** - This Internal control objective relates to the presentation and disclosure assertion. There is possibility that transactions are not properly summarized from source documents or posted properly from journal to subsidiary and general ledgers. Therefore, the control test should include as, reconciling sales invoices to the daily sales report (summary report) and the daily recordings in sales

journal should be reconciled with the posting to the accounts receivable subsidiary ledger, this ledger should periodically be reconciled to the general ledger control account.

- ❖ **Adequate Separation of Duties** - Proper separation of duties helps prevent various types of misstatements due to both errors and fraud. To prevent fraud, management should deny cash access to anyone responsible for entering sales and cash receipts transaction information into the computer. The credit-granting function should be separated from the sales function, because credit checks are intended to offset the natural tendency of sales personnel to optimize volume even at the expense of high bad debt write-offs. Personnel responsible for doing internal comparisons should be independent of those entering the original data.

For example, comparison of batch control totals with summary reports and comparison of accounts receivable master file totals with the general ledger balance should be done by someone independent of those who input sales and cash receipt transactions.

QUICK CHECK

3. Discuss the control objectives and Test of controls that are applicable in the accounts Receivable and sales (Revenue) Transaction.

3.6. Documents in the Sale cycle

The table below can be used to familiarize you with the documents in the cycle when studying this chapter. We are especially interested in controls associated with each document.

Table 3.2. Documents in Sales Cycle

Document	Controls (objective)	Comments
Customer order		Process is initiated with the customer order. The customer order is not primary for the existence assertion (shipping document is). Order could be received by mail, phone, over the internet, or through EDI.

Document	Controls (objective)	Comments
Sales order	Credit approval and authorization of shipment (occurrence).	Sales orders should receive approval prior to shipment, including authorization of credit (specific or general). Credit should be authorized by someone <i>independent of sales</i> (often done automatically by computer). ⁽¹⁾ Credit approval process affects extent of netrealizable value tests (test of allowance for doubtful accounts).
Continued in the next page		
Shipping document (bill of lading)	Checking of quantities (accuracy). Account for sequence (completeness).	Shipper is primary evidence of occurrence , because all recorded sales should be supported by a shipper. Account for numerical sequence to ensure completeness (all shippers should result in a sales invoice).
Sales invoice	Matched with shipper (occurrence). Prices, quantities and extensions checked (accuracy). Account for sequence (completeness).	The sales invoice is the main document for the recording of sales. Accounting for the sequence of sales invoices in the sales journal also assures completeness by determining that all sales were recorded. ⁽²⁾
Sales journal	Footings and postings checked (posting and summarization). Posted as soon as possible after goods are shipped (timeliness).	Sales invoices are recorded in the sales journal. Posted to the G/L, usually monthly. With computerized system, individual entries should also be posted automatically to the A/R sub ledger.
Credit Memo	Proper approval (occurrence). Receiving report for returned goods (occurrence).	Source document for returns and allowances. Returns should be supported by a receiving report; other allowances should be properly authorized. Testing depends upon materiality of amounts.
Cash receipt prelist	Prepared by someone independent of accounts	Beginning of cash receipts cycle, and point where cash enters business.

Document	Controls (objective)	Comments
	receivable, often an administrative assistant or someone with no accounting duties (completeness).	Establishes record of cash received to prevent theft. Checks should also be restrictively endorsed at this point. This assumes payment by mail, usually in the form of a check. Checks can also be sent directly to a lockbox, or wire transferred. Different controls are necessary for firms that receive payments in cash.
Continued in the next page		
Remittance advice	Document that accompanies payment by check - often the lower portion of the check (completeness and accuracy). The remittance advice is also important evidence of the occurrence of a cash receipt because the other evidence (the check) is deposited. The actual cash receipts should be deposited - usually on a daily basis (timeliness)	Additional evidence of amount of cash received. When no remittance advice is received, it is customary for the person who prelists cash to prepare one.
Cash receipts journal	Posting and summarization checked (P&S). CR recorded at time of receipt (timeliness)	The cash receipts journal is used to record individual cash receipts. Individual cash receipts are automatically posted by computer to individual customer A/R.
Accounts receivable sub ledger	Reconciled to the general ledger by someone independent of sales and cash receipts (posting and summarization , as well as other objectives)	The accounts receivable sub ledger is important because it is the interface between the sales and cash receipts cycle. The reconciliation of the sub ledger to the general ledger is an important control.
Bad debt charge-off	Should be authorized (occurrence)	Company should have proper procedures to charge-off accounts. Should be authorized by

Document	Controls (objective)	Comments
		someone independent of authorization of credit and recording of sales.

3.7. Steps and procedures in Sales and Collection Cycle

Sale involves a series of steps and procedures. At this point it is important to discuss the steps and procedures that sales involve. This procedure includes the following seven steps and procedure which will be discussed as follows:

1. Processing Customer Orders

A customer's request for goods initiates the entire cycle. Legally, it is an offer to buy goods under specified terms. The receipt of a customer order often results in the immediate creation of a sales order.

 **Customer Order** - A customer order is a request for merchandise by a customer. It may be received by telephone, letter, a printed form that has been sent to prospective and existing customers, through salespeople, electronic submission of the customer order through the Internet, or other network linkage between the supplier and the customer.

 **Sales Order** - A sales order is a document for communicating the description, quantity, and related information for goods ordered by a customer. This is often used to indicate credit approval and authorization for shipment.

2. Granting Credit

Before goods are shipped, a properly authorized person must *approve credit* to the customer for sales on account. Weak practices in credit approval often result in excessive bad debts and accounts receivable that may be uncollectible. An indication of credit approval on the sales order often serves as the approval to ship the goods. In some companies, the computer automatically approves a credit sale based on preapproved credit limits maintained in a customer master file. The computer allows the sale to proceed only when the proposed sales order total plus the existing customer balance is less than the credit limit in the master file.

3. Shipping Goods

This critical function is the first point in the cycle at which the company gives up assets. Most companies recognize sales when goods are shipped. A shipping document is prepared at the time of shipment, which can be done automatically by a computer, based on sales order information. The shipping document, which is often a multicopy bill of lading, is essential to the proper billing of shipments to customers. Companies that maintain perpetual inventory records also update them based on shipping records.

- ❖ **Shipping Document** - A shipping document is prepared to initiate shipment of the goods, indicating the description of the merchandise, the quantity shipped, and other relevant data. The company sends the original to the customer and retains one or more copies. The shipping document serves as a signal to bill the customer and may be in electronic or paper form.

4. Billing Customers and Recording Sales

Because billing customers is the means by which the customer is informed of the amount due for the goods, it must be done correctly and on a timely basis. The most important aspects of billing are:

- ❖ All shipments made have been billed (completeness)
- ❖ No shipment has been billed more than once (occurrence)
- ❖ Each one is billed for the proper amount (accuracy)

Billing the proper amount is dependent on charging the customer for the quantity shipped at the authorized price, which includes consideration for freight charges, insurance, and terms of payments.

- ❖ **Sales Invoice** - A sales invoice is a document or electronic record indicating the description and quantity of goods sold, the price, freight charges, insurance, terms, and other relevant data. The sales invoice is the method of indicating to the customer the amount of a sale and the payment due date. Companies send the original to the customer, and retain one or more copies.
- ❖ **Sales Transaction File** - This is a computer-generated file that includes all sales transactions processed by the accounting system for a period, which could be a day,

week, or month. It includes all information entered into the system and information for each transaction, such as customer name, date, amount, account classification or classifications, salesperson, and commission rate. The file can also include returns and allowances or there can be a separate file for those transactions. The information in the sales transaction file is used for a variety of records, listings, or reports, depending on the company's needs. These may include a sales journal, accounts receivable master file, and transactions for a certain account balance or division.

- ❖ **Sales Journal or Listing** - This is a listing or report generated from the sales transaction file that typically includes the customer name, date, amount, and account classification or classifications for each transaction, such as division or product line. It also identifies whether the sale was for cash or accounts receivable. The journal or listing is usually for a month but can cover any period of time. Typically, the journal or listing includes totals of every account number for the time period. The same transactions included in the journal or listing are also posted simultaneously to the general ledger and, if they are on account, to the accounts receivable master file. The journal or listing can also include returns and allowances or there can be a separate journal or listing of those transactions.
- ❖ **Accounts Receivable Master File** - This is a computer file used to record individual sales, cash receipts, and sales returns and allowances for each customer and to maintain customer account balances. The master file is updated from the sales, sales returns and allowances, and cash receipts computer transaction files. The total of the individual account balances in the master file equals the total balance of accounts receivable in the general ledger. A printout of the accounts receivable master file shows, by customer, the beginning balance in accounts receivable, each sales transaction, sales returns and allowances, cash receipts, and the ending balance.
- ❖ **Accounts Receivable Trial Balance** - This list or report shows the amount receivable from each customer at a point in time. It is prepared directly from the accounts receivable master file, and is usually an *aged* trial balance that includes the total balance outstanding and the number of days the receivable has been outstanding, by category of days (such as less than 30 days, 31 to 60 days and so on).
- ❖ **Monthly Statement** - This is a document sent by mail or electronically to each customer indicating the beginning balance of their accounts receivable, the amount and date of

each sale, cash payments received, credit memos issued, and the ending balance due. It is, in essence, a copy of the customer's portion of the accounts receivable master file.

5. Processing and Recording Cash Receipts

The four sales transaction functions are necessary for getting the goods into the hands of customers, correctly billing them, and reflecting the information in the accounting records. The remaining four functions involve the collection and recording of cash, sales returns and allowances, write-off of uncollectible accounts, and providing for bad debt expense.

- ❖ **Remittance Advice** - A remittance advice is a document mailed to the customer and typically returned to the seller with the cash payment. It indicates the customer name, the sales invoice number, and the amount of the invoice. A remittance advice is used as a record of the cash received to permit the immediate deposit of cash and to improve control over the custody of assets. If the customer fails to include the remittance advice with the payment, it is common for the person opening the mail to prepare one at that time.
- ❖ **Prelisting of Cash Receipts** - This is a list prepared when cash is received by someone who has no responsibility for recording sales, accounts receivable, or cash, and who has no access to accounting records. It is used to verify whether cash received was recorded and deposited at the correct amounts and on a timely basis.
- ❖ **Cash Receipts Transaction File** - This is a computer-generated file that includes all cash receipts transactions processed by the accounting system for a period, such as a day, week, or month. It includes the same type of information as the sales transaction file.
- ❖ **Cash Receipts Journal or Listing** - This listing or report is generated from the cash receipts transaction file and includes all transactions for a time period. The same transactions, including all relevant information, are included in the accounts receivable master file and general ledger.

6. Processing and Recording Sales Returns and Allowances

When a customer is dissatisfied with the goods, the seller often accepts the return of the goods or grants a reduction in the charges. The company prepares a receiving report for returned goods and returns them to storage. Returns and allowances are recorded in the sales returns and

allowances transaction file, as well as the accounts receivable master file. Credit memos are issued for returns and allowances to aid in maintaining control and to facilitate record keeping.

- ❖ **Credit Memo** - A credit memo indicates a reduction in the amount due from a customer because of returned goods or an allowance. It often takes the same general form as a sales invoice, but it supports reductions in accounts receivable rather than increases.
- ❖ **Sales Returns and Allowances Journal** - This is the journal used to record sales returns and allowances. It performs the same function as the sales journal. Many companies record these transactions in the sales journal rather than in a separate journal.

7. Writing Off Uncollectible Accounts Receivable

Regardless of the diligence of credit departments, some customers do not pay their bills. After concluding that an amount cannot be collected, the company must write it off. Typically, this occurs after a customer files for bankruptcy or the account is turned over to a collection agency. Proper accounting requires an adjustment for these uncollectible accounts.

- ❖ **Uncollectible Account Authorization Form** - This is a document used internally to indicate authority to write an account receivable off as uncollectible.

8. Providing for Bad Debts

Because companies cannot expect to collect on 100% of their sales, accounting principles require them to record bad debt expense for the amount they do not expect to collect. Most companies record this transaction at the end of each month or quarter.

QUICK CHECK

4. Describe the nature of the following documents and records and explain their use in the sales and collection cycle: bill of lading, sales invoice, credit memo, remittance advice, monthly statement to customers.

3.8. Objectives for the Audit of Receivables and Revenue

The audit objectives for the receivables and sales relate to obtain to sufficient competent evidence about each significant financial statement assertion that pertains receivables and sales transactions and balances. To achieve each of these specific audit objectives, the auditors employ various parts of the audit planning and audit testing methodology.

The auditors' objectives in the examination of receivables and sales are:

1. To consider internal control over receivables and sales transactions.
2. To determine the existence of receivables, the clients ownership of these assets, and the occurrence of sales transactions.
3. To establish the completeness of receivables and sales transactions.
4. To establish the clerical accuracy of records and supporting schedules of receivables and sales.
5. To determine that the valuation of receivables is at appropriate net realizable values.
6. To determine that the statement presentation of receivables and sales is adequate.

Table 2.2 Selected specific audit objectives for receivables and sales

Assertion Category	Transaction class	Audit objective
Existence or Occurrence	Recorded sales transactions represent goods shipped during the period. Recorded cash receipts transactions represent cash received during the period.	Accounts receivable include all amounts owed by the customers exists at the balance sheet date.
Completeness	All sales, cash receipts sales adjustments that occurred during the period have been recorded.	Accounts receivable include all claims on customers at the balance sheet date.
Rights and Obligations	The entity has rights to the receivables and cash resulting from sales transactions.	Accounts receivable at the balance sheet date represents legal claims of the entity.
Valuation	All sales, cash receipts and sales adjustments transactions are correctly journalized, summarized, and posted.	Accounts receivable represent gross claims, On customers at the balance sheet date. The allowance for uncollectible accounts represents a reasonable estimate.
Presentation ad	The details of sales, cash receipts and	Accounts receivables are properly

disclosure	sales adjustments support their presentation in the financial statements.	identified and classified.
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3.9. Internal Control over Account Receivable and Revenue/Sale

The objectives of internal controls over receivables are to ensure:

- ❖ All goods dispatched are invoiced.
- ❖ Invoicing is at correct price and discount.
- ❖ Goods are only dispatched on credit to approved customers.
- ❖ Invoices are recorded and related to subsequent cash receipts.
- ❖ Receivables are controlled and bad debts pursued.
- ❖ Credit notes approved.

In addition the internal control over receivables should be such that the possibility of any falsification of the receivables accounts is eliminated. An important part of the controls would be to ensure that the cashier does not have access to the sales ledger, and the sales ledger clerk does not have access to cash received. Control procedures, over sales and receivables include the following.

❖ **Orders:**

- ✚ The orders should be checked against the customer's account.
- ✚ All orders received should be recorded on pre – numbered sales order documents.
- ✚ All orders should be authorized before goods are dispatched.

❖ **Dispatch:**

- ✚ Dispatch notes should be pre - numbered and a register kept of them to relate to sales invoices and orders.
- ✚ Goods dispatch notes should be authorized as goods leave.

❖ **Invoicing:**

- ✚ Sales invoices should be authorized by a responsible official.
- ✚ Sales invoices should be checked for prices and calculations by a person other than the one preparing the invoice.
- ✚ All invoices should be pre – numbered consecutively.
- ✚ Copies of cancelled invoices should be retained.

❖ **Receivables:**

- ✚ A receivable ledger control account should be prepared and checked to individual sales ledger balances.
- ✚ Receivables ledger personnel should be independent of dispatch and cash receipt functions.
- ✚ Statements should be sent regularly to customers.

❖ **Bad debts:**

- ✚ The authority to write off a bad debt should be given in writing and adjustments made to the accounts receivable ledger.
- ✚ The use of court action or write – off of a bad debt should be authorized by an official independent of the cash receipts function.

QUICK CHECK

6. What are the auditors' objectives in the examination of receivables and sales?

3.9.1. Revenue Cycle Controls

The revenue/sales cycle control includes the following points:

- ❖ 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

3.9.2. Audit program for receivables and sales transactions

The following audit procedures are typical of the work done in the verification of notes, accounts receivable, and sales transaction.

