**CHAPTER 2**

**FINANCIAL STATEMENT AUDIT**

An audit program is a detailed list of the audit procedures to be performed in the course of the examination. The audit program usually is divided in to two major sections. The first section deals with the procedures to obtain an understanding of the client’s internal control structure, and the second section deals with the substantiation of specific financial statement amounts, as well as the adequacy of financial statement disclosures.

**The systems portion of the program**

Audit procedures in the systems portion of the program typically include preparation of internal control questionnaire, flowcharts for each transaction cycle (e.g. sales and collection cycle, Purchase cycle etc), tests of the significant internal controls, identification of strengths and weaknesses, and assessment of control risk.

After their consideration of internal control, the auditors will make appropriate modifications in the substantive test portion of the audit program. For example, as a result of weaknesses in internal control in the sales transaction, the auditors may assess control risk for accounts receivable to be high and decide to perform more extensive substantive test of receivables.

**The substantive test portion of the program**

This portion of the audit program is aimed at substantiating financial statement amounts.

**Systems approach  substantive approach**

The systems approach involves heavy reliance upon the client’s internal control, whereas the substantive approach relies more heavily up on substantive testing as the basis for the auditor’s opinion. Actually, every audit involves a blend of reliance on internal control and substantive testing. Thus, systems approach and substantive approach are relative terms, indicating the emphasis that a particular CPA firm places in the systems or substantive portions of its audit program on a given engagement. Some CPA firms may lean toward one approach or the other as a matter of firm policy. However, in the audit of a client with weak internal control, the auditor has no choice but to emphasize the substantive approach.

**OBJECTIVES OF AUDIT PROGRAMS**

Audit procedures are designed to accomplish certain objectives with respect to each major account in the financial statements. These objectives follow directly from the assertions that are contained in the client’s financial statements.

**Management assertions**- Assertions are representations of management that are set forth in the financial statements. Broadly speaking, a set of financial statements contains the following five management assertions:

1. **Existence or occurrence**: - Assets, Liabilities, and owner’s equity reflected in the financial statements exist; the recorded transactions have occurred.

2. **Completeness**: - all transactions, assets, liabilities, and owners’ equity that should be presented in the financial statements are included.

3. **Rights and Obligations**: - the client has rights to assets and obligations to pay liabilities that are included in the financial statements.

4. **Valuation or allocation**:- assets, liabilities, owner’s equity, revenues, and expenses are presented at amounts that are determined in accordance with generally accepted accounting principles.

5. **Presentation and disclosure**:- accounts are described and classified in the financial statements in accordance with generally accepted accounting principles, and all material disclosures are provided.

From these assertions, general objectives may be developed for each major type of balance sheet account, including assets, liabilities, and owners’ equity.

**GENERAL OBJECTIVES OF AUDIT PROGRAMS FOR ASSET ACCOUNTS.**

The audit procedures for each financial statement accounts must be tailored to accomplish the specific audit objectives for that account. The specific objectives for auditing cash are not identical to the specific objectives for auditing inventory. Although the specific audit objectives and, therefore, the audit procedures differ for each account, it is useful to realize that each audit program follows basically the same approach to verifying the balance sheet items and related income statement amounts. The audit program for every asset category includes procedures designed to accomplish the following general objectives.

**Audit Program for asset accounts stated in terms of general objectives**

I. Consideration of internal control

1. Obtain an understanding of internal control sufficient to plan the audit.
2. Assess control risk and design additional tests of controls.
3. Conduct additional tests of controls.
4. Reassess control risk and design substantive tests.

II. Substantiate account balances (substantive tests).

1. Establish the existence of assets.
2. Establish that the company has rights to the assets.
3. Establish completeness of recorded assets.
4. Determine the appropriate valuation of the assets.
5. Establish the clerical accuracy of the underlying records.
6. Determine the appropriate financial statement, presentation and disclosure of the assets.

These general objectives are common to all audit programs for asset accounts. Changes in these audit objectives, with respect to audit programs for liability and owners’ equity accounts, will be discussed in later sections.

In what immediately follows we will discuss the specific audit objectives for various balance sheet and income statement accounts.

? Developan audit program for asset accounts stated in terms of general objectives.

**2.1 CASH**

**SOURCES AND NATURE OF CASH**

Cash normally includes checking accounts, cash on hand, petty cash fund and less frequently, savings accounts. Cash sales, collections of receivables, and investment of additional capital typically increase the account; business expenditures decrease it.