- A. ***Consider internal control for receivables and sales:*** Obtain an understanding of internal control for receivables and sales. How do auditors obtain an understanding of internal control? Using one typical approach for sales, auditors study the client's flowcharts, make inquiries of the client using an internal control questionnaire, and perform walkthrough tests of sales. The auditors' consideration of internal controls over receivables and sales may begin with the preparation of a written narrative or flow chart and the completion of an internal control questionnaire. As the auditors' confirm their understanding of the sales and collection cycle, they will observe whether there is appropriate segregation of duties, and enquire as to who performed various functions throughout the year.
- B. ***Use the understanding of the client and its environment:*** this is help to consider inherent risks, including fraud risks, related to receivables and revenue.
- C. ***Assess control risk and design additional tests of controls for receivables and sales:*** After obtain an understanding of the client's internal control for receivables and sales transactions, the auditors perform their initial assessment of control risk for the variant financial statement assertions. The auditor uses the information obtained in understanding internal control to assess control risk. Four steps are essential steps to this assessment.
 - 1. The auditor needs a framework for assessing control risk. The six transactions related audit objectives provide this framework. These six objectives are the same for every audit of sales.
 - 2. The auditor must identify the key internal controls and deficiencies for sales. These will differ for every audit because every client has different internal controls.
 - 3. After identifying the controls and deficiencies, the auditor associates them with the objectives.
 - 4. The auditor assesses control risk for each objective by evaluating the controls and deficiencies for each objective. This step is critical because it affects the auditor's

decisions about both tests of controls and substantive tests. It is a highly subjective decision.

D. ***Perform additional tests and controls:*** Tests directed towards the effectiveness of control help to evaluate the client's internal control, and determine the extent to which the auditors are justified in reducing their assessed levels of control risk for the assertion about the receivables and sales accounts. The following are examples of additional tests:

- ❖ Examine significant aspects of a sample of sales transactions.
- ❖ Compare a sample of shipping documents to related sales invoices.
- ❖ Review the use and authorization of credit memoranda.
- ❖ Reconcile selected cash register tapes and sales invoices with sales journals.
- ❖ Reconcile selected cash register tapes and sales tickets with sales journals.
- ❖ Test IT application controls.
- ❖ Examine evidence of review and approval of revenue estimates.

E. ***Reassess control risk and design substantial tests:*** When auditors have completed the procedures described in the preceding sections, they should assess the extent of control risk for each financial statement assertions regarding receivables and sales transactions. The assessment will determine the nature, extent, and timing of auditors' substantive tests for receivables and sales.

F. ***Perform further audit procedures:*** 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 recognition.

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 disclosure of receivables and revenue.

Table 3.3. Illustrative Substantive Tests of Transactions

Objective	Procedure	Comment
Recorded sales exist (occurrence)	Trace from sales journal or invoice to shipper.	Almost always done, even if controls are effective.
Existing sales are recorded (completeness)	Trace from shippers to recorded sales (invoice or journal)	Probably not necessary if tested controls.
Sales are recorded at proper amounts (accuracy)	Recompute quantities and extensions (reperformance). Agree price to price list.	Normally done. Can reduce sample size if controls exist.
Sales are properly classified	Check documents supporting sale for proper account distribution in sales journal.	Not normally an important issue.
Sales are timely recorded	Compare dates on shipper with sales invoice and entry in sales journal	Really a test of control.
Sales are summarized	Foot sales journal and trace to entry in general ledger. Test reconciliation of A/R subledger to general ledger.	Generally always done.

QUICK CHECK

7. Discuss the audit procedures in the verification of notes, accounts receivable, and sales transaction.

3.10. Sales returns and allowances

The transaction-related audit objectives and the client's methods of controlling misstatements are essentially the same for processing credit memos as those described for sales, with two differences. The first is *materiality*. In many instances, sales returns and allowances are so immaterial the auditor can ignore them.

The second difference is *emphasis on the occurrence objective*. For sales returns and allowances, auditors usually emphasize testing recorded transactions to uncover any theft of cash from the collection of accounts receivable that was covered up by a fictitious sales return or allowance. (Although auditors usually emphasize the occurrence objective for sales returns and allowances transactions, the *completeness* objective is especially important in tests of account balances to determine if sales and returns are understated at year-end.)

Naturally, other objectives should not be ignored. But because the objectives and methodology for auditing sales returns and allowances are essentially the same as for sales, we do not include a detailed study of them. If you need to audit sales returns and allowances, you should be able to apply the same logic to arrive at suitable controls, tests of controls, and substantive tests of transactions to verify the amounts.

✚ **Recording** - theoretically should be matched with sale. In practice returns and allowances are recorded as they occur. This does not present a problem, if there are no significant returns after year-end.

✚ **Authorization** - Returned goods should be sent to the receiving department, and a **receiving report** prepared. Other allowances should be specifically authorized.

✚ **Objectives:**

- ✓ **Transactions** - focus is on the ***occurrence*** of returns and allowances since they *can be used to hide theft of cash*.
- ✓ **Balances** - In the year-end tests of accounts receivable, the focus is on ***completeness***, since the failure to record returns overstates accounts receivable.

The significance of sales returns and allowances determines the extent to which they are tested.

3.11. Audit tests for the write-off of uncollectible accounts

The same as for sales returns and allowances, the auditor's primary concern in the audit of the write-off of uncollectible accounts receivable is the possibility of client personnel covering up an embezzlement by writing off accounts receivable that have already been collected (the occurrence transaction-related audit objective). The major control for preventing this fraud is proper authorization of the write-off of uncollectible accounts by a designated level of management only after a thorough investigation of the reason the customer has not paid.

Normally, verification of the accounts written off takes relatively little time. Typically, the auditor examines approvals by the appropriate persons. For a sample of accounts written off, it is also usually necessary for the auditor to examine correspondence in the client's files establishing their uncollectibility. In some cases, the auditor also examines credit reports. After the auditor has concluded that the accounts written off by general journal entries are proper, selected items should be traced to the accounts receivable master file to test whether the write-off was properly recorded.

The estimation of bad debt expense, which is the fifth class of transactions in the sales and collection cycle, obviously relates to the write-off of uncollectible accounts. However, because the estimation of bad debts is based on the year-end accounts receivable balances, the auditor evaluates the estimate for uncollectible accounts as part of the tests of details of ending accounts receivable balances.

Summary

This chapter deals with designing tests of controls and substantive tests of transactions for each of the five classes of transactions in the sales and collection cycle, including sales, cash receipts, sales returns and allowances, write-off of uncollectible accounts receivable, and bad debt expense. The methodology for designing tests of controls and substantive tests of transactions is, in concept, the same for each of the five classes of transactions and includes the following steps:

- Understand internal control
- Assess planned control risk
- Determine the extent of testing controls
- Design tests of controls and substantive tests of transactions to meet transaction related audit objectives

In designing tests of controls for each class of transactions, auditors focus on testing internal controls that they intend to rely upon to reduce control risk. First, the auditor identifies internal controls, if any exist, for each transaction-related audit objective. After assessing control risk for each objective, the auditor then determines the extent of tests of controls that must be performed.

If the auditor is reporting on the effectiveness of internal control over financial reporting, extensive tests of controls must be performed to provide the basis for the auditor's report. For audits of non-accelerated filers and nonpublic companies, the decision to perform tests of controls is based on the effectiveness of controls and the extent to which the auditor intends to rely on them to reduce control risk.

The auditor also designs substantive tests of transactions for each class of transactions to determine whether the monetary amounts of transactions are correctly recorded. Like tests of controls, substantive tests of transactions are designed for each transaction-related audit

objective. After the design of tests of controls and substantive tests of transactions for each audit objective and each class of transactions is completed, the auditor organizes the audit procedures into a performance format audit program. The purpose of this audit program is to help the auditor complete the audit tests efficiently.

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question.

1. An auditor is considering the internal control system for purchasing and disbursement procedures. The auditor will be least influenced by
 - A. The availability of a company manual describing purchasing and disbursement procedures.
 - B. The strength or weakness of internal control in other areas, e.g., sales and accounts receivable.
 - C. The scope and results of audit work by the company's internal auditor.
 - D. The existence within the purchasing and disbursement area of internal control strengths that offset weaknesses.
 - E. None of the above
2. To determine that sales transactions have been recorded in the proper accounting period, the auditor performs a cut-off review. Which of the following best describes the overall approach used when performing a cut-off review?
 - A. Ascertain that management has included in the representation letter a statement that transactions have been accounted for in the proper accounting period.
 - B. Confirm year-end transactions with regular customers.
 - C. Analyze transactions occurring within a few days before and after year-end.
 - D. Examine cash receipts in the subsequent period.
 - E. None of the above
3. Which of the following can be used as substantive test for receivables and sales transactions?
 - A. Confirm receivable with debtors.

- B. Perform analytical procedures.
 - C. Review the year-end cutoff of sales transactions.
 - D. All of the above.
4. Which of the following is (are) primary audit objective for receivables/sales?
- A. Clerical accuracy
 - B. Existence
 - C. Valuation
 - D. Statement Presentation
 - E. All of the above
5. Which assertions relating to receivables/sales are addressed when auditors select a sample of sales invoices and compare details to shipping documents?
- A. Existence
 - B. Ownership
 - C. Valuation
 - D. All

Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. Explain the importance of proper credit approval for sales. What effect do adequate controls in the credit function have on the auditor's evidence accumulation?
2. Distinguish between the sales journal and the accounts receivable master file. What type of information is recorded in each and how do these accounting records relate?
3. List the most important duties that should be segregated in the sales and collection cycle. Explain why it is desirable that each duty be segregated.
4. What audit procedures are most likely to be used to verify accounts receivable written off as uncollectible? State the purpose of each of these procedures.
5. State the relationship between the confirmation of accounts receivable and the results of the tests of controls and substantive tests of transactions.

CHAPTER FOUR

AUDIT OF INVENTORY AND COSTS OF GOODS SOLD

4. Learning objectives

At the end of this chapter, learners should be able to:

- ❖ Develop an understanding of the purchasing process.
- ❖ Identify the types of transactions in the purchasing process and the financial statement accounts affected.
- ❖ Understand the functions in the purchasing process.
- ❖ Identify and describe the types of documents and records used in the purchase process.
- ❖ Know the appropriate segregation of duties for the purchase process.
- ❖ Know the appropriate segregation of duties for the inventory management process.
- ❖ Identify key internal controls and develop relevant tests of controls for inventory transactions.
- ❖ Identify substantive analytical procedures used to audit inventory and related accounts.

4.1. Introduction

A purchase transaction usually begins with a purchase requisition being generated by a department or support function. The purchasing department prepares a purchase order for the purchase of goods or services from a vendor. When the goods are received or the services have been rendered, the entity records a liability to the vendor. Finally, the entity pays the vendor. On the other hand, inventories are major items on the balance sheet, i.e. in total assets, especially in the current asset section. Inventories play also a very significant and important role in preparation of income statement and determination of net income or loss.

The relationship of inventories and purchase makes it logical for the two topics to be considered together. The Internal control that assures the fair valuation of inventories is found in the purchase (or acquisition) cycle. These procedures include procedures for the selection of vendors, ordering merchandise or materials, inspecting goods, receive, recording the liabilities to the vendor, and authorizing and making cash disbursements.

This chapter explains the essential control procedures and tests of controls used by the auditors for purchase and inventory. Thus student should be able to understand these procedures and Tests with relation to necessary documents and records used for control purposes. Besides, in this chapter we are going to discuss the typical internal control procedures and the auditors' objectives in the examination of inventories and purchases.

4.2. Types of Transactions and Financial Statement Accounts Affected

Three types of transactions are processed through the purchasing process:

- ❖ Purchase of goods and services for cash or credit.
- ❖ Payment of the liabilities arising from such purchases.
- ❖ Return of goods to suppliers for cash or credit.

The first type is a purchase transaction that includes acquiring goods and services. The second type is a cash disbursement transaction that involves paying the liabilities that result from purchasing goods and services. The final type is a purchase return transaction, in which goods previously purchased are returned to a supplier for cash or credit.

4.3. Types of Documents and Records

Here we are going to see the important documents and records that are normally involved in the purchasing process. Each of these items is briefly discussed here. The use of an IT system may affect the form of the documents and the auditor's approach to testing the purchasing process. This documents and records include the following:

- ❖ **Purchase Requisition** - This document requests goods or services for an authorized individual or department within the entity. Examples of such requests include an order for supplies from an office supervisor and an order for newspaper advertising space from a marketing manager.
- ❖ **Purchase Order** - This document includes the description, quality, and quantity of, and other information on, the goods or services being purchased. The purchase order also indicates who approved the acquisition and represents the authorization to purchase the

goods or services. The purchase order may be mailed, faxed, or placed by telephone with the supplier or vendor.

- ❖ **Receiving Report** - This document records the receipt of goods. Normally, the receiving report is a copy of the purchase order with the quantities omitted. This procedure encourages receiving department personnel to make an adequate, independent count of the goods received. Receiving department personnel record the date, description, quantity, and other information on this document. In some instances, the quality of the goods is determined by receiving department personnel. In other cases, an inspection department determines whether the goods meet the required specifications. The receiving report is important because receiving goods is generally the event that leads to recognition of the liability by the entity.
- ❖ **Vendor Invoice** - This document is the bill from the vendor. The vendor invoice includes the description and quantity of the goods shipped or services provided, the price including freight, the terms of trade including cash discounts, and the date billed.
- ❖ **Voucher** - This document is frequently used by entities to control payment for acquired goods and services. This document serves as the basis for recording a vendor's invoice in the voucher register or purchases journal. In many purchasing systems the voucher is attached to the purchase requisition, purchase order, receiving report, and vendor invoice to create a *voucher packet*. The voucher packet thus contains all the relevant documentation supporting a purchase transaction.
- ❖ **Voucher Register/Purchases Journal** - A voucher register is used to record the vouchers for goods and services. The voucher register contains numerous columns for recording the account classifications for the goods or services, including a column for recording credits to accounts payable, and columns for recording debits to asset accounts such as inventory and expense accounts such as repairs and maintenance. The voucher register also contains columns for miscellaneous debits and credits. Some entities use a purchases journal instead of a voucher register. With a purchases journal, either vouchers or vendors' invoices may be used to record the liability. The major difference between a voucher register and a purchases journal is in the way individual vouchers or vendor invoices are summarized.

- ❖ **Accounts Payable Subsidiary Ledger** - When a purchases journal is utilized, this subsidiary ledger records the transactions with, and the balance owed to, a vendor. When a voucher register system is used, the subsidiary ledger is a listing of the unpaid vouchers. The total in the subsidiary ledger should equal the balance in the general ledger accounts payable account.
- ❖ **Vendor Statement** - This statement is sent monthly by the vendor to indicate the beginning balance, current-period purchases and payments, and the ending balance. The vendor's statement represents the purchase activity recorded on the vendor's records. It may differ from the client's records because of errors or, more often, timing differences due to delays in shipping goods or recording cash receipts. The client verifies the accuracy of its records by comparing vendor statements with the accounts payable records.
- ❖ **Check or Electronic Funds Transfer (EFT) Listing** - These disbursements, signed by an authorized individual, pays for goods or services. Additionally, goods and services may be paid for through electronic transfer of funds.
- ❖ **Cash Disbursements Journal/Check Register** - This journal records disbursements made by check. It is sometimes referred to as a *check register*. The cash disbursements journal contains columns for recording credits to cash and debits to accounts payable and cash discounts. Columns may also record miscellaneous debits and credits. Payments recorded in the cash disbursements journal are also recorded in the voucher register or in the accounts payable subsidiary ledger, depending on which system is used by the entity.

QUICK CHECK

1. List the three types of transactions that are processed through the purchasing process.
2. Discuss the important documents and records that are normally involved in the purchasing process.

4.4. The Major Functions in purchasing process

The principal business objectives of the purchasing process are acquiring goods and services at the lowest cost consistent with quality and service requirements and effectively using cash resources to pay for those goods and services. Here we are going to see the functions that are normally part of the purchasing process.

- ❖ **Requisitioning** - The initial function in the purchasing process is a request for goods or services by an authorized individual from any department or functional area within the entity. The important issue is that the request meets the authorization procedures implemented by the entity. One frequent organizational control is the establishment of authorization dollar limits for different levels of employees and executives.
- ❖ **Purchasing** - The purchasing function executes properly authorized purchase orders. This function is normally performed by a purchasing department, which is headed by a purchasing manager (or agent) and has one or more buyers responsible for specific goods or services. The purchasing function ensures that goods and services are acquired in appropriate quantities and at the lowest price consistent with quality standards and delivery schedules. Using multiple vendors and requiring competitive bidding are two ways the purchasing function can achieve its objectives.
- ❖ **Receiving** - The receiving function is responsible for receiving, counting, and inspecting goods received from vendors. The personnel in the receiving department complete a receiving report that is forwarded to the accounts payable function.
- ❖ **Invoice Processing** - The accounts payable department processes invoices to ensure that all goods and services received are recorded as assets or expenses and that the corresponding liability is recognized. This function involves matching purchase orders to receiving reports and vendor invoices as to terms, quantities, prices, and extensions. The invoice-processing function also compares the account distributions with established account classifications. The invoice-processing function is also responsible for purchased goods returned to vendors. Appropriate records and control activities must document the return of the goods and initiate any charges back to the vendor.
- ❖ **Disbursements** - The disbursement function is responsible for preparing and signing checks for paying vendors and authorizing electronic funds transfers. Adequate

supporting documentation must verify that the disbursement is for a legitimate business purpose, that the transaction was properly authorized, and that the account distribution is appropriate. To reduce the possibility that the invoice will be paid twice, all documentation (such as purchase order, receiving report, and vendor invoice) should be marked **“CANCELED” or “PAID”** by the cashier’s department. Finally, the checks should be mailed to the vendor by the cashier’s department or treasurer.

- ❖ **Accounts Payable** - The accounts payable department is also responsible for ensuring that all vendor invoices, cash disbursements, and adjustments are recorded in the accounts payable records. In IT systems, these entries may be made directly as part of the normal processing of purchase, cash disbursement, or returns and allowances transactions. Proper use of control totals and daily activity reports provides controls for proper recording.
- ❖ **General Ledger** The main objective of the general ledger function for the purchasing process is to ensure that all purchases, cash disbursements, and payables are properly accumulated, classified, and summarized in the accounts. In an IT system the use of control or summary totals ensures that this function is performed correctly. The accounting department is normally responsible for this function.

4.5. The Key Segregation of Duties

As discussed in previous chapters, proper segregation of duties is one of the most important control activities in any accounting system. Duties should be assigned so that no one individual can control all phases of processing a transaction in a way that permits errors or fraud to go undetected. Because of the potential for theft and fraud in the purchasing process, individuals responsible for requisitioning, purchasing, and receiving should be segregated from the invoice processing, accounts payable, and general ledger functions. If IT is used in the purchasing application, there should be proper segregation of duties in the IT department.

Table below shows the key segregation of duties for the purchasing process and examples of possible errors or fraud that can result from conflicts in duties.

Table 4.1.Key Segregation of Duties in the Purchasing Process and Possible Errors or Fraud

Segregation of Duties Possible	Errors or Fraud Resulting from Conflicts of Duties
The purchasing function should be segregated from the requisitioning and receiving functions	If one individual is responsible for the requisition, purchasing, and receiving functions, fictitious or unauthorized purchases can be made. This can result in the theft of goods and possibly payment for unauthorized purchases.
The invoice-processing function should be segregated from the accounts payable function.	If one individual is responsible for the invoice-processing and the accounts payable functions, purchase transactions can be processed at the wrong price or terms, or a cash disbursement can be processed for goods or services not received. This can result in overpayment for goods and services or the theft of cash.
The disbursement function should be segregated from the accounts payable function.	If one individual is responsible for the disbursement function and also has access to the accounts payable records, unauthorized checks supported by fictitious documents can be issued, and unauthorized transactions can be recorded. This can result in theft of the entity's cash.
The accounts payable function should be segregated from the general ledger function.	If one individual is responsible for the accounts payable records and also for the general ledger, that individual can conceal any defalcation that would normally be detected by reconciling subsidiary records with the general ledger control account.

QUICK CHECK

1. Discuss the key segregation of duties in purchase procedures.

4.6. Control Activities and Tests of Controls - Purchase Transactions

There are seven control procedures applied for control of purchase transactions which includes the following points:

- ❖ **Validity** - the Auditors concern in testing of the validity of purchase transaction is that factious or non-existent purchase may have been recorded in the client's records. If fraudulent transactions are recorded, assets or expenses will be overstated. A liability will also be recorded and a resulting payment made, usually to the individuals who initiated the factious purchase transactions proper segregation is the control test for preventing factious purchases. The critical segregation of duties is the separation of the reacquisition, and purchasing functions from the accounts payable and disbursement functions.
- ❖ **Completeness of purchase transaction**- If the client fails to record a purchase that has been made assets or expenses will be understated and the corresponding accounts payable will also understate. Control Test that provides assurance that the completeness objective is being met includes accounting or checking the numerical sequence of purchase orders, receiving Reports, and Vouchers; matching receiving vouchers with vender invoices, etc.
- ❖ **Timeliness of recording of purchase transaction** - the client should have controls to ensure that purchase transactions are recorded on timely basis (in a proper time). For example, the client's procedure should require that all receiving reports should be forwarded to the accounts payable department or section on daily basis.
- ❖ **Authorization of purchase transaction** - possible misstatements due to improper authorization includes the purchase of unauthorized goods and the purchase of goods or services at unauthorized price or terms. The major control procedure to prevent these misstatements is the use of authorization schedule or table which shows the amount that different levels of employees (personnel) are authorized to purchase.
- ❖ **Cutoff of Purchase Transactions** - The client should have controls to ensure that purchase transactions are recorded promptly and in the proper period. For example, the client's procedures should require that all receiving reports be forwarded to the accounts payable department daily. There should also be a requirement in the accounts payable department that receiving reports be matched on a timely basis with the original purchase order and the related vendor invoice. The auditor can test these control activities by

comparing the date on the receiving report with the date on the voucher. There should seldom be a long period between the two dates. The auditor also wants to ensure that the vouchers are recorded in the accounting records in the correct period. This can be tested by comparing the dates on vouchers with the dates the vouchers were recorded in the voucher register.

- ❖ **Valuation of purchase transactions** - The possible misstatements for valuation of Internal control objective is that purchase transactions may be recorded at in correct amounts due to improper pricing or erroneous calculation.
- ❖ **Classification of purchases** - Proper classification of purchase transactions is an important internal control objective for the purchasing cycle. If purchase transactions are not properly classified, asset and expense accounts will be misstated. A control test for this objective is proper documentation and records for example having chart of accounts.

QUICK CHECK

1. What are the major control activities and tests of controls in purchase transactions?

4.7. Inventory Transactions

The inventory cycle is affected by the control procedures previously discussed for cash receipts review purchasing, and payroll cycles. The acquisition of and payment for raw materials and overhead costs is controlled via the purchasing cycle. The cost of both direct and indirect labor assigned to inventory is controlled through payroll cycle. Finally, finished goods are sold and accounted for as part of revenue cycle. Thus, the cycle for Inventory in manufacturing company begins when goods are purchased and stored as raw materials, proceeds to the processing of the goods through manufacturing departments, and ends when the finished goods are shipped to customers.

4.8. Control Activities and Tests of Controls - Inventory Transactions

Here we are going to discuss of the control activities, and selected tests of controls for inventory transactions. The discussion includes control activities that are present in a manufacturing setting. A number of control activities in the revenue and purchasing processes provide assurance for selected assertions for inventory.

The discussion is limited to the more important assertions and it includes the following control activities and test of control points:

- ❖ **Occurrence of Inventory Transactions:** The auditor's main concern is that all recorded inventory exists. The major control activity for preventing fictitious inventory transactions from being recorded is proper segregation of duties, in which the inventory management and inventory stores functions are separated from the departments responsible for inventory and cost-accounting records. This control prevents operating personnel from having access to both inventory and the perpetual inventory records. Additionally, prenumbered documents to handle the receipt, transfer, and withdrawal of inventory may prevent the recording of fictitious inventory in the accounting records.
- ❖ **Completeness of Inventory Transactions:** The control activities for the completeness assertion relate to recording inventory that has been received. Typically, the control activities for this assertion are contained within the purchasing process. For example, in some instances, additional control activities may be used in the raw materials stores department to ensure that the goods are recorded in the perpetual inventory records. This might include comparing a summary of the receiving reports to the inventory status report.
- ❖ **Authorization of Inventory Transactions:** The auditor's concern with authorization in the inventory system is with unauthorized purchase or production activity that may lead to excess levels of certain types of finished goods. If such goods can quickly become obsolete, ending inventory may be overstated. The use of some type of inventory-planning system, such as a material requirements planning system or a just-in-time inventory system, may also limit unauthorized production.
- ❖ **Accuracy of Inventory Transactions:** Accuracy is an important assertion because inventory transactions that are not properly recorded result in misstatements that directly affect the amounts reported in the financial statements for cost of goods sold and inventory. The accurate processing of inventory purchase transactions involves applying

the correct price to the actual quantity received. Similarly, when inventory is shipped, accurate processing requires that the actual number of items shipped be removed from inventory and that the proper cost be recorded to cost of goods sold. The use of a perpetual inventory system in conjunction with a periodic or annual physical inventory count should result in the proper quantities of inventory being shown in the client's perpetual inventory records.

- ❖ **Cutoff of Inventory Transactions:** Inventory transactions recorded in the improper period could affect a number of accounts, as illustrated by this simple inventory computation:

$$\text{Beginning inventory} + \text{Purchases} - \text{Cost of goods sold} = \text{Ending inventory}$$

The cutoff risks, control activities, and tests of controls associated with inventory transactions were already addressed in revenue and purchase cycle, since the sale of inventory involves the revenue process and purchase of inventory involves the purchasing process. For sold (purchased) inventory, a common test of the client's controls to ensure transactions are recorded in a timely manner is to compare the date on the shipping document (receiving report) with the date in the sales journal (payment voucher). There should not be a long period between these two dates. As discussed later, auditors also often focus tests of details on transactions near year-end. It is important to understand that failure to record inventory in the proper period can result in misstatements on both the balance sheet and income statement.

- ❖ **Classification of Inventory Transactions:** In a manufacturing company, the client must have control activities to ensure that inventory is properly classified as raw materials, work in process, or finished goods. This can usually be accomplished by determining which departments in the manufacturing process are included in raw materials, work in process, and finished goods inventory. Thus, by knowing which manufacturing department holds the inventory, the client is able to classify it by type.

QUICK CHECK

1. What are the major control activities and tests of controls in inventory transactions?

4.9.The auditors' objectives in the examination of inventories and purchases

The auditors' have the following objectives in the examination of inventories and purchases.

- ❖ To consider internal control over inventories and purchases.
- ❖ To determine the existence of inventories, and the client's ownership of these assets.
- ❖ To establish the completeness of inventories and purchase transaction.
- ❖ To establish clerical accuracy of records and supporting schedules for inventories and purchases.
- ❖ To determine that the valuation inventories is based on appropriate methods.
- ❖ To determine the statement presentation of inventories is adequate, including disclosure of classification of inventories, accounting records and any inventories pledged as collateral for loans.

4.10. Internal control over inventories and purchases control objectives

Although inventory records may vary considerably from client to client, the control objectives of a sound system of internal control over inventories are the same in all cases, namely:

- ❖ Authorization and purchase procedures.
- ❖ Control over goods inwards.
- ❖ Inventory records substantiated by physical counts.
- ❖ Control over dispatches and goods outwards.
- ❖ Inventory levels should be controlled so that materials are available when required but that inventory is not unnecessarily large. Control procedures over inventories.

Internal control procedures for inventories affect nearly all the functions involved in producing and disposing of the company's products, purchasing, receiving, storing, issuing, processing, and shipping are the physical functions directly connected with inventories. The basic internal control procedures are the following:

QUICK CHECK

1. What are the auditor objectives and internal control objective in the examination of inventories and purchases?

4.11. Limitations (weakness) of internal control over Inventory

Internal control weaknesses to observe in inventory audit are:

- ❖ **Purchases:** ordering unauthorized goods: goods that are not needed by the organization may be ordered for personal whim at the cost of the organization. goods ordered can also be diverted before they can enter into the organization. in this connection, in depth examination of purchase requisition, purchase order and store receiving reports are important.
- ❖ **Over invoicing:** purchases may be made at prices especially agreed between purchaser and supplier to include commission. The venders invoice is thus over invoiced to include kick back to the purchaser. Hence, it is necessary to check the competitiveness of suppliers in terms of price, quality and delivery time.
- ❖ **Inventory valuation:** there are different inventory valuation methods and each organization may have the prerogative to use inventory methods it deems appropriate. However, the auditor must carefully note the effect of different methods of valuation on net income, taxes and balance sheet in order to avoid presentation of misleading information or misstatement of overall financial position. The importance of the accuracy of clerical operation here is also obvious. There are many opportunities for intentional or unintentional errors for misstatement of facts or fraud.
- ❖ **Physical inventory:** establishment of existence of physical inventory first involves a matter of physical count only, which by itself is problematic. especially I counting packaged goods or held in big container whose unfolding and emptying may cause damage to goods, i.e sacks of coffee, bottles of whisky, barrels of oil or sensitive scientific instruments such as lenses. As a result, it is possible to count or observe physical count of empty containers with sham contents. Problem also arises with inventory found in distant geographical location. Secondly, establishment of physical

inventory involves determining inventory ownership title by ensuring title transfer, which can be corroborated by examining terms of sale or purchase. Moreover, it is important to be aware of alternative methods of satisfying oneself of physical existence of inventory, and examining goods-in-transit or on consignment and or on installment sales.

4.12. Audit procedures of inventories and purchases

The following audit procedures for the verification of inventories and purchases may be used by auditors:

- A ***Obtain an understanding of internal control for inventories and purchases:*** In obtaining an understanding of internal control over inventory, the auditor should become thoroughly conversant with the procedures for purchasing, receiving, storing, and issuing goods as well as acquiring an understanding of the cost accounting system and the perpetual records.
- B ***Assess control risk and design additional tests of control for inventories and purchases:*** After obtaining an understanding of the client's internal control over inventories and purchases, the auditors perform their initial assessment of control risk for the various financial statement assertions.
- C ***Perform additional tests of controls:*** Tests directed toward the effectiveness of controls help to evaluate the client's internal control and to determine the extent to which the auditors are justified in reducing their assessed level of control risk for the assessments about the inventory and purchase accounts. The following are examples of typical additional test.
 - ❖ Examine significant aspects of a sample of purchase transactions.
 - ❖ Test the cost accounting system.
 - ❖ Reassess control risk and design substantive tests.
- D ***Perform the following Substantive tests:***
 - ❖ Obtain listings of inventory and reconcile to ledgers.
 - ❖ Evaluate the client's planning of physical inventory.
 - ❖ Observe the taking of physical inventory and make test counts.
 - ❖ Review the year – end cutoff of purchases and sales transactions.

- ❖ Obtain a copy of the completed physical inventory, test its clerical accuracy, and trace test counts.
- ❖ Evaluate the bases and methods of inventory pricing.
- ❖ Review inventory quality and condition.
- ❖ Perform analytical procedures.
- ❖ Determine whether any inventories have been pledged and review purchase and sales commitments.
- ❖ Evaluate financial statement presentation of inventories, including the adequacy of disclosure

QUICK CHECK

1. Discuss the audit procedures for the verification of inventories and purchases used by auditors:

Summary

In this chapter, we discussed the audit of the inventory and purchase cycle. Because of the difficulties associated with establishing the existence and valuation of inventories, the cycle is often the most time-consuming and complex part of the audit. This cycle is also unique because many of the tests of the inputs to the cycle are tested as part of the audit of other cycles.

A purchase transaction usually begins with a purchase requisition being generated by a department or support function. The purchasing department prepares a purchase order for the purchase of goods or services from a vendor. When the goods are received or the services have been rendered, the entity records a liability to the vendor. Finally, the entity pays the vendor. On the other hand, inventories are major items on the balance sheet, i.e. in total assets, especially in the current asset section. Inventories play also a very significant and important role in preparation of income statement and determination of net income or loss.

The relationship of inventories and purchase makes it logical for the two topics to be considered together. The Internal control that assures the fair valuation of inventories is found in the purchase (or acquisition) cycle. These procedures include procedures for the selection of vendors, ordering merchandise or materials, inspecting goods, receive, recording the liabilities to the vendor, and authorizing and making cash disbursements.

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question.

1. When auditing merchandise inventory at year-end, the auditor performs a purchase cutoff test to obtain evidence that
 - A. All goods purchased before year-end are received before the physical inventory count.
 - B. No goods held on consignment for customers are included in the inventory balance.
 - C. No goods observed during the physical count are pledged or sold.
 - D. All goods owned at year-end are included in the inventory balance.
 - E. None of the above
2. In an audit of inventories, an auditor would least likely verify that
 - A. All inventory owned by the clients is on hand at the time of the count.
 - B. The client has used proper inventory pricing.
 - C. The financial statement presentation of inventories is appropriate.
 - D. Damaged goods and obsolete items have been properly accounted for.
 - E. None of the above
3. The financial statement assertion of valuation is not related to inventories.
 - A. True
 - B. False
4. Efficient and effective inventory taking requires careful planning in advance.
 - A. True
 - B. False
5. Auditors should not observe the quality or condition of inventories
 - A. True
 - B. False

Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. What major types of transactions occur in the purchasing process? What financial statement accounts are affected by each type of transaction?
2. Briefly describe each of the following documents or records: purchase requisition, purchase order, receiving report, vendor invoice, and voucher. Why would an entity combine all documents related to a purchase transaction into a “voucher packet”?
3. List the key segregation of duties in the purchasing process. What errors or fraud can occur if such duties are not segregated?
4. What control activities typically ensure that the occurrence, authorization, and completeness assertions are met for a purchase transaction? What tests of controls are performed for each of these assertions?
5. Briefly describe each of the following documents or records: production schedule, materials requisition, inventory master file, production data information, and cost accumulation and variance reports.
6. List three substantive analytical procedures that can test the fairness of inventory and related accounts.