**Audit objectives for cash**

The auditors’ objectives in the examination of cash are to determine that:

1. Internal control over cash transactions is adequate.
2. The recorded cash is valid (existence and rights).
3. All cash accounts are recorded (completeness).
4. Cash schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).
5. The presentation and disclosure of cash, including restricted funds (such as compensating balances and bond sinking funds) is adequate.

**INTERNAL CONTROL OVER CASH TRANSACTIONS**

Most of the functions relating to cash handling are the responsibility of the finance department, under the direction of the treasurer. These functions include handling and depositing cash receipts; signing checks; investing idle cash; and maintaining custody of cash, marketable securities, and other negotiable assets. In addition, the finance department must forecast cash requirements and make both short term and long-term financing arrangements.

Ideally, the functions of the finance department and the accounting department should be integrated in a manner that provides assurance that:

* + - 1. All cash that should have been received was in fact received, recorded accurately, and deposited promptly.
      2. Cash disbursements have been made only for authorized purposes and have been properly recorded.
      3. Cash balances are maintained at adequate, but not excessive, levels by forecasting expected cash receipts and payments related to normal operations. The need for obtaining loans or for investing excess cash is thus made known on a timely basis.

A detailed study of the operating routines of the individual business is necessary in developing the most efficient control procedures, but there are some general guidelines to good cash-handling practices in all types of business. These universal rules for achieving internal control over cash may be summarized as follows:

1. Do not permit any one employee to handle a 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 check, with the exception of small

expenditures from petty cash.

8. Have monthly bank reconciliations prepared by employees not responsible for the issuance of checks or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official.

? What are the auditors’ objectives in the examination of cash?

**AUDIT PROCEDURES FOR CASH**

The following audit procedures indicate the general pattern of work performed by the auditors in the verification of cash. Selection of the most appropriate procedures for a particular audit will be guided, of course, by the nature of the internal controls in force and by other circumstances of the engagement.

**A) Consider internal control for cash**

**1) Obtain an understanding of internal control for cash.**

In the audit of a small business, auditors may prepare a written description of controls in force, based up on the questioning of owners and employees and up on first hand observation. For larger companies, a flow chart or internal control questionnaire is usually employed to describe the internal control structure. Among the questions included in a questionnaire for cash disbursements are whether all disbursement (except those from petty cash) are made by prenumbered checks and whether voided checks are mutilated, preserved, and filed. The existence of these controls permits the auditors to determine that all disbursements have been recorded by accounting for the sequence of checks issued or voided during the period.

Other points to be made clear by the questionnaire include;(a) whether check–signing authority is restricted to selected executives not having access to accounting records or to vouchers and other documents supporting checks submitted for signature, and (b) whether checks are mailed directly to the payees after being signed.

The internal control questionnaire will also cover cash disbursements for payroll and for dividends, as well as bank reconciliation procedures. All questions on the internal control questionnaire are designed to require affirmative answers when satisfactory controls exists.

After the auditors have prepared a flow-chart (or other description) of internal control, they should conduct a walk-through of a system. The term walk-through means to trace a few transactions through each step of the system to determine that transaction actually are being processed in the manner indicated by the flow chart.

**2. Assess control risk and design additional tests of controls for cash.**

Control risk for a financial statement assertion may be assessed below the maximum only when tests indicate that related controls are designed and operating effectively. The auditors must decide which additional tests of controls will likely result in cost justified restrictions of substantive tests.

**3. Perform tests of controls for those controls which the auditors plan to rely upon to restrict their assessment of control risk, and reduce the extent of substantive testing** such as:

1. **Prove footings of cash journals and trace postings to ledger accounts.**

The purpose of proving footings and postings of the cash records is to verify the mechanical accuracy of the journals and ledger. In a computer based system, journal and ledger entries are created simultaneously from the same source documents. The auditors might choose to use a test data approach to test controls over the postings of ledgers. The accuracy of footings may be proved with the auditors’ generalized audit software.

In a manual system, information on source documents is entered first in a journal; at a latter date the information is summarized and posted from journals to ledgers. Therefore, in a manual system, the auditors must manually determine that journals are accurately footed and the data properly posted to the ledger. The auditors also should trace the monthly posting of column total from the cash receipts journal to the cash account and to the controlling account for accounts receivable. Similar Verification may be made for the totals posted from the cash payments journal to the cash account and to the accounts payable account in the general ledger.