CHAPTER FIVE

AUDIT OF FIXED ASSETS

5. LEARNING OBJECTIVES

At the end of this chapter, the learners should be able to:

- ❖ Understand the objectives fixed assets audit
- ❖ Know audit procedures of fixed assets audit
- ❖ Describe the internal control checklist for fixed asset audit
- ❖ Understand the verification of fixed asset audit
- ❖ Design typical test of control used by auditors to evaluate the effectiveness of control over fixed asset audit

5.1. Introduction

Dear Learners! It is obvious that every private and governmental sectors have a fixed assets held in order to accomplish the day to day activities and those assets must be audited. Accordingly, fixed assets are those assets acquired by a business for the purpose of use in the business with the objective of earnings revenue, and which are not intended for resale at a profit and conversion into cash in the ordinary course of business. They may broadly be classified into tangible assets and intangible assets. Tangible assets are those which have definite shapes and which can be seen, e.g., plant and machinery including motor vehicles, land and buildings, furniture and fittings, investment properties, etc. Intangible fixed assets are those which are not perceptible by touch, but nevertheless employed in the business for earning revenue, e.g. patents, copy rights, trade marks, goodwill deferred expenditure such as development costs and franchises etc.

There are four types' transactions in fixed assets. These are acquisition of capital assets for cash, or other non-monetary considerations (exchange by other fixed assets); disposition of capital (fixed assets) through sale, exchange, retirement, or abandonment; depreciation of capital assets over their useful economic life and Leasing of capital assets.

The primary accounting record for equipment and other property, plant, and equipment accounts is generally a **fixed asset master file**. The master file includes a detailed record for each piece of equipment and other types of property owned. Each record in the file includes a description of the asset, date of acquisition, original cost, current year depreciation, and accumulated depreciation for the property. The totals for all records in the master file equal the general ledger balances for the related accounts: ***equipment, depreciation expense, and accumulated depreciation***. The master file also contains information about property acquired and disposed of during the year. Auditors verify equipment differently from current asset accounts for three reasons:

1. There are usually fewer current period acquisitions of equipment, especially large equipment used in manufacturing.
2. The amount of any given acquisition is often material.
3. The equipment is likely to be kept and maintained in the accounting records for several years.

Because of these differences, the auditing of equipment emphasizes the verification of current period acquisitions rather than the balance in the account carried forward from the preceding year.

Therefore, this chapter deals with the audit of fixed asset for instance, its objectives, internal control, basic procedures, and tests undertaken by the auditor.

5.2. Audit Objectives of Fixed Assets

The audit objectives in the verification of fixed assets in short are the following:

1. The verification of existence;
2. The verification of ownership;
3. The examination and full disclosure of the valuation methods used (and also of the depreciation policies, where applicable);
4. The verification of the propriety of the fixed asset transaction for the year under audit; and,
5. The review and evaluation of the internal control,

6. An audit of fixed assets significantly varies from an audit of current assets (cash, receivable, stocks, etc.). Current assets are of short life usually falling due within an accounting period of one year whereas fixed assets are of a long life.

So, the auditors' objectives in fixed asset audit are to determine that:

- ❖ The recorded property , plant, and equipment is valid (existence and right)
- ❖ All property , plant, and equipment is recorded (completeness)
- ❖ Property , plant, and equipment records an supporting schedules are mathematically correct and agree with general ledger account (clerical accuracy)
- ❖ The valuation of fixed assets is proper (valuation)
- ❖ The presentation and disclosure of fixed assets , including disclosure of depreciation method, is adequate(disclosure)

All these items we can summarized here under in the table 4.1.

Table 5.1: General audit objectives of fixed assets

S.No.	Audit objectives	Purpose
1	Internal control	To ensure that all the necessary controls over plant (fixed) assets were applied by the management of the client.
2	Completeness	To ensure that all fixed assets owned by the entity at the end of the accounting period have been recorded.
3	Existence	To ensure that the recorded fixed assets were in existence at the end of the accounting period and remain in use by the entity.
4	Ownership	To ensure that the recorded fixed assets were properly owned by the entity at the end of the accounting period and that all lines and other loaded on them have been properly identified.
5	Valuation	To ensure that the recorded fixed assets were properly valued at the end of the accounting period in

		accordance with GAAP.
6	Disclosure	To ensure that the disclosure of fixed assets is to accordance with GAAP.

QUICK CHECK

1. Describe the objectives of audit of fixed assets?

5.3. Nature of Internal control over fixed assets audit

This sub section took about the nature of internal control over fixed assets audit. Hence, it comprise of validity and authorization, completeness and segregation of duties. Let us discuss one by one.

1. Validity and Authorization

The control procedures for the validity and Authorization objectives are normally part of the purchasing cycle. Purchase reacquisition are initiated in relevant departments and authorized at the appropriate level within the entity. However large capital asset transactions may be subject to control procedures outside the purchasing cycle for example, highly specialized equipment may require skilled engineers approval for the technical specifications for the equipment, for such transactions, the auditor may need to examine more than the vendors invoices to test validity; review of additional documentations, such as capital – budgeting documents and engineering specifications may be needed.

2. Completeness

The control procedures used in the purchasing cycle for ensuring completeness provide some assurance that all capital asset transactions are recorded in the property, plant, and equipment subsidiary ledger and general ledger. One procedure that helps to ensure that this objective is met is reconciliation of the property, plant and equipment subsidiary ledger to the general ledger one procedure that helps to ensure that this objective is met is reconciliation of the property, plant and equipment subsidiary ledger to the general ledger control accounts on monthly basis.

Another control procedure that an entity may use to ensure that all capital assets are recorded is periodic comparison of the detailed records in the subsidiary ledger with the existing capital assets. The client may take a complete physical examination of property, plant, and equipment on periodic or rotating basis and compare the physical asset to the subsidiary ledger.

3. Segregation of duties

The existence of adequate segregation of duties for property, plant and equipment within an entity depends on the volume and significance of the transaction processed. For example, if an entity purchases large quantities of machinery and equipment, or if it has large capital projects under construction, there is a likely to be a formal internal control system. On the other hand, if an entity has few capital purchases, the entity will generally not have formal control system.

The following notes show the key segregation of duties for property, plant, and equipment transactions.

1. If one individual is responsible for initiating a capital asset transaction and also has final approval, it is possible for fictitious or unauthorized purchases of assets to occur. This can result in purchases of unnecessary assets, assets that do not meet the company's quality control standards, or illegal payments to suppliers or contractors. Thus, there must be final approval functions.
2. If one individual is responsible for the records and also for the general ledger functions, It is possible for that individual to conceal (fraud) any defalcation that would normally be detected by reconciling subsidiary records with the general ledger control account. Thus, the recording function should be segregated from the general ledger function.
3. If one Individual is responsible for the records and also has custodian responsibility for the related assets, it is possible for tools and equipment to be stolen and for the theft to be concealed by adjustment of the accounting records. Thus, the recording functions should be segregated from the custodian function.
4. If the individual, who is responsible for the periodic physical inventory fixed assets, is also responsible for the custodian and record keeping functions, it is possible for theft of the entity's capital assets to be concealed. Thus, individual responsible for the inventory should be independent of the custodian and record keeping functions.

5.4. Internal control principles for fixed asset audit

The most important controls applicable in fixed assets are as follows:

- ❖ A subsidiary ledger consisting of separate records for each unit of property .an adequate fixed asset ledger facilitates your work in analyzing additions and retirement; in verifying depreciation provision and maintenance expenses; and in compering authorization with actual expenditure.
- ❖ A system of authorization requiring advance executives approval of all assets whether by purchase, lease or construction.
- ❖ A reporting procedures assuring prompt disclosure and analysis of variances between authorized expenditure and actual costs.
- ❖ A policy requiring all purchase of fixed assets to be handled through the purchasing department and subjected to standard routine for receiving , inspection, and payment.
- ❖ Periodic physical inventories designed to verify the existence, location, and conditions of all property listed in the account and disclose the existence of any unrecorded units.
- ❖ The reconciliation of detailed records with control accounts Physical security over fixed asset and of appropriate, the title to fixed assets recorded in the accounts.

5.4.1. Internal control questionnaires for fixed assets

The following table summarized some of the checklist for internal control related to fixed assets.

Table 4.2: Sample internal control questionnaires

S.no	Items
1	Are fixed assets register or similar records maintain detailed the cost and accumulated depreciation of each individual asset and identifying each asset by number which also appears on the asset itself?
2	Are these records maintained by persons other than those responsible for the custody to the physical properties?
3	Are the detailed records agreed at least annually for each class of asset with the cost and accumulated depreciation according to the general ledger account?
4	Is a nominal book value in respect of fully depreciated asset retained in the records until the assets are disposed of?
5	Is the original cost and accumulated depreciation eliminated from the accounting records

and fixed assets records whenever an asset is sold or scrapped?

- 6 Are adequate records maintained of capital works in progress to identify expenditure incurred on each separate project and provide proper control over cost?
- 7 Are adequate records maintained to control small toll, cutlery, line and other miscellaneous items?
- 8 Are fixed assets adequately physical safeguarded?
- 9 Are fixed assets adequately covered by insurance?
- 10 Are physical inventories of fixed assets taken periodically by or under the supervision of employees not responsible for physical custody or recorded keeping of such properties?
- 11 Is adequate follow-up action taken by management in respect of assets reported as missing or damaged?
- 12 Are document of title kept in safe custody and controlled by register?

5.5. Audit procedures for fixed assets

The audit procedures for fixed assets are in general similar to the procedures for other items.

The audit of fixed assets involves the examination of fixed assets records and evidences such as contracts, invoices, and receipt documents. Regarding proposed acquisitions of fixed assets some of the questions that may need to be answered are the following:

- ❖ Will the acquisition of new fixed assets improve the efficiency of the Public Body in achieving its objectives?
- ❖ Will expenses be reduced by the acquisition of the fixed assets?
- ❖ What will the acquisition of the new fixed assets cost the Public Body and what will the savings be in terms of finances?
- ❖ How many years will the new fixed asset serve at a lower running and maintenance cost and when should it be replaced or disposed of?

The following procedures were taken in to account while the auditors engaged in the audit of fixed assets.

4. To ascertain that validity of the recorded of fixed assets:

-  Examine the fixed asset register, and trace the balance to the ledger account and the balance sheet.

- ✚ Trace the purchase invoice during the year to the fixed asset register, the ledger account and the balance sheet.
 - ✚ Examine the purchase invoice to verify that all the fixed assets acquisitions recorded in the books are for transaction that have occurred,
 - ✚ Review minutes of the executive committee for approval of acquisitions.
 - ✚ Physical observation of assets to ascertain existence of fixed assets.
5. To verify the completeness of the fixed asset records, apply the following audit procedures.
- ✚ Examine the fixed asset register, and trace the balance to the ledger account and balance sheet.
 - ✚ Trace the purchase invoices during the year to fixed asset register, the ledger account and the balance sheet.
 - ✚ Examine plant asset acquisition and disposal to make sure that these transactions are in the right period.
6. To verify the clerical accuracy of reconcile the figure of cost, accumulated depreciation and book value with the corresponding figure in the previous year end.
- ✚ Verify calculation of depreciation
 - ✚ Examine the valuation of assets acquisition
 - ✚ Verify arithmetic accuracy of additions
 - ✚ Examine sales invoices and accounting records for disposal and check that depreciation is calculated to date of disposal.
7. For proper disclosure and presentation in the financial statement, you have to examine the chart of account and the balance sheet for the proper presentation of fixed asset, separate from current asset and notes to the financial statements regarding depreciation.

QUICK CHECK

1. Describe the major procedures undertaken by the auditors in audit of fixed assets?
2. Write the most important controls applicable in fixed assets

5.6. Verification of Fixed assets audit

In the audit of equipment as fixed asset and related accounts, it is helpful to separate the tests into the following categories:

- ❖ Perform analytical procedures
- ❖ Verify current year acquisitions
- ❖ Verify current year disposals
- ❖ Verify the ending balance in the asset account
- ❖ Verify depreciation expense
- ❖ 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.

5.6.1. Perform Analytical Procedures

As in all audit areas, the type of analytical procedures depends on the nature of the client's operations. The following Table 4.3 illustrates analytical procedures often performed for equipment as fixed asset.

Table 5.3: Analytical procedure for equipment audit

Analytical producers	Possible misstatements
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, supplies expense, small tools expense, and similar accounts with previous years.	Expensing amounts that should be capitalized.
Compare gross manufacturing cost divided by some Idle measure of production with previous years	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.

5.6.2. Verify Current Year Acquisitions

Companies must correctly record current year additions because the assets have long-term effects on the financial statements. The failure to capitalize a fixed asset, or the recording of an acquisition at the incorrect amount, affects the balance sheet until the company disposes of the asset. The income statement is affected until the asset is fully depreciated.

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, cutoff, detail tie-in, and rights and obligations.

The balance-related audit objectives and common audit tests are shown in the following table 5.4. ***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.

Table 5.4: **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 tolerated master file amounts, and the total agrees with the general descriptions. ledger (detail tie-in).	Foot the acquisitions schedule. Trace the individual acquisitions and the master file for amounts 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	Examine vendors' invoices of	This objective is one of the

recorded (completeness)	closely related (accounts such as repairs and maintenance. To uncover items that should be recorded as equipment. Review lease and rental agreements	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 are recorded in the correct period (cutoff).	Review transactions near the balance sheet date for correct period	Usually done as part of accounts payable cutoff 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 fore land or major buildings.
Current year acquisitions as listed are correctly classified (classification).	Examine vendors' invoices in various should be classified as manufacturing or office equipment, part of the buildings, 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.

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. The client obtains this information from the property master file. 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.

In testing acquisitions, the auditor must understand accounting standards to make certain the client follows the related requirements. For example, the auditor needs to be alert for the possibility of the client's failure to include material transportation and installation costs as part of the asset's acquisition cost and the failure to properly record the trade-in of existing equipment. The auditor also needs to know the client's capitalization policies to determine whether acquisitions are treated consistently with those of the preceding year. For example, if the client's policy is to automatically expense acquisitions that are less than a certain amount, such as birr1,000, the auditor should verify that the policy is followed in the current year.

Auditors should also verify recorded transactions for correct classification among various equipment accounts. In some cases, amounts recorded as manufacturing equipment should be classified as office equipment or as a part of the building. Clients commonly include transactions that should be recorded as assets in repairs and maintenance expense, lease expense, supplies, small tools, and similar accounts.

The misstatement may result from a lack of understanding accounting standards or from clients' desires to avoid income taxes. If auditors conclude this type of material misstatement is likely, they may need to vouch larger amounts debited to the expense accounts. It is a common practice to do so as part of the audit of the property, plant, and equipment accounts.

Auditors also need to examine whether the client has a right to record equipment as an asset. Some large manufacturing equipment and other types of machinery, such as sophisticated medical equipment or computer data center equipment, may be under an operating lease. Auditors frequently examine purchase or lease contracts to determine whether capitalization of the equipment is appropriate.

5.6.3. 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.

Detail tie-in tests of the recorded disposals schedule are necessary, including footing the schedule, tracing the totals on the schedule to the recorded disposals in the general ledger, and tracing the cost and accumulated depreciation of the disposals to the property master file.

Because the failure to record disposals of equipment no longer used in the business can significantly affect the financial statements, the search for unrecorded disposals is essential. 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.

5.6.4. 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. Ideally, auditors are able to conclude that controls are sufficiently strong to allow them to rely on balances carried forward from the prior year. Important controls include the use of a master file for individual fixed assets, adequate physical controls over assets that are easily movable (such as computers, tools, and vehicles), assignment of identification numbers to each plant asset, and periodic physical count of fixed assets and their reconciliation by accounting personnel. A formal method of informing the accounting department of all disposals of fixed assets is also an important control over the balance of assets carried forward into the current year.

Typically, the first audit step concerns the detail tie-in objective: Equipment, as listed in the master file, agrees with the general ledger. Examining a printout of the master file that totals to the general ledger balance is ordinarily sufficient. The auditor may choose to use audit software to foot an electronic version of the master file or manually test-foot a few pages.

After assessing control risk for the existence objective, the auditor decides whether it is necessary to verify the existence of individual items of equipment included in the master file. If there is a high likelihood of a material amount of missing fixed assets still included in the master file, the auditor can select a sample from the master file and examine the actual assets. Similarly, 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. In rare cases, the auditor may decide it is necessary for the client to take a complete physical inventory of fixed assets to make sure they all exist, and the fixed asset records are complete. If a physical inventory is taken, the auditor normally observes the count.

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 the auditor should be aware that companies may occasionally have equipment on hand that is no longer used in operations. If the amounts are material, 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.”

In addition to performing procedures to obtain evidence related to balance-related audit objectives for fixed assets, auditors also perform audit procedures related to the four presentation and disclosure objectives for fixed assets. A major consideration in verifying disclosures related to fixed assets is the possibility of legal encumbrances. Auditors may use several methods to determine whether equipment is encumbered, including:

- ❖ Read the terms of loan and credit agreements
- ❖ Mail loan confirmation requests to banks and other lending institutions
- ❖ Have discussions with the client or send letters to legal counsel

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 four presentation and disclosure objectives are met.

5.6.5. 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 into account obsolescence or the company's normal policy of upgrading equipment), and established company policies on trading in equipment.

Occasionally, changing circumstances may necessitate a company to reevaluate the useful life of an asset. When this occurs, the revaluation should involve a change in accounting estimate rather than a change in accounting principle. The effect of this on depreciation must be evaluated.

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. Many CPA firms maintain an electronic spreadsheet in their permanent file that includes a breakdown of the fixed assets by method of depreciation and length of life. If the software calculations are reasonably close to the client's totals and if assessed control risk for depreciation expense is low, tests of details for depreciation can be eliminated.

When an overall reasonableness test cannot be accomplished, more detailed tests are usually needed. To do this, auditors re-compute depreciation expense for selected assets to determine whether the client is following a proper and consistent depreciation policy. To be relevant, the detailed calculations should be tied in to the total depreciation calculations by footing the depreciation expense on the property master file and reconciling the total with the general ledger. 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 four 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.

5.6.6. 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.

QUICK CHECK

1. How tests classified in order to verify a fixed asset audit for instance, equipment? Clearly describe each category of tests?

5.7. Audit Approach in Relation to Fixed Assets

The detailed audit steps the auditor should cover in relation to fixed assets are the following:

1. Study and evaluate the adequacy of internal controls in relation to fixed assets.
2. Check the opening balances with those of the closing balances appearing in the audited accounts of the previous year.
3. Review the fixed assets register to ensure that the entries appearing therein are up to date.
4. Confirm that additions have been properly recorded in the fixed assets register. Additions may be by way of purchased or self-construction. In either case check the authorization documentation.
5. Check that assets scrapped or disposed of have been eliminated from the fixed assets register. Verify whether they represent valid scrapings or disposals.
6. Confirm that fixed assets have been recorded in both the fixed assets register and the relevant ledger accounts.
7. Review period reconciliations of the fixed assets register with the general ledger accounts.
8. Check whether any significant items of capital expenditure have been charged to revenue.
9. Select a sample of items and carry out physical inspection, checking from the fixed assets register to the assets and vice versa.
10. Using the sample as above, make sure that the assets are being used for the purpose of the entity's activities.
11. Review the list of additions to fixed assets during the accounting period and see whether they appear appropriate for use in the entity's activities.
12. Test a sample of additions, during the accounting period in order to ensure that the amounts recorded are in accordance with the supporting documentation.
13. Select a sample and confirm that the cost of disposals and the relevant depreciation are removed from the appropriate general ledger accounts.

14. Ensure that the basis of depreciation and the rates applied are the same as in the previous year.
15. Select a sample and test the depreciation calculations on individual assets in the fixed assets registered.
16. Verify that the entity has consistently followed its method (whether straight line, units of production level, sum-of-years digits or declining balance method) of dealing with depreciation on additions during the accounting period.
17. Obtain fixed assets summary and supporting schedules containing additions, disposals, transfers and depreciation and test with the nominal ledger and the working papers in order to confirm that they have been properly prepared.
18. Check the schedules showing expenditure on repairs.
19. Make sure that the depreciation charge is fully traced and reference to the income statement.
20. Make sure that fixed assets are properly classified and disclosed on a consistent basis.

Summary

This chapter deals with the audit of fixed assets in relation to its objectives, basic procedures, substantive tests or verifications and internal controls.

Fixed assets are those assets acquired by a business for the purpose of use in the business with the objective of earning revenue, and which are not intended for resale at a profit and conversion into cash in the ordinary course of business.

The primary accounting record for equipment and other property, plant, and equipment accounts as a fixed asset is generally a fixed asset master file. The master file includes a detailed record for each piece of equipment and other types of property owned. The auditors' objectives in fixed asset audit are to determine that: the recorded property, plant, and equipment is valid (existence and right); all property, plant, and equipment is recorded (completeness); property, plant, and equipment records and supporting schedules are mathematically correct and agree with general ledger account (clerical accuracy); the valuation of fixed assets is proper (valuation) and the

presentation and disclosure of fixed assets , including disclosure of depreciation method, is adequate (disclosure).

The audit procedures for fixed assets are in general similar to the procedures for other items.

The audit of fixed assets involves the examination of fixed assets records and evidences such as contracts, invoices, and receipt documents. In the audit of equipment as fixed asset and related accounts, it is helpful to separate the tests categorized as: Perform analytical procedures, Verify current year acquisitions, Verify current year disposals, Verify the ending balance in the asset account, Verify depreciation expense, and Verify the ending balance in accumulated depreciation

SELF ASSESSEMENT QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives and write the answers on the given space under each question

1. Which of the following audit procedures is most likely to enable an auditor to discover unrecorded disposal of fixed assets?
 - A. Examination of insurance policies
 - B. Review of repairs and maintenance expense
 - C. Examination of invoice relating to additions to fixed asset
 - D. All
2. Which of the following procedures is most likely to enable an auditor to discover unrecorded additions to fixed assets?
 - A. Examination of capital budget
 - B. Review of repairs and maintenance expenses
 - C. Examination of invoice relating to additions to fixed asset
 - D. None of the above
3. Auditors verify fixed asset audit differently from current asset accounts due to:
 - A. There are usually fewer current period acquisitions of fixed assets
 - B. The amount of any given acquisition is often material.
 - C. The fixed asset is likely to be kept and maintained in the accounting records for several years
 - D. All
4. To verify the completeness of the fixed asset records, the first step to apply by the auditor is:
 - A. Examine the fixed asset register, and trace the balance to the ledger account and balance sheet.
 - B. Trace the purchase invoices during the year to fixed asset register, the ledger account and the balance sheet.

- C. Examine plant asset acquisition and disposal to make sure that these transactions are in the right period.
 - D. Both B & C
5. To verify the clerical accuracy of reconcile the figure of cost, accumulated depreciation and book value with the corresponding figure in the previous year end, the auditor should:
- A. Verify calculation of depreciation
 - B. Examine the valuation of assets acquisition
 - C. Verify arithmetic accuracy of additions
 - D. Examine sales invoices and accounting records for disposal and check that depreciation is calculated to date of disposal.
 - E. All
6. In Perform analytical procedures for audit of fixed assets when the auditors Compare depreciation expense divided by gross equipment cost with previous years; the possible misstatement is/are:
- A. Misstatement in depreciation expense
 - B. Accumulated depreciation
 - C. capitalized costs
 - D. A & B
7. 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.
- A. True
 - B. False
8. The auditor's objectives when auditing the ending balance in the equipment accounts is to determine:
- A. All recorded equipment physically exists on the balance sheet date (existence).
 - B. All equipment owned is recorded (completeness).
 - C. All
 - D. None

9. Which of the following method(s) the Auditors may use to determine whether a particular fixed asset is encumbered?

- 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
- D. All

10. Periodic analysis of the scrape sales and the repairs and maintenance accounts which of the following combinations of procedures would an auditor be most likely to perform to obtain evidence about fixed asset additions?

- A. Inspection of documents and physical examination of assets.
- B. Re computation of calculations and obtaining of written management representations
- C. Observation of operating activities and comparison of balances to prior period balances.
- D. Confirmation of ownership and corroborating of transaction through inquiries of client personnel.

Part II: Essay type Questions (self-study)

Give clear and brief answers for the following questions by yourself by referring material

- 1. List the objectives of fixed asset audit?
- 2. Discuss the audit procedures used in audit of fixed assets?
- 3. Describe the internal control principles in audit of fixed assets?

Part III: Problem Type Questions (self-study)

Give appropriate answer for the following problems by your own self.

- 1. For each of the following misstatements in property, plant, and equipment accounts, state an internal control that the client can implement to prevent the misstatement from occurring and a substantive audit procedure that the auditor can use to discover the misstatement:
 - a. The asset lives used to depreciate equipment are less than reasonable, expected useful lives.

- b. Capitalizable assets are routinely expensed as repairs and maintenance, perishable tools, or supplies expense.
 - c. Acquisitions of property are recorded at incorrect amounts.
 - d. A loan against existing equipment is not recorded in the accounting records. The cash receipts from the loan never reached the company because they were used for the down payment on a piece of equipment now being used as an operating asset. The equipment is also not recorded in the records.
 - e. Computer equipment that is abandoned or traded for replacement equipment is not removed from the accounting records.
 - f. Depreciation expense for manufacturing operations is charged to administrative expenses.
 - g. Tools necessary for the maintenance of equipment are stolen by company employees for their personal use.
2. The following audit procedures were planned by Linda King, CPA, in the audit of the acquisition and payment cycle for Cooley Products, Inc.:
- 1. Review the acquisitions journal for large and unusual transactions.
 - 2. Send letters to several vendors, including a few for which the recorded accounts payable balance is zero, requesting them to inform us of their balance due from Cooley. Ask the controller to sign the letter.
 - 3. Examine a sample of receiving report numbers and determine whether each one has an initial indicating that it was recorded as an account payable.
 - 4. Select a sample of equipment listed on fixed asset master files and inspect the asset to determine that it exists and to determine its condition.
 - 5. Re-foot the acquisitions journal for 1 month and trace all totals to the general ledger.
 - 6. Calculate the ratio of equipment repairs and maintenance to total equipment and compare with previous years.
 - 7. Obtain from the client a written statement that all mortgages payable have been included in the current period financial statements and have been accurately recorded and that the collateral for each is included in the footnotes.
 - 8. Select a sample of cancelled checks and trace each one to the cash disbursements journal, comparing the name, date, and amount.

9. For 20 nontangible acquisitions, select a sample of line items from the acquisitions journal and trace each to related vendors' invoices. Examine whether each transaction appears to be a legitimate expenditure for the client and that each was approved and recorded at the correct amount and date in the journal and charged to the correct account per the chart of accounts.
10. Examine invoices and related shipping documents included in the client's unpaid invoice file at the audit report date to determine whether they were recorded in the appropriate accounting period and at the correct amounts.
11. Recalculate the portion of insurance premiums on the client's prepaid insurance schedule that is applicable to future periods.
12. When the check signer's assistant writes "paid" on supporting documents, watch whether she does it after the documents are reviewed and the checks are signed.

Required:

- A. For each procedure, identify the type of evidence being used.
- B. For each procedure, identify whether it is an analytical procedure, a test of control, substantive test of transactions, or a test of details of balances.
- C. For each test of control or substantive test of transactions, identify the transaction related audit objective(s) being met.
- D. For each test of details of balances, identify the balance-related audit objective(s) being met.

CHAPTER SIX

AUDIT OF LIABILITIES

6. LEARNING OBJECTIVES

At the end of this chapter, the learners should be able to:

- ❖ Describe the objectives of both current and long-term liabilities.
- ❖ Discuss the internal control principles in audit of liabilities
- ❖ Understand the basic procedures taken in audit of liabilities

6.1. Introduction

Dear Learners! Liabilities or debt is one of the major sources of revenue in the real world. Every sector participates in borrowing in order to satisfy their expenses or expenditures. So, the audit of such liabilities is very essential. Liabilities are obligation of a firm which arise from past transactions and need future scarification of resources for their settlement. Liabilities can be generally classified as current or short term assets (like account payable, sales tax payable, unclaimed wages, customer's deposits, accrued liabilities, notes payable, etc.) and long term assets (like mortgage payable, bonds payable etc.).

Payables are financial obligations to be paid in the future date in connection with services or goods or money received now. Payables can be categorized into two. Short term payables are those that will be paid in the next twelve months. Long-term payables are those that will be paid after a year.

In the FGE (Federal Government of Ethiopia) accounting system, payables are classified into two. The short-terms are those that will be paid in the next budget year. This includes payables arising from receipt of goods and services; payables among Public Bodies, to or by Regions and to employees; short-term domestic loan taken by the Government; deposits received that will be paid when certain conditions are fulfilled (like court deposit); and retentions from payments to contractors. Long-term payables are those that will not be paid in the next budget year. Foreign loan is one of the significant long-term payables.

In this chapter we presented the audit objectives and audit procedures for account payable and notes payable, accrued liabilities and long term liabilities were discussed as below.

6.2. Audit of Account Payable

Account payables are obligations for the acquisition of raw materials, equipment, utilities, repairs, advertising, and many other types of goods and services that were received before the end of the year and are to be settled with in a fiscal year. Interest-bearing obligations should not be included in account payable. If an obligation includes the payment of interest, it should be recorded properly as a note payable, contract payable or bond.

Accounts payable includes 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. A liability is an account payable only if the total amount of the obligation is known and owed at the balance sheet date. If the obligation includes the payment of interest, it should be recorded as a note payable, contract payable, mortgage payable, or bond payable.

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 recent focus by many companies on improving their supply-chain management activities has led to numerous changes in the design of systems used to initiate and record acquisition and payment activities. Efforts to streamline the purchasing of goods and services, including greater emphasis on just-in-time inventory purchasing, increased sharing of information with suppliers, and the use of technology and e-commerce to transact business, are changing all aspects of the acquisition and payment cycle for many companies. These arrangements and systems can be complex.

Significant client business risks may arise from these changes. For example, suppliers may have greater access to accounts payable records, allowing them to continually monitor the status of

payable balances and to perform detailed reconciliations of transactions. Access by external parties, such as suppliers, to accounting records threatens the likelihood of misstatement if that access is not properly controlled. Also, increased focus on improving the logistics of physically moving inventory throughout a company's distribution chain may increase the difficulty of establishing effective cutoff of accounts payable balances at year-end. The auditor needs to understand the nature of changes to these systems to identify whether client business risks and related management controls affect the likelihood of material misstatements in accounts payable.

6.2.1. Audit Objectives of Account Payable

The overall objective in the audit of accounts payable is to determine whether accounts payable balance is fairly stated and properly disclosed on the financial statements. The auditors should consider the following audit objectives in an audit of account payable:

1. Consider **internal control** over account payable
2. Determine the **existence** of recorded accounts payable and that the client has obligations to pay these liabilities.
3. Establish the **completeness** of recorded accounts payable
4. Establish the **clerical accuracy** of records and supporting schedules of account payable
5. Determine the **valuation** of accounts payable is in accordance with GAAP.
6. To determine the **presentation and disclosure** of account payable are appropriate

QUICK CHECK

1. Define account payable for the purpose of audit?
2. List and describe the objectives of account payable audit?

6.2.2. Audit Approach in Relation to Accounts Payables

The following are some of the audit procedures used in testing transactions related to accounts payable:

- ❖ Trace individual vendor's invoices to master file for names and amounts
- ❖ Trace the total to the general ledger

- ❖ Confirm that all accounts payable related transactions are properly recorded
- ❖ Confirm that all recorded account payable transactions are valid and occurred
- ❖ Review statements to make sure that long term and interest bearing notes are segregated.

QUICK CHECK

1. Discuss the approaches in relating to account payable audit?

6.2.3. Internal control and verification in audit of Account Payable

Like accounts receivable, a large number of transactions can affect accounts payable. The balance is often large and made up of a large number of vendor balances and it is relatively expensive to audit the account. For these reasons, auditors typically set tolerable misstatement for accounts payable relatively high. For the same reasons, auditors often assess inherent risk as medium or high. They are especially concerned about the completeness and cutoff balance-related audit objectives because of the potential for understatements in the account balance. After auditors set tolerable misstatement and inherent risk for accounts payable, they assess control risk based on an understanding of internal control.

The auditor's ultimate substantive tests depend on the relative effectiveness of internal controls related to accounts payable. Therefore, auditors must have a thorough understanding of how these controls relate to accounts payable.

The effects of the client's internal controls on accounts payable tests can be illustrated by two examples:

1. Assume that the client has highly effective internal controls over recording and paying for acquisitions. The receipt of goods is promptly documented by pre-numbered receiving reports; pre-numbered vouchers are promptly and efficiently prepared and recorded in the acquisition transactions file and the accounts payable master file. Cash disbursements are made promptly when due and immediately recorded in the cash disbursements transactions file and the accounts payable master file. Individual accounts payable balances in the master file are reconciled monthly with vendors' statements, and the computer automatically reconciles the master file total to the general ledger. Under these

circumstances, the verification of accounts payable should require little audit effort once the auditor concludes that internal controls are operating effectively.