**b) Compare the detail of a sample of cash receipts listings to the cash receipts journals, accounts receivable postings, and authenticated deposit slips.**

Satisfactory internal control over cash receipts demands that each day’s collections be deposited intact no later than the next banking day. To provide assurance that cash receipts have been deposited intact, the auditors should compare the detail of the original cash receipts listings (mail room listings and register tapes) to the detail of the daily deposit tickets.

Comparison of the daily entries in the cash receipts journal with bank deposits may disclose a type of fraud known as **lapping**. Lapping means the concealment of a cash shortage by delaying the recording of cash receipts. If cash collected from customer A is withheld by the cashier, a subsequent collection from customer B may be entered as a credit to A’s account. B’s account will not be shown as paid until a collection from customer C is recorded as a credit to B.

**c) Compare the detail of a sample of recorded disbursements in cash payments journal, accounts payable postings, purchase orders, receiving reports, invoices, and paid checks.**

Satisfactory internal control over cash disbursements requires that controls exist to provide assurance that disbursements are properly authorized. Testing cash disbursements involves tracing selected items back through the cash payments journal to original source documents, including vouchers, purchase orders, receiving reports, invoices, and paid checks.

**4. Reassess control risk and design substantive tests**

When the auditors have completed the procedures described in the preceding sections, they should assess the extent of control risks for each financial statement assertion regarding cash. The auditors then draft the portion of the audit program devoted to the substantive tests of cash transactions and balances.

**B) Perform substantive tests of cash transactions and balances.**

**5. Obtain analyses of cash balances and reconcile to general ledger.**

The auditors will prepare or obtain a schedule that lists all of the client’s cash accounts. For cash in bank accounts, this schedule will typically list the bank, the account number, account type, and the year end balance per books. The auditors will trace and reconcile all accounts to the general ledger as necessary.

**6. Send Confirmation letters to banks to verify amounts on deposit.**

One of the objectives of the auditors’ work on cash is to substantiate the validity of the amount of cash shown on the balance sheet. A direct approach to this objective is to confirm amounts on deposit, count the cash on hand, and obtain or prepare reconciliations between bank statements and the accounting records.

**7.** **Obtain or prepare reconciliations of bank accounts as of the balance sheet date and consider need to reconcile bank activity for additional months**.

Determination of a company’s cash positions at the close of the period requires a reconciliati on of the balance per the bank statement at that date with the balance per the company’s accounting records. Even though the auditors may not be able to begin their field work for some time after the close of the year, they will prepare a bank reconciliation as of the balance sheet date or review the one prepared by the client. Inspection of a reconciliation prepared by the client will include verifying the arithmetical accuracy, tracing balances to the bank statement and ledger account, and investigating the reconciling items.

**8. Obtain a cutoff bank statement containing transactions of at least seven business days subsequent to balance sheet date.**

A cut off bank statement is a statement covering a specified number of business days (usually 7 to 10) following the end of the client’s fiscal year. The client will request the bank to prepare such a statement and deliver it directly to the auditors. This statement is used to test the accuracy of the year-end reconciliation of the Company’s bank accounts. It allows the auditors to examine first hand the checks listed as outstanding and the details of deposits in transit on the company’s reconciliation.

**9. Count and list cash on hand**

Cash on hand ordinarily consists of undeposited cash receipts, petty cash funds, and change funds. The petty cash funds and change funds may be counted at any time before or after the balance sheet date; many auditors prefer to make a surprise count of these funds.

The count of cash on hand is of special importance in the audit of banks and other financial institutions. Whenever auditors make cash count, they should insist that the custodian of the funds be present throughout the count. At the completion of the count, the auditors should obtain from the custodian a signed and dated acknowledgement that the funds were counted in the custodian’s presence and were returned intact by the auditors. Such procedures avoid the possibility of an employee trying to explain a cash shortage by claiming that the funds were intact when turned over to the auditors.

**10. Verify the client’s cutoff of cash transactions**

The balance sheet figure for cash should include all cash received on or before the final day of the year and none received subsequently. Such tests help to uncover misleading actions known as **window dressing**. The term window dressing refers to actions taken shortly before the balance sheet date to improve the cash position or in other ways to create an improved financial picture of the company. For example, if the cash receipts-journal is held open for a few days after the close of the year, the balance sheet figure for cash is improperly increased to include cash collections actually received after the balance sheet date

**11. Trace all bank transfers for the last week of audit year and first week of following year.**

The purpose of tracing bank transfers is to disclose overstatements of cash balances resulting from **kiting**. Consider the following example. Two bank accounts appear as follows:

Kansas city New York

Balance per bank Br 15, 000 Br 10,000

Balance per books 20, 000 10,000

The Kansas City bank account is short Br 5000 representing collections which the cashier has withheld. To conceal the shortage, the cashier draws a transfer check on Dec. 31 to transfer Br 5000 from New York to Kansas city. The cashier then deposits the check in the Kansas city bank but enters the check in the company records for January. The transfer check in the above example would be shown on a schedule of inter bank transfers in this manner:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  | Date withdrawn | | Date Depositor | |
| Check no | Kansas city | New York | Per book | Per bank | Per book | Per bank |
| 4297 | $ 5000 | 0 | 1/2 | 1/3 | ½ | 12/31 |

You can see that kitting has occurred because Br 5000 have been deposited in the Kansas city bank on Dec. 31 but was not recorded on the book until January 2.

**12. Investigate any checks representing large or unusual Payments to related parties**

Any large or unusual checks payable to directors, officers, employees, affiliated companies, or cash should be carefully reviewed by the auditors to determine whether the transactions (a) were Properly authorized and recorded and (b) are adequately disclosed in the financial statements. If checks have been issued payable to cash, the auditors should determine who received these payments and why this form of check was used.

To provide assurance that cash disbursements to related parties were authorized transactions and were properly recorded, the auditors should determine that each such transaction has been charged to the proper account, is supported by adequate vouchers or other records, and was specifically approved in advance by an officer other than the one receiving the funds.

**13. Determine proper financial statement presentation and disclosure.**

The balance sheet figure for cash should include only those amounts that are available for use in current operations. Most users of the balance sheet are not interested in the breakdown of cash by various bank accounts or in the distinction between cash on hand and on deposit. Consequently, all cash on hand and in banks that is available for general use is presented as a single amount on the balance sheet. Change funds and petty cash funds are usually not material in amount and are included in the balance sheet figure for cash. A bank deposit that is restricted in use (for example, cash deposited with a trustee for payments on long-term debt) should not be included in cash.

? Develop an audit program (audit procedures) to be performed by an auditor in the verification of cash.

**2.2 ACCOUNTS RECEIVABLE, NOTES RECEIVABLE, AND SALES TRANSACTIONS**

**Sources and nature of receivables**

Receivable include not only claims against customers arising from the sale of goods or services, but also a variety of miscellaneous claims such as loans to officers or employees, loans to subsidiaries, uncollected stock subscriptions, claims against various other firms, claims for tax refunds, and advances to suppliers. Trade notes and accounts receivable usually are relatively large in amount and should appear as separate items in the current assets section of the balance sheet at their net realizable value. Auditors are especially concerned with the presentation and disclosure of loans to officers, directors, and affiliated companies. These related party transactions are commonly made for the convenience of the borrower rather than to benefit the lending company. Consequently, such loans are often collected only at the convenience of the borrower.

**The auditors objectives in examination of receivables**

The auditors’ objectives are to determine that:

1. Internal control over receivables is adequate.
2. The recorded receivables are valid (existence and rights).
3. All receivables are recorded (completeness).
4. Receivable records and supporting schedules are mathematically

correct and agree with general ledger accounts (clerical accuracy).

1. The valuation of receivables approximates their realizable value.
2. The presentation and disclosure of receivables is adequate, including the separation of receivables into appropriate categories, and adequate reporting of any receivables pledged as collateral and related party receivables.

**OBJECTIVES OF INTERNAL CONTROL**

In order to be able to evaluate the adequacy of internal control system in relation to receivables, the auditor must have knowledge of the objectives of internal control for receivable.

Internal control over receivables is generally expected to give assurance that:

1. All orders received are filled promptly
2. Credit is approved before goods are released for shipment.
3. Customers are correctly billed for all merchandise released by the shipping department.
4. All receivables resulting from Completed Sales transactions are correctly recorded.
5. Credits for returns, allowances and bad debt write-off are properly authorized.
6. Amounts receivable from customers are collected if at all possible.
7. Collections on receivables are fully accounted for.
8. Reports adequately summarize sales and credit activities and reveal the current status of uncollected receivables.

How can we develop a good internal control system over receivables?

Usually, internal control over receivables is strengthened by a division of duties so that different departments or individuals are responsible for different tasks. When different tasks are done by different individuals the work of one individual will serve as a check on the work of another.