2. Assume that receiving reports are not used; the client defers recording acquisitions until cash disbursements are made and because of cash shortages, bills are often paid several months after their due date. When an auditor faces such a situation, there is a high likelihood of an understatement of accounts payable; therefore, extensive tests of details of accounts payable are necessary to determine whether accounts payable is correctly stated on the balance sheet date.

In addition to those controls, each month an independent person or computer program should reconcile vendors' statements with recorded liabilities and the accounts payable master file with the general ledger. After assessing control risk, the auditor designs and performs tests of controls and substantive tests of transactions for acquisitions and cash disbursements.

The use of analytical procedures is as important in the acquisition and payment cycle as it is in every other cycle, especially for uncovering misstatements in accounts payable. Auditors should compare current year expense totals with prior years to uncover misstatements of accounts payable as well as in the expense accounts. Because of double-entry accounting, a misstatement of an expense account usually also results in an equal misstatement of accounts payable. Therefore, comparing current expenses such as rent, utilities, and other regularly scheduled bills with prior years is an effective procedure for analyzing accounts payable when expenses from year to year are expected to be relatively stable.

The overall objective in the audit of accounts payable is to determine whether the accounts payable balance is fairly stated and properly disclosed. Seven of the eight balance-related audit objectives are applicable to accounts payable: existence, completeness, accuracy, classification, cutoff, detail tie-in, and rights and obligations. Realizable value is not applicable to liabilities.

There is an important difference in emphasis in the audit of liabilities and assets.

When auditors verify assets, they emphasize overstatements through verification by confirmation, physical examination, and examination of supporting documents. The opposite approach is taken in verifying liability balances; that is, the main focus is on understated or omitted liabilities.

The difference in emphasis in auditing assets and liabilities results directly from the legal liability of CPAs. If equity investors, creditors, and other users determine subsequent to the issuance of the audited financial statements that earnings and owners' equity were materially overstated, a lawsuit against the CPA firm is fairly likely. Because an overstatement of owners' equity can arise either from an overstatement of assets or an understatement of liabilities, it is natural for CPAs to emphasize those two types of misstatements. Auditors should not ignore the possibility that assets are understated or liabilities are overstated, and should design tests to detect material understatements of earnings and owners' equity, including those arising from material overstatements of accounts payable.

We can use the same balance-related audit objectives applied to verifying accounts receivable, as they also apply to liabilities, with three minor modifications:

1. The realizable value objective is not applicable to liabilities. Realizable value applies only to assets.
2. The rights aspect of the rights and obligations objective is not applicable to liabilities. For assets, the auditor is concerned with the client's rights to the use and disposal of the assets. For liabilities, the auditor is concerned with the client's obligations for the payment of the liability. If the client has no obligation to pay a liability, it should not be included as a liability.
3. For liabilities, there is emphasis on the search for understatements rather than for overstatements, as we just discussed.

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 four presentations and disclosure objectives, especially when performing completeness objective tests. Other procedures related to presentation and disclosure objectives are done as part of procedures to complete the audit.

QUICK CHECK

1. Discuss the internal control mechanisms in an audit of account payable?

6.2.3. Account payable audit and test procedures

Out-of-Period Liability Tests: Because of the emphasis on understatements in liability accounts, out-of-period liability *tests* are important for accounts payable. The extent of tests to uncover unrecorded accounts payable, often called the search for unrecorded accounts payable, depends heavily on assessed control risk and the materiality of the potential balance in the account. The same audit procedures used to uncover unrecorded payables are applicable to the accuracy objective. The following are typical audit procedures:

- ❖ **Examine Underlying Documentation for Subsequent Cash Disbursements:** Auditors examine supporting documentation for cash disbursements subsequent to the balance sheet date to determine whether a cash disbursement was for a current period liability. If it is a current period liability, the auditor should trace it to the accounts payable trial balance to make sure it is included. The receiving report indicates the date inventory was received and is therefore an especially useful document. Similarly, the vendor's invoice usually indicates the date services were provided. Auditors often examine documentation for cash disbursements made in the subsequent period for several weeks after the balance sheet date, especially when the client does not pay bills on a timely basis.
- ❖ **Examine Underlying Documentation for Bills Not Paid Several Weeks After the Year End:** Auditors carry out this procedure in the same manner as the preceding one and for the same purpose. This procedure differs in that it is done for unpaid obligations near the end of the audit rather than for obligations that have already been paid.
- ❖ **Trace Receiving Reports Issued Before Year-End to Related Vendors' Invoices:** All merchandise received before the year-end of the accounting period should be included as accounts payable. By tracing receiving reports issued up to year-end to vendors' invoices and making sure that they are included in accounts payable, the auditor is testing for unrecorded obligations.
- ❖ **Trace Vendors' Statements That Show a Balance Due to the Accounts Payable Trial Balance:** If the client maintains a file of vendors' statements; auditors can trace any statement that has a balance due at the balance sheet date to the listing to make sure it is included as an account payable.

- ❖ **Send Confirmations to Vendors with Which the Client Does Business** :Although the use of confirmations for accounts payable is less common than for accounts receivable, auditors use them occasionally to test for vendors omitted from the accounts payable list, omitted transactions, and misstated account balances. Sending confirmations to active vendors for which a balance has not been included in the accounts payable list is a useful means of searching for omitted amounts. This type of confirmation is commonly called a zero balance confirmation.

- ❖ **Cutoff Tests: Accounts payable cutoff tests** are done to determine whether transactions recorded a few days before and after the balance sheet date are included in the correct period. The five out-of-period liability audit tests we just discussed are all cutoff tests for acquisitions, but they emphasize understatements. For the first three procedures, it is also appropriate to examine supporting documentation as a test of overstatement of accounts payable. For example, the third procedure tests for understatements (unrecorded accounts payable) by tracing receiving reports issued before year-end to related vendors 'invoices. To test for overstatement cutoff amounts, the auditor should trace receiving reports issued after year-end to related invoices to make sure that they are not recorded as accounts payable (unless they are inventory in transit, which is discussed shortly).

- ❖ **Relationship of Cutoff to Physical Observation of Inventory:** In determining that the accounts payable cutoff is correct, it is essential that the cutoff tests be coordinated with the physical observation of inventory. The cutoff information for acquisitions should be obtained during the physical observation of inventory. At that time, the auditor should review the procedures in the receiving department to determine that all inventory received was counted, and the auditor should record in the audit documentation the last receiving report number of inventory included in the physical count. Subsequent to the physical count date, the auditor should then test the accounting records for cutoff. The auditor should trace the previously documented receiving report numbers to the accounts payable records to verify that they are correctly included or excluded.

- ❖ **Inventory in Transit:** In accounts payable, auditors must distinguish between acquisitions of inventory that are on an **FOB destination** basis and those that are made

FOB origin. For FOB destination, title passes to the buyer when the inventory is received; so only inventory received on or before the balance sheet date should be included in inventory and accounts payable at year-end. When an acquisition is FOB origin, the company must record the inventory and related accounts payable in the current period if shipment occurred on or before the balance sheet date.

Auditors can determine whether inventory has been acquired FOB destination or origin by examining vendors' invoices. Auditors should examine invoices for merchandise received shortly after year-end to determine whether they were on an FOB origin basis. For those that were, and when the shipment dates were on or before the balance sheet date, the inventory and related accounts payable must be recorded in the current period if the amounts are material.

QUICK CHECK

1. Describe the procedures employed by the auditors in an audit of account payable?
2. List the major tests taken in verification of account payable

5.3. Audit of Note Payable

A note payable is a legal obligation of entities that includes interest and requires the written promise of the maker. A note is issued for a period between one month and one year, and even for more than a year- are called long term notes.

6.3.1. Audit Objectives of Notes Payable

The auditor's objectives in examination of notes payable are summarized in to the following three major objectives:

1. The internal control over notes payable is adequate

In evaluating the internal control over notes payable the auditors should consider the following:

- a. Proper authorization for the issue of new notes: Responsibility for the issuance of new notes should be vested in the board of director or higher level management. The

agreement should contain the amount of the loan, the interest rate and the repayment terms.

- b. Adequate control over the repayment of the principal and interest: The periodic payments of interest and principal should be controlled. When the note is issued a copy should be sent to the accounting department for proper recording
- c. Proper documents and recorded: This includes maintenance of subsidiary records and use of appropriate documents: Periodic independent verification

The details of the note records should be reconciled with the general ledger and compared with the note holders' records by an employee who is not responsible for maintaining the detailed records.

- 2. Transaction for principal and interest involving notes are properly authorized and recorded.
- 3. The liability for notes payable and the related interest expenses and accrued liabilities are properly stated in the financial statements.

6.3.2. Audit Approach in Relation to Notes Payable

Notes payable transactions involve the issue of notes and the repayment of principal and interest. The following are some of the audit procedures used in testing transactions related to notes payable.

- ❖ Obtain a schedule of notes payable and accrued interest a schedule usually includes detailed information of all transactions that have been taken place during the entire year for the principal and interest, the beginning and ending balances of notes and interest payable, and descriptive information about the notes, such as the due date and the interest rate
- ❖ Confirm that all existing notes payable are included
- ❖ Confirm that notes payables are properly valued
- ❖ Confirm that notes payable are properly disclosed.

QUICK CHECK

1. List the objective of notes payable audit?
2. Describe procedures used in testing transactions related to notes payable?

6.4. Audit of accrued liabilities

Many accrued liabilities represent future obligations for unpaid services resulting from the passage of time but are not payable at the balance sheet date. For example, the benefits of property rental accrue throughout the year. Therefore, at the balance sheet date, a certain portion of the total rent cost that has not been paid should be accrued. Other similar liabilities include:

- ❖ Accrued payroll
- ❖ Accrued professional fees
- ❖ Accrued payroll taxes
- ❖ Accrued rent
- ❖ Accrued officers' bonuses
- ❖ Accrued interest
- ❖ Accrued commissions

The following discussion of the audit of accrued property taxes is used as an example of the audit of an accrued liability account.

6.4.1. Auditing Accrued Property Taxes

As with insurance expense, the balance in property tax expense is a residual amount that results from the beginning and ending balances in accrued property taxes and the payments of property taxes. Therefore, the emphasis in the tests should be on the ending property tax liability and payments. When auditors verify accrued property taxes, all eight balance-related audit objectives except realizable value are relevant. Two are especially significant:

1. Existing properties for which accrual of taxes is appropriate are on the accrual schedule. The failure to include properties for which taxes should be accrued will understate the property tax liability (completeness). A material misstatement can occur, for example, if

taxes on property were not paid before the balance sheet date and not included as accrued property taxes.

2. Accrued property taxes are accurately recorded. The auditor's concern is the consistent treatment of the accrual from year to year (**accuracy**).

The auditor uses two primary tests for the inclusion of all accruals. Auditors verify the accruals at the same time as the audit of current year property tax payments. In most audits, there are few property tax payments, but each payment is often material, and therefore it is common to verify each one. Auditors also compare the accruals with those of previous years.

The auditor often begins by obtaining a schedule of property tax payments from the client and comparing each payment with the preceding year's schedule to determine whether all payments have been included in the client-prepared schedule. The fixed asset audit schedules also must be examined for major additions and disposals of assets that may affect the property taxes accrual. All property affected by local property tax regulations should be included in the schedule, even if the first tax payment has not yet been made.

After auditors are satisfied that all taxable property has been included in the client prepared schedule, they evaluate the reasonableness of property taxes on each property used by the client to estimate the accrual. In some instances, the total has already been set by the taxing authority and sent to the client so it is possible to verify the amount by comparing the amount on the schedule with the tax bill. In other cases, the preceding year's total payments must be adjusted for the expected increase in property tax rates.

The auditor can verify the accrued property tax by recalculating the portion of the total tax applicable to the current year for each piece of property. The most important consideration is to use the same portion of each tax payment for the accrual that was used in the preceding year, unless there are justifiable conditions for a change. After the accrual and property tax expense for each piece of property have been recalculated, the totals should be added and compared with the general ledger. In many cases, property taxes are charged to more than one expense account. In that case, the auditor should test for correct classification by evaluating whether the correct amount was charged to each account.

QUICK CHECK

1. Examine the audit procedures and tests in audit of accrued liabilities?

6.5. Audit of long term liabilities

6.5.1. Audit objectives to long term liabilities

In carrying out an audit of liabilities, the auditor seeks to obtain sufficient appropriate audit evidence to reasonably assure him/her in respect of the following assertions:

- ❖ **Existence:** The obligations in respect of liabilities shown on the balance sheet are outstanding at the balance sheet date.
- ❖ **Right and obligation:** liabilities represents obligation of the enterprise to the third parties
- ❖ **Completeness:** the outstanding obligation the third parties are included in liabilities shown in the balance sheet
- ❖ **Valuation :** liabilities are stated in the financial statement at appropriate amounts
- ❖ **Presentation and disclosure:** liabilities are classified and disclosed in the financial statement in accordance with recognized accounting principles and relevant statutory requirements.

6.5.2. Internal control principles for long term liabilities

The auditor evaluates the accounting system and internal control relating to loans and borrowing aspects focusing on the following;

1. The term relating to loan and borrowing to ensure if it covers the following aspects:
 - ❖ Interest, securely, repayment, etc.
 - ❖ Maximum amount up to which a loan or a borrowing can authorize the acceptance of loan or borrowing along with the limit on the amount of all loans and borrowing;
 - ❖ Procedures for negotiating the term; the person who can be authorize the acceptance of loan or borrowing along with the limit on the amount

- ❖ Documentation ,i.e agreements and there documents to be executed for different kind of loans and borrowing
 - ❖ Procedures for ensuring compliance with the relevant legal requirements
2. The availability of proper system for safe custody of document relating to loans and borrowing
 3. The availability of a system of periodic review of the condition and value of securities offered.
 4. The availability of system of obtaining periodic confirmation of balance relating to each loan and borrowing. The auditor should also check if the discrepancies revealed by such confirmation investigated and appropriate follow up action taken.
 5. The auditor should also ascertain if there is a periodic review of all loans and borrowing to identify case where the enterprise has failed to comply with the term and conditions, particularly those where the ammos of principal and or inter have become overdue.

6.5.3. Audit procedures for long term liabilities

The following specific procedures are employed in auditing of long term liabilities.

1. Examine whether the total amount of liabilities is within the statutory or other limit on the limit on the borrowing power.
2. Examine the relevant agreement and other documents supporting the transactions relating to loan, borrowing, etc. in particular, the auditors has to examine the following.
 - ❖ Are important terms of loan agreement being complied with? The auditors pay particular attention to those terms which affects the financial statements and examines whether these requirements or restrictions have been complied with.
 - ❖ In the case loan classified as secured, is the market value of the security as at the balance sheet date at least equal to the amount of the loan outstanding?
 - ❖ In the case of loans and advances from bank and financial institution, do the amounts shown as outstanding agree with the statement of account/ confirmation received from the lender? In the case of discrepancy, has reconciliation been carried out between the amount shown in the book of the company and that shown in the statement of the lender? Similarly, have confirmation of balance been obtained from other providers of loan and advances and the difference, if any duly reconciled?

3. Examine any specific aspects relating to loans and borrowing which are required to be examined or reported up on under the status governing the company
4. In the case of bonds issued by a company, you have to carry out the following procedure.
 - A. Verify the opening balance of bonds with the amount shown in the audited balance sheet of the previous year.
 - B. In respect of bond issued during the year, examine the memorandum and the articles of association of the company as well as the relevant resolution of the board of directors and where relevant of the general meeting, authorized the issue of bonds.
5. Examine whether the loan s and borrowing have been properly classified in the financial statement in accordance with recognized accounting principles.

QUICK CHECK

1. Innumerate the objectives of long-term liabilities?
2. Discuss the internal control of long term liability audit?
3. Describe the procedures taken in audit of long term liabilities?

Summary

So far, under this chapter we have seen audit of both current liabilities and long term liabilities in respect to its objectives, internal control, and procedures.

Liabilities are obligation of a firm which arises from past transactions and need future scarification of resources for their settlement. In the FGE (Federal Government of Ethiopia) accounting system, payables are classified into two. The short-terms are those that will be paid in the next budget year. This includes payables arising from receipt of goods and services; payables among Public Bodies, to or by Regions and to employees; short-term domestic loan taken by the Government; deposits received that will be paid when certain conditions are fulfilled (like court deposit); and retentions from payments to contractors. Long-term payables are those that will not be paid in the next budget year. Foreign loan is one of the significant long-term payables.

The overall objective in the audit of accounts payable is to determine whether accounts payable balance is fairly stated and properly disclosed on the financial statements. Seven of the eight balance-related audit objectives are applicable to accounts payable: existence, completeness, accuracy, classification, cutoff, detail tie-in, and rights and obligations. Realizable value is not applicable to liabilities. Some of the audit procedures used in testing transactions related to accounts payable are: trace individual vendor's invoices to master file for names and amounts; trace the total to the general ledger; confirm that all accounts payable related transactions are properly recorded; confirm that all recorded account payable transactions are valid and occurred and review statements to make sure that long term and interest bearing notes are segregated.

The auditor's objectives in examination of notes payable are: the internal control over notes payable is adequate; transaction for principal and interest involving notes are properly authorized and recorded and the liability for notes payable and the elated interest expenses and accrued liabilities are properly stated in the financial statements. In carrying out an audit of long term liabilities, the auditor seeks to obtain sufficient appropriate audit evidence to reasonably assure him/her in respect of the following assertions: Existence, Right and obligation, Completeness, Valuation and Presentation and disclosure.

Finally, you can understand the definition of payables, audit procedures and verification procedures in an audit of liabilities or payables in Ethiopia and audit of letter of credit.

SELF ASSESSEMENT QUESTIONS

Part I: True or False Questions

Write true if the statement is correct and false if the statement is incorrect.

1. Payables are financial obligations to be paid in the future date in connection with services or goods or money received now.
2. The overall objective in the audit of accounts payable is to determine whether accounts payable balance is fairly stated and properly disclosed on the financial statements.
3. The auditor's ultimate substantive tests taken depend on the relative effectiveness of internal controls related to accounts payable.
4. Accounts payable cutoff tests are done to determine whether transactions recorded a few days before and after the balance sheet date are included in the correct period.
5. In carrying out an audit of liabilities, the auditor doesn't obligate seeks to obtain sufficient appropriate audit evidence.
6. The auditor evaluates the accounting system and internal control relating to loans and borrowing in an audit of long term liabilities.

Part II: Multiple Choice Questions

Choose the correct answer among the given alternatives

1. The auditor's actual audit procedures in audit of account payable vary considerably depending on:
 - A. the nature of the entity
 - B. the materiality of accounts payable,
 - C. the nature and effectiveness of internal controls
 - D. inherent risk
 - E. All
2. The auditor's objectives in examination of notes payable are:
 - A. Evaluating the internal control over notes payable is adequate.
 - B. Checked out the transaction for principal and interest involving notes are properly authorized and recorded.

- C. To proof the liability for notes payable and the elated interest expenses and accrued liabilities are properly stated in the financial statements.
 - D. All
3. Which of the following procedures is least likely to be completed before the balance sheet date?
- A. Confirmation of receivables
 - B. Search for unrecorded liabilities
 - C. Observation of inventory
 - D. Review of internal accounting control over cash disbursement
4. An audit of the balance sheet in account payable account is ordinarily not designed to:
- A. Detect account payable that are substantially past due
 - B. Verify account payable were properly authorized
 - C. Ascertain the reasonable of recorded liabilities
 - D. Ascertain that all existing liabilities at the balance sheet date have been recorded.
5. Which of the following is the best audit procedure for determining the existence of unrecorded liabilities?
- A. Examine confirmation request returned by creditors
 - B. Examine unusual relationship between monthly account payable balance and recorded purchase
 - C. Examine sample invoice a few day prior to and subsequent to year end to ascertain whether they have been properly recorded.
 - D. Examine selected cash disbursement in the period subsequent to year end.
6. Auditors confirmation of account payable balance at the balance sheet date may be unnecessary because :
- A. This is duplication of cutoff tests
 - B. Account payable balance at the balance sheet date may not be paid before the audit is completed
 - C. Correspondence with the audit clients' attorney will reveal all legal action by vendors for nonpayment.
 - D. There is likely to be other reliable external evidence available to support the balance.

Part III: Short answer and Essay type Questions (self-study)

Give clear and precise answers for the following questions by your own referring the material.

1. Describe the audit approaches in relating to notes payable?
2. Innumerate Audit objectives to long term liabilities?
3. Discuss the internal control principles for long term liabilities?
4. Describe the audit procedures taken in audit of long term liabilities?

Part IV: Problem type Questions (self-study)

Forward the answers for the following questions

1. Items 1 through 6 are questions typically found in a standard internal control questionnaire used by auditors to obtain an understanding of internal control for notes payable. In using the questionnaire for a client, a “yes” response indicates possible internal control, whereas a “no” indicates a potential deficiency.
 1. Are liabilities for notes payable incurred only after written authorization by a proper company official?
 2. Is a notes payable master file maintained?
 3. Is a periodic reconciliation made of the notes payable master file with the actual notes outstanding by an individual who does not maintain the master file?
 4. Is the individual who maintains the notes payable master file someone other than the person who approves the issue of new notes or handles cash?
 5. Are paid notes cancelled and retained in the company files?
 6. Are interest expense and accrued interest recomputed periodically by an individual who does not record interest transactions?

Required:

- A. For each of the preceding questions, state the purpose of the control.
 - B. For each of the preceding questions, identify the type of financial statement misstatement that can occur if the control were not in effect.
 - C. For each of the potential misstatements in part b, list an audit procedure that can be used to determine whether a material misstatement exists.
2. The ending general ledger balance of \$186,000 in notes payable for the Sterling Manufacturing Company is made up of 20 notes to eight different payees. The notes vary

in duration anywhere from 30 days to 2 years, and in amounts from \$1,000 to \$10,000. In some cases, the notes were issued for cash loans; in other cases, the notes were issued directly to vendors for the acquisition of inventory or equipment. The use of relatively short-term financing is necessary because all existing properties are pledged for mortgages. Nevertheless, there is still serious cash shortage. Record-keeping procedures for notes payable are not good, considering the large number of loan transactions. There is no notes payable master file or independent verification of ending balances; however, the notes payable records are maintained by secretary who does not have access to cash. The audit has been done by the same CPA firm for several years. In the current year, the following procedures were performed to verify notes payable:

1. Obtain a list of notes payable from the client, foot the notes payable balances on the list, and trace the total to the general ledger.
2. Examine duplicate copies of notes for all outstanding notes included on the listing. Compare the name of the lender, amount, and due date on the duplicate copy with the list.
3. Obtain a confirmation from lenders for all listed notes payable. The confirmation should include the due date of the loan, the amount, and interest payable at the balance sheet date.
4. Re-compute accrued interest on the list for all notes. The information for determining the correct accrued interest is to be obtained from the duplicate copy of the note. Foot the accrued interest amounts and trace the balance to the general ledger.

Required:

- A. What should be the emphasis in the verification of notes payable in this situation? Explain.
- B. State the purpose of each of the four audit procedures listed.
- C. Evaluate whether each of the four audit procedures was necessary. Evaluate the sample size for each procedure.
- D. List other audit procedures that should be performed in the audit of notes payable in these circumstances.

CHAPTER SEVEN

AUDIT OF DEBT AND EQUITY

7. LEARNING OBJECTIVES

At the end of this chapter, learners will able to:

- ❖ Understand the objectives and procedures in an audit of owners' equity
- ❖ Describe the internal control of owners' equity audit
- ❖ Understand equity audit procedures in partnership and corporation
- ❖ Examine audit procedures of retained earnings and dividends

7.1. Introduction

Dear Learners! Equity refers to the net worth of the business, i.e. the amount remaining after deducting total liabilities from total assets. It consists of capital stocks (preferred stock and common stock), paid in capital, dividends, and retained earnings.

There is an important difference in the audit of owners' equity between a publicly held corporation and a closely held corporation. In most closely held corporations, which typically have few shareholders, occasional, if any, transactions occur during the year for capital stock accounts. The only transactions entered in the owners' equity section are likely to be the change in owners' equity for the annual earnings or loss and the declaration of dividends, if any. Closely held corporations rarely pay dividends, and auditors spend little time verifying owners' equity, even though they must test the corporate records. For publicly held corporations, however, the verification of owners' equity is more complex because of the larger numbers of shareholders and frequent changes in the individuals holding the stock. The rest of this chapter deals with tests for verifying the major owners' equity accounts in a publicly held corporation, including: Capital and common stock, Paid-in capital in excess of par and Retained earnings and related dividends.

The objective for each is to determine whether: Internal controls over capital stock and related dividends are adequate; Owners' equity transactions are correctly recorded, as defined by the six transaction-related audit objectives; Owners' equity balances are properly recorded, as defined by the eight balance related audit objectives, and properly presented and disclosed, as defined by the four presentation and disclosure-related audit objectives for owners' equity accounts. Other

accounts in owners' equity are verified in much the same way as these. Then, this chapter dealt with the objectives, procedures, internal control of equity audit in general and stock audit in Ethiopia.

7.2. Internal Controls in audit of owners' equity

Several internal controls are important for owners' equity activities. We discuss several of these in the following sections.

- ❖ **Proper Authorization of Transactions:** Because each owner's equity transaction is typically material, many of these transactions must be approved by the board of directors.
- ✓ **Issuance of Capital Stock.** The authorization includes the type of equity to issue (such as preferred or common stock), number of shares to issue, par value of the stock, privileged condition for any stock other than common, and date of the issue.
- ✓ **Repurchase of Capital Stock.** The repurchase of common or preferred shares, the timing of the repurchase, and the amount to pay for the shares should all be approved by the board of directors.
- ✓ **Declaration of Dividends.** The board of directors must authorize the form of the dividends (such as cash or stock), the amount of the dividend per share, and the record and payment dates of the dividends.
- ❖ **Proper Record Keeping and Segregation of Duties:** When a company maintains its own records of stock transactions and outstanding stock, the internal controls must be adequate to ensure that:
 - ✓ Actual owners of the stock are recognized in the corporate records
 - ✓ The correct amount of dividends is paid to the stockholders owning the stock as of the dividend record date
 - ✓ The potential for misappropriation of assets is minimized

The proper assignment of personnel, adequate record-keeping procedures, and independent internal verification of information in the records are useful controls for these purposes. The client should also have well-defined policies for preparing stock certificates and for recording capital stock transactions.

When issuing and recording capital stock, the client must comply with both the state laws governing corporations and the requirements in the corporate charter. The par value of the stock, the number of shares the company is authorized to issue and state taxes on the issue of capital stock all affect issuance and recording.

As a control over capital stock, most companies maintain stock certificate books and a shareholders' capital stock master file. A capital stock certificate record records the issuance and repurchase of capital stock for the life of the corporation. The record for a capital stock transaction includes the certificate number, the number of shares issued, the name of the person to whom it was issued, and the issue date. When shares are repurchased, the capital stock certificate book should include the cancelled certificates and the date of their cancellation.

A shareholders' capital stock master file is the record of the outstanding shares at any given time. The master file acts as a check on the accuracy of the capital stock certificate record and the common stock balance in the general ledger. It is also used as the basis for the payment of dividends.

Internal controls affecting dividend payments may include:

- ✓ Dividend checks are prepared from the capital stock certificate record by someone who is not responsible for maintaining the capital stock records.
- ✓ After the checks are prepared, there is independent verification of the stockholders' names and the amounts of the checks and a reconciliation of the total amount of the dividend checks with the total dividends authorized in the minutes.
- ✓ A separate impress dividend account is used to prevent the payment of a larger amount of dividends than was authorized.

❖ **Independent Registrar and Stock Transfer Agent:** Any company with stock listed on a securities exchange is required to engage an *independent registrar* as a control to prevent the improper issue of stock certificates.

The responsibility of an independent registrar is to make sure that stock is issued by a corporation in accordance with the capital stock provisions in the corporate charter and the authorization of the board of directors. When there is a change in the ownership of the stock, the registrar is responsible for signing all newly issued stock certificates and making sure that old certificates are received and cancelled before a replacement certificate is issued.

Most large corporations also employ the services of a **stock transfer agent** to maintain the stockholder records, including those documenting transfers of stock ownership. The employment of a transfer agent helps strengthen control over the stock records by putting the records in the hands of an independent organization and helps reduce the cost of record keeping by using a specialist. Many companies also have the transfer agent disburse cash dividends to shareholders, further improving internal control.

7.3 Audit procedures for stockholders Equity (Corporation)

As any change in share capital is likely to be a material transaction which is subjected to special legal requirements, changes should be checked. The main procedures employed by the auditors in stockholders equity are listed below.

- ❖ Obtain an understanding of internal control over capital stock transactions.
- ❖ Review the articles of incorporation by law and minutes for provisions relating to capital stock.
- ❖ Obtain and prepare analysis of the capital stock account.
- ❖ Check authorized capital limit to legislation and company constitutions documents.
- ❖ Check changes to issue capital in year and agree to board minutes.
- ❖ Trace all transactions involving cash to the book and bank statement.
- ❖ Ensure that any necessary registration has been made and that the company's register of members has been updated.
- ❖ For a corporation acting as its own stock register and transfer agent, reconcile the stock records with the general ledger.
- ❖ Ensure appropriate disclosure as either debt or equity.
- ❖ Ensure that all transactions are legal and that premium in particular has been accounted for properly.

7.4 Procedures for audit partners' account

A most significant document underlying the partnership form of organization is the partnership contract. You will be particularly interested in determine that the distribution of net income has been carried out in accordance with the profit sharing provision of the partnership contract. You have to verify whether partners' capital account are maintained at prescribed levels and

restriction of drawing by partners to specify amounts are according to the partnership contracts. You should be comparing the partner's loan account with the partnership contract to determine the treatment by the partners.

Occasionally, you may find that a partnership is operating without any written agreement of partnership. This situation raises a question of whether profit have been divided in accordance with the underlying existing between the partners. You may obtain from each partner written statements confirming the balance in his/her capital account and approval of the method used in dividing the year's earning.

In general, the same principles described for the audit of corporate capital are applicable to the examination of the capital account and drawing accounts of sole proprietorship .the following are the major audit procedures in auditing owners' equity of sole proprietorship or partnership.

- ❖ Analyze all accounts from beginning of the business
- ❖ Trace the initial capital investment and any addition to the cash and asset records
- ❖ Verify the net income or loss for the period and any withdrawals are verified.

7.5. Audit of Capital Stock and Paid in Capital

Auditors have four main concerns in auditing capital stock and paid-in capital in excess of par:

1. Existing capital stock transactions are recorded (completeness transaction-related objective).
2. Recorded capital stock transactions occurred and are accurately recorded (occurrence and accuracy transaction-related objectives).
3. Capital stock is accurately recorded (accuracy balance-related objectives).
4. Capital stock is properly presented and disclosed (all four presentation and disclosure objectives).

The first two concerns involve tests of controls and substantive tests of transactions, and the last two involve tests of details of balances and related disclosures.

7.5.1. Objectives of capital stock Audit

1. Existing Capital Stock Transactions Are Recorded: This objective is easily satisfied when a registrar or transfer agent is used. The auditor can confirm with them whether any capital stock transactions occurred and the accuracy of existing transactions and then determine if all of

those transactions have been recorded. To uncover issuances and repurchases of capital stock, auditors also review the minutes of the board of directors meetings, especially near the balance sheet date, and examine client-held stock record books.

2. Recorded Capital Stock Transactions Occurred and Are Accurately Recorded:

Extensive auditing is required for transactions involving issuance of capital stock such as the issuance of new capital stock for cash, the merger with another company through an exchange of stock, donated shares, and the purchase of treasury shares. Regardless of the controls, it is normal practice for auditors to verify all capital stock transactions because of their materiality and permanence in the records. The occurrence transaction-related objective can ordinarily be tested by examining the minutes of the board of directors meetings for proper authorization.

Auditors can readily verify accurate recording of capital stock transactions for cash by confirming the amount with the transfer agent and tracing the amount of the recorded capital stock transactions to cash receipts. (In the case of treasury stock, the amounts are traced to the cash disbursements journal.) In addition, the auditor must verify whether the correct amounts were credited to capital stock and paid-in capital in excess of par by referring to the corporate charter to determine the par or stated value of the capital stock.

Auditing capital stock transactions such as stock dividends, acquisition of property for stock, mergers, or similar noncash transfers is challenging because considerable technical expertise is required and there is often judgment involved to determine proper valuations. For example, in the audit of a major merger transaction, the auditor must often do considerable research to determine the appropriate accounting treatment and proper valuation of the transaction, after considering all the facts in the merger.

- 3. Capital Stock Is Accurately Recorded:** Auditors verify the ending balance in the capital stock account by first determining the number of shares outstanding at the balance sheet date. A confirmation from the transfer agent is the simplest way to obtain this information. When no transfer agent exists, the auditor must rely on examining the stock records and accounting for all shares outstanding in the stock certificate records, examining all cancelled certificates, and accounting for blank certificates.

After the auditor is satisfied that the number of shares outstanding is correct, the recorded par value in the capital account can be verified by multiplying the number of shares by the par value of the stock. The ending balance in the capital in excess of par account is a residual amount. It is audited by verifying the amount of recorded transactions during the year and adding them to or subtracting them from the beginning balance in the account.