Duties which ideally should be performed by different individuals include:

* Order Processing
* Credit authorization
* Preparation of shipping order
* Shipping
* Billing
* Invoice verification
* Maintenance of control accounts
* Maintenance of customer’s ledgers
* Mailing of statements to customers
* Collection follow-up
* Cash handling
* Approval of non-cash credits

The discussion which immediately follows has paramount significance in judging the adequacy of the internal control and also helps in understanding how thefts occur.

**Charges to Receivables**

Under good internal control, any person who handles or has access to cash collections from customers should have no other responsibilities relating to accounts receivable. This comment applies particularly to the process of originating and establishing control over the charges to customers for sales. Violation of this aspect of internal control would open the way for a person to bill a customer but omit the charge from the day’s accounting figures, and then merely appropriate the payment when it is received.

**Non-cash Credits**

An especially important aspect of internal control over receivables is the approval of credits to customers’ accounts for returned goods, allowances or uncollectible accounts. The approval of such credits represents a key operating-responsibility and proper delegation of the authority is important from a business point of view since the approval of these credits presents an excellent opportunity to detect operating deficiencies which are producing costly returns and allowances.

Poor judgment in granting credit and ineffective collection procedures can also be detected. It does not also open the way for a person to defraud a business.

A person authorized to approve non-cash credits should under no circumstances have access to cash collections. Failure to follow this rule is practically an engraved invitation to an employee to defraud the business by withholding cash collections. After misappropriating the collections, the employee can readily conceal the act by authorizing a credit for an allowance or for returned goods for the amount involved. Should the abstracted cash represent a final payment from a customer, the employee can dispose of the remaining balance on the records by authorizing the write-off of the account as a bad debt.

**Cash Receipts**

Complete separation of accounting and operating responsibilities is a cardinal rule for achieving good internal control. This rule certainly applies to receivables, and if any separation of duties is possible, the handling of cash should be separated from the preparation of the accounting records. Failure to make this separation gives the employee handling both functions unlimited possibilities for manipulating the records to conceal the theft of cash receipts. It would be possible to credit a customer’s account for a remittance which has been withheld by making the usual entry in the cash receipts record and then understating the total of the cash column and overstating the total of the cash discount column. Another possibility would be to credit the account by means of a journal entry, burying the offsetting debit in some expense or asset account (credit must be made to the customer’s account for the payment which has been withheld in order to avoid the possibility that someone else might attempt to collect the amount which would otherwise appear to be past due. Collection effort would probably reveal that the payment had been misappropriated)

**Audit procedures for Receivables and Sales Transactions**

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

**A. Consider internal control for receivables and sales**

1. **Obtain an understanding of internal control.**

The auditors’ consideration of internal controls over receivables and sales may begin with the preparation of a written description or flowchart or the filling in of an internal control questionnaire. Typical of the questions comprising an internal control questionnaire for receivables and sales are the following. Are orders from customers recorded and reviewed by a sales department? Are Sales invoices prenumbered and all numbers accounted for? Are all Sales approved by the credit department before shipment?

1. **Assess control risk and design additional tests of controls**

Control risk for a financial statement assertion may be assessed below the maximum only when tests indicate that related controls are designed and operating effectively. The auditors must decide which additional tests of controls will likely result in cost justified restrictions of substantive test.

1. **Perform additional tests of controls**

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

In manufacturing companies, the audit procedure for verification of a sales transaction that has been selected for testing may begin with a comparison of the customer’s purchase order, the client’s sales order, and the duplicate copy of the sales invoice. The descriptions of items and the quantities are compared on these three documents and traced to the duplicate copy of the related shipping document. The credit manager’s signature denoting approval of the customer’s credit should appear on the sales order.

The extensions and footings an each invoice in the sample should be proved to be arithmetically correct. In addition, the date of each invoice should be compared with two other dates:

a. The date on the related shipping document.

b. The date of entry in the accounts receivable subsidiary ledger.

Prices on the invoices can be verified by comparison with price lists, catalogs, or other sources used in preparing invoices. After proving the accuracy of selected individual invoices, the auditors next trace the invoices to the sales journal. The footing of the sales journal is proven, and the total is traced to the general ledger account for sales.

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

The preceding step in the audit program called for an examination of selected sales transactions and a comparison of the invoices with sales records and shipping documents. That procedure would not, however, disclose orders that had been shipped but not billed. To assure that all shipments are billed it is necessary for the auditors to obtain a sample of shipping documents issued during the year and to compare these to sales invoices. In making this test, particular emphasis should be placed upon accounting for all shipping documents by serial number.