A major consideration when auditing the accuracy balance-related objective for capital stock is verifying whether the number of shares used in the calculation of earnings per share is accurate. It is easy to determine the correct number of shares to use in the calculation when there is only one class of stock and a small number of capital stock transactions. The problem becomes much more complex when there are convertible securities, stock options, or stock warrants outstanding. Auditors must have thorough understanding of requirements of relevant accounting standards before verifying the number of shares for determining basic and diluted earnings per share.

4. Capital Stock Is Properly Presented and Disclosed: The most important sources of information for determining whether all four presentation and disclosure-related objectives for capital stock activities are satisfied are the corporate charter, the minutes of board of directors meetings, and the auditor's analysis of capital stock transactions.

The auditor should determine that each class of stock has a proper description, including the number of shares issued and outstanding and any special rights of an individual class. Auditors should also verify the proper presentation and disclosure of stock options, stock warrants, and convertible securities by examining legal documents or other evidence of the provisions of these. To sum up, the auditor's objectives in examination of owners Capital Stock and Paid In Capital are:

1. To determine whether the internal control over owners' equity is adequate. This includes determining whether there is:
 - a. Proper authorization of transactions – for issuance of stock, repurchasing of capital stock, and declaration of dividend.
 - b. Proper record keeping of capital stock and paid in capital.
 - c. Adequate segregation of duties between maintaining owner's equity records and handling cash
 - d. Independent internal verification of information in the records

2. To determine whether owner's equity related transactions are recorded: Existing capital stock transactions are properly recorded.
3. To determine whether owner's equity balances are properly stated and disclosed

7.6 Audit Approach in Relation to Capital Stock and Paid In Capital

The following procedures are typical of the work required in many engagements for the verification of capital stock and paid in capital.

- ❖ Obtain an understanding of internal control over capital stock and paid in capital.
- ❖ Examine the articles of incorporation, by laws, and minutes for provisions relating to capital stock and paid in capital.
- ❖ Obtain or prepare analyses of the capital stock accounts.
- ❖ Account for all proceeds from stock issues.
- ❖ Confirm shares outstanding with the independent registrar and stock transfer agent.
- ❖ Account for stock certificate numbers, examine cancelled certificates and reconcile the stockholder records with the general ledger.
- ❖ Determine the compliance with stock option plans and with other restrictions and preferences pertaining to capital stock and paid in capital.

7.7. Audit of Dividends and Retained Earning

7.7.1. Audit Objectives of Dividends and Retained Earnings

The most important objectives in audit of dividends and retained earnings include determining whether:

- ❖ Existing transactions are for dividends and retained earnings were fully recorded
- ❖ Recorded dividends and retained earnings are authorized
- ❖ Dividends paid to stockholders and retained earnings are properly valued
- ❖ Dividend payables are properly valued and recorded
- ❖ Retained earnings balance is properly disclosed in the balance sheet

7.7.2 Audit Approach in Relation to dividends and retained earning

Audit work on dividends and retained earnings includes the following two major procedures:

1. Analysis of retained earnings and any appropriations of retained earnings: Check whether the amounts debited and credited to retained earnings are appropriate. Credits to retained earnings represent amounts of net income transferred from income summary account. Debits to retained earnings account ordinarily include entries for net losses, cash and capital dividends, and for the creation or enlargement of appropriated reserves. Appropriations of retained earnings require specific authorization by board of directors.
2. Review of dividend procedures for both cash and stock dividends: In the verification of cash dividends, the auditors usually will perform the following:

√ Determine the dates and amounts of dividends authorized.

√ Verify the amounts paid.

√ Determine the amount of any preferred dividend in arrears.

√ Review the treatment of unclaimed dividend checks. Dividends declared but not paid must be shown as liabilities in the balance sheet.

7.8 Audit of Dividends objectives and verifications

The emphasis in the audit of dividends is on dividend transactions rather than on the ending balance. The exception is when there are dividends payable.

All six transaction-related audit objectives for transactions are relevant for dividends. But typically, dividends are audited on a 100 percent basis. The most important objectives, including those concerning dividends payable, are:

1. Recorded dividends occurred (**occurrence**).
2. Existing dividends are recorded (**completeness**).
3. Dividends are accurately recorded (**accuracy**).
4. Dividends are paid to stockholders that exist (**occurrence**).
5. Dividends payable are recorded (**completeness**).
6. Dividends payable are accurately recorded (**accuracy**).

Auditors can verify the occurrence of recorded dividends by examining the minutes of board of directors meetings for authorization of the amount of the dividend per share and the dividend

date. When doing so, the auditor should be alert to the possibility of unrecorded dividends declared, particularly shortly before the balance sheet date. A closely related audit procedure is to review the audit permanent file to determine whether restrictions exist on the payment of dividends in bond indenture agreements or preferred stock provisions.

The accuracy of a dividend declaration can be audited by recalculating the amount on the basis of the dividend per share times the number of shares outstanding. If the client uses a transfer agent to disburse dividends, the total can be traced to a cash disbursement entry to the agent and also confirmed.

When a client keeps its own dividend records and pays the dividends itself, the auditor can verify the total amount of the dividend by recalculation and reference to cash disbursed. In addition, auditors must verify whether the payment was made to the stockholders who owned the stock as of the dividend record date. They can test this by selecting a sample of recorded dividend payments and tracing the payee's name on the cancelled check to the dividend records. At the same time, auditors can verify the amount and the authenticity of the dividend check.

Tests of dividends payable should be done in conjunction with declared dividends.

Any unpaid dividend should be included as a liability.

7.9. Audit of Retained Earnings

For most companies, the only transactions involving retained earnings are net earnings for the year and dividends declared. Other changes in retained earnings may include corrections of prior-period earnings, prior-period adjustments charged or credited directly to retained earnings, and the setting up or elimination of appropriations of retained earnings.

To begin the audit of retained earnings, auditors first analyze retained earnings for the entire year. The audit schedule showing the analysis, which is usually a part of the permanent file, includes a description of every transaction affecting the account.

To accomplish the audit of the credit to retained earnings for net income for the year (or the debit for a loss) auditors simply trace the entry in retained earnings to the net earnings figure on the income statement. This procedure must, of course, take place fairly late in the audit after all adjusting entries affecting net earnings have been completed. In auditing debits and credits to

retained earnings, other than net earnings and dividends, auditors must determine whether the transactions should have been included.

For example, prior-period adjustments can be included in retained earnings only if they satisfy the requirements of accounting standards. After the auditor is satisfied that the recorded transactions were correctly classified as retained earnings transactions, the next step is to decide whether they were accurately recorded. The audit evidence necessary to determine accuracy depends on the nature of the transactions. For example, if an appropriation of retained earnings is required for a bond sinking fund, auditors can determine the correct amount of the appropriation by examining the bond indenture agreement. If there is a major loss charged to retained earnings because of a material nonrecurring abandonment of a plant, the evidence needed to determine the amount of the loss can be complex and include examining a large number of documents and records, as well as discussions with management.

Auditors must also evaluate whether any transactions should have been included but were not. For example, if the client declared a stock dividend, the market value of the securities issued should be capitalized by a debit to retained earnings and a credit to capital stock. Similarly, if the financial statements include appropriations of retained earnings, the auditor should evaluate whether it is still necessary to have the appropriation as of the balance sheet date.

Accounting standards require presentation and disclosure of information related to retained earnings. The auditor's primary concern in determining whether presentation and disclosure objectives for retained earnings are satisfied primarily relates to disclosure of any restrictions on the payment of dividends. Often, agreements with bankers, stockholders, and other creditors prohibit or limit the amount of dividends the client can pay. These restrictions must be disclosed in the footnotes to the financial statements.

Summary

This chapter elaborates the equity audit procedures in partnership and corporation, internal control of equity audit, retained earning audit and defended audit.

Equity refers to the net worth of the business, i.e. the amount remaining after deducting total liabilities from total assets. Some of the internal controls for owners' equity activities are: Proper Authorization of Transactions; Proper Record Keeping and Segregation of Duties; Independent Registrar and Stock Transfer Agent. In audit of a corporations equity there is own procedures presented in the main body of this chapter and partnerships also. Hence, the same principles described for the audit of corporate capital are applicable to the examination of the capital account and drawing accounts of sole proprietorship. The major audit procedures in auditing owners' equity of sole proprietorship or partnership are: Analyze all accounts from beginning of the business; Trace the initial capital investment and any addition to the cash and asset records and Verify the net income or loss for the period and any withdrawals are verified.

The most important objectives in audit of dividends and retained earnings include determining whether: Existing transactions are for dividends and retained earnings were fully recorded; Recorded dividends and retained earnings are authorized; Dividends paid to stockholders and retained earnings are properly valued; Dividend payables are properly valued and recorded and Retained earning balance is properly disclosed in the balance sheet. And their own audit procedures discussed under this chapter.

Unlike other accounts, there is no need to develop detailed audit procedures for the audit of Net Asset/ Equity because; the balance is checked when checking the other accounts that give rise to that balance. The objectives of examining stocks include: Establishing credibility of the accounting records in respect of the stocks; Ascertaining the reasonableness of the stock account balances; Review of cut-off of recorded stock account transactions; Establishing the physical existence and the reasonableness of the stocks quantity figures determined by count; Determining the accuracy of the cost and of extension and footing of the stock valuations; and Determining that slow moving, damaged or obsolete items of stocks are segregated and reported.

SELF ASSESSEMENT QUESTIONS

Part I: True or False Questions

Write true if the statement is correct and false if the statement is incorrect.

1. A shareholders' capital stock master file is the record of the outstanding shares at any given time.
2. Auditors can verify the occurrence of recorded dividends by examining the minutes of board of directors meetings for authorization of the amount of the dividend per share and the dividend date.
3. To begin the audit of retained earnings, auditors first analyze retained earnings for the entire year.
4. The auditor's primary concern in determining whether presentation and disclosure objectives for retained earnings are satisfied primarily relates to disclosure of any restrictions on the payment of dividends.

Part II: Multiple Choice Questions

Choose the correct answer among the given alternatives.

1. Internal control is important for audit of equity to:
 - A. Proper Authorization of Transactions
 - B. Proper Record Keeping and Segregation of Duties
 - C. Independent Registrar and Stock Transfer Agent
 - D. All
2. Internal controls affecting dividend payments to:
 - A. Dividend checks are prepared from the capital stock certificate record by someone who is not responsible for maintaining the capital stock records.
 - B. After the checks are prepared, there is independent verification of the stockholders' names and the amounts of the checks and a reconciliation of the total amount of the dividend checks with the total dividends authorized in the minutes.
 - C. A separate impress dividend account is used to prevent the payment of a larger amount of dividends than was authorized.
 - D. All

E. B & C

3. The main concern of auditors in auditing capital stock and paid-in capital in excess of par are:
 - A. Existing capital stock transactions are recorded (completeness transaction-related objective).
 - B. Recorded capital stock transactions occurred and are accurately recorded (occurrence and accuracy transaction-related objectives).
 - C. Capital stock is accurately recorded (accuracy balance-related objectives).
 - D. Capital stock is properly presented and disclosed (all four presentation and disclosure objectives).
 - E. All.
4. Objectives of capital stock Audit are to examine:
 - A. Existing Capital Stock Transactions Are Recorded
 - B. Recorded Capital Stock Transactions Occurred and Are Accurately Recorded
 - C. Capital Stock Is Accurately Recorded
 - D. Capital Stock Is Properly Presented and Disclosed
 - E. All
5. To determine whether the internal control over owners' equity is adequate the auditors' verifying that:
 - A. Proper authorization of transactions – for issuance of stock, repurchasing of capital stock, and declaration of dividend.
 - B. Proper record keeping of capital stock and paid in capital.
 - C. Adequate segregation of duties between maintaining owner's equity records and handling cash
 - D. Independent internal verification of information in the records
 - E. All except B
 - F. All except E

6. Review of dividend procedures for both cash and stock dividends in the verification of cash dividends, the auditors usually will perform:
- A. Determine the dates and amounts of dividends authorized.
 - B. Verify the amounts paid.
 - C. Determine the amount of any preferred dividend in arrears.
 - D. Review the treatment of unclaimed dividend checks. Dividends declared but not paid must be shown as liabilities in the balance sheet.
 - E. None
7. An audit program for the audit of the retained earnings account should include a step that requires verification of:
- A. Market value used to charge retained earnings to account for a 2-for-1 stock split.
 - B. Approval of the adjustment to the beginning balance as a result of a write-down of an account receivable.
 - C. Authorization for both cash and stock dividends.
 - D. Gain or loss resulting from disposition of treasury shares.
8. Which of the following internal controls is least likely to reduce risks related to the occurrence transaction-related audit objective for issuances of stock?
- A. The board of directors must approve the distribution of cash dividends.
 - B. The issuance of any shares of stock must be pre-approved by the board of directors.
 - C. The company engages an independent registrar to issue stock certificates.
 - D. The company maintains a capital stock certificate record that includes certificate number, number of shares issued, issue date, and name of person to whom certificates are issued.
9. Which of the following audit procedures would be most relevant when examining the completeness transaction-related audit objective for capital stock?
- A. The auditor examines minutes of the board of directors' meetings to identify any actions involving the issuance of capital stock.
 - B. The auditor vouches entries in the client's capital stock records to board minutes.
 - C. Confirmations of new stock issuances are sent to the client's stock transfer agent.

- D. The auditor traces entries of new stock issuances to the cash receipts journal.

Part III: Essay Type Questions (self-study)

Give short and clear answers for the following questions by your own self by referring the material you have.

1. Discuss the Audit Objectives and procedures of capital stock and paid in capital.
2. Describe the audit procedures in corporations and partnership.

Part IV: Case study questions (self-study)

After reading two wise and give appropriate answer for the following questions.

1. Items A through F are common questions found in internal control questionnaires used by auditors to obtain an understanding of internal control for owners' equity. In using the questionnaire for a client, a "yes" response indicates a possible internal control, whereas a "no" indicates a potential deficiency.
 - A. Does the company use the services of an independent registrar or transfer agent?
 - B. If an independent registrar and transfer agent are not used:
 - (a) Are unissued certificates properly controlled?
 - (b) Are cancelled certificates mutilated to prevent their reuse?
 - C. Are common stock master files and stock certificate books periodically reconciled with the general ledger by an independent person?
 - D. Is an independent transfer agent used for disbursing dividends? If not, is an impress dividend account maintained?
 - E. Are issues and retirements of stock authorized by the board of directors?
 - F. Are all entries in the owners' equity accounts authorized at the proper level in the organization?

Required:

- a. For each of the preceding questions, state the purpose of the control.
- b. For each of the preceding questions, identify the type of potential financial statement misstatements if the control is not in effect.
- c. For each of the potential misstatements in part b, list an audit procedure that the auditor can use to determine whether a material misstatement exists.

2. The following audit procedures are commonly performed by auditors in the verification of owners' equity:

1. Review the articles of incorporation and bylaws for provisions about owners' equity.
2. Analyze all owners' equity accounts for the year and document the nature of any recorded change in each account.
3. Account for all certificate numbers in the capital stock book for all shares outstanding.
4. Examine the stock certificate book for any stock that was cancelled.
5. Review the minutes of the board of directors' meetings for the year for approvals related to owners' equity.
6. Re-compute earnings per share.
7. Review debt provisions and senior securities with respect to liquidation preferences, dividends in arrears, and restrictions on the payment of dividends or the issue of stock.

Required:

- a. State the purpose of each of these seven audit procedures.
- b. List the type of misstatements the auditors can uncover by the use of each audit procedure.
3. You are engaged in the audit of a corporation whose records have not previously been audited by you. The corporation has both an independent transfer agent and a registrar for its capital stock. The transfer agent maintains the record of stockholders and the registrar checks that there is no over issue of stock. Signatures of both are required to validate certificates. It has been proposed that confirmations be obtained from both the transfer agent and the registrar as to the stock outstanding at the balance sheet date. If such confirmations agree with the books, no additional work is to be performed as to capital stock.

Required:

If you agree that obtaining the confirmations as suggested will be sufficient in this case, give the justification for your position. If you do not agree, state specifically all additional steps you would take and explain your reasons for taking them.

ANSWER KEY FOR SELF-ASSESSMENT QUESTIONS

Chapter Two

1. B 2. C 3. D 4. E 5. D

Chapter Three

1. D 2. A 3. B 4. A 5. B

Chapter Four

- | | |
|------|-------|
| 1. A | 6. D |
| 2. B | 7. A |
| 3. D | 8. C |
| 4. A | 9. D |
| 5. E | 10. A |

Chapter Five

Part I

1. True 2. True 3. True 4. True 5. False 6. True

Part II

1. E 2. D 3. D 4. B 5. C 6. B

Chapter Six

Part I

1. True 2. True 3. True 4. True

Part II

1. D 2. D 3. E 4. E 5. F 6. E 7. C 8. A 9. B

Chapter Seven

Part I

1. True 2. True 3. True

Part II

1. B 2. E 3. D 4. D 5. D 6. E 7. E

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