**c. Review the use and authorization of credit memoranda**

All allowances to customers for returned or defective merchandise should be supported by serially numbered credit memoranda signed by an officer or responsible employee having no duties relating to handling cash or to the maintenance of customers’ ledgers. Good internal control over credits for returned merchandise usually includes a requirement that the returned good be received and examined before credit is given. The memoranda should then bear the date and serial number of the receiving report on the return shipment.

In addition to establishing that credit memoranda were properly authorized, the auditors should make tests of these documents similar to those suggested for sales invoices. Prices, extensions, and footings should be verified, and postings traced from the sales return journal or other accounting record to the customers’ accounts in the subsidiary receivable ledgers.

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

In the audit of clients that make a substantial amount of sales for cash, the auditors may compare, selected daily totals in the sales journal with cash register readings or tapes. The serial numbers of all sales tickets used during the selected periods should be accounted for and individual tickets examined for accuracy of calculations and traced to the sales summary or journal.

**4. Reassess control risk and design substantive tests**

When the auditors have completed the procedures described in the preceding sections, they should assess the extent of control risk for each financial statement assertion regarding receivables and sales transactions. In their assessment, the auditors will identify those weaknesses that require extension of substantive procedures and those strengths that permit curtailment of procedures.

**B. Substantive tests**

**5**. **Obtain an aged trial balance of trade account receivable and analyses of other accounts receivable and reconcile to ledgers.**

An aged trial balance of trade accounts receivable at the audit date is commonly prepared by employees of the client for the auditors, often in the form of a computer printout. The client-prepared schedule is a multipurpose format designed to display the aging of customers’ accounts, the estimate of probable credit losses, and the confirmation control information.

When trial balances or analyses of accounts receivable are furnished to the auditors by the client’s employees, some independent verification of the listing is essential. In testing the aging, it is important to test some accounts classified as current, as well as those shown as past due. These selected accounts should be traced to the subsidiary ledgers.

**6. Obtain analyses of notes receivable and related interest**

An analysis of notes receivable supporting the general ledger controlling account may be prepared for the auditors by the client’s staff. The information to be included in the analysis normally will include the name of the maker, date, maturity, amount, and interest rate. In addition to verifying the accuracy of the analysis prepared by the client, the auditors should trace selected items to the accounting records and to the notes themselves.

**7. Inspect notes on hand and confirm those not on hand with holders**

The inspection of notes receivable on hand should be performed concurrently with the count of cash and securities to prevent the concealment of a shortage by substitution of cash for misappropriated negotiable instruments, or vice versa. Any securities held by the client as collateral for notes receivable should be inspected and listed at the same time. Notes receivable owned by the client may be held by others at the time of the examination. Confirmation in writing from the holder of the note is considered as an acceptable alternative to inspection; it does not, however, eliminate the need for securing confirmation from the maker of the note.

**8. Confirm receivables with debtors**

Confirmation is also called customers circularization. The technique of ascertaining the validity of receivables through correspondence with the debtors is known as confirming, or circularizing, the accounts. Debtors’ circularization implies obtaining confirmation of debtor balances by communicating directly with debtors, thus confirming the existence of debts. It is still the auditor’s duty to satisfy himself that these debts will be paid in due course. Debtors’ circularization is particularly useful in those cases where the auditor detects weaknesses in the internal controls surrounding accounts receivable and as a consequence suspects possibilities of irregularities. It is important that the auditor should get the consent of the client before attempting debtors’ circularization. Only the client can authorized third parties to disclose information to the auditors. Hence the letters sent to the debtors will be signed by an authorized responsible official of the client. The auditors address should be given on the envelops so that undelivered letters are returned to the auditor directly. This is important since such undelivered letters may indicate fictitious debtors which will need further investigation.

**Selection of Balances for circularization**

A complete list of all accounts of debtors should be obtained by the auditor from the client. This list should agree with the account in the ledger. It should be from this list that the auditor has to make his selection of debtors for circularization. This will avoid any possibility of concealment of accounts by any interested party in the client’s office.

Statistical sampling is best suited to select debtors for circularization. Stratified sampling is particularly useful. By selecting a higher proportion of all debtors over a certain value and a representative sample of the balance, the auditor can ensure a higher level of efficacy of the circularization procedure. It is important that the sample selected should include the following:

* Debtors with nil balance
* Debtors with credit balance
* Debtors with unpaid balances

**Positive and Negative circularization**

Debtors’ circularization may take two forms, Viz, positive circularization and negative circularization. In the case of positive circularization, the customer concerned is requested to reply whether he agrees with the balance stated or not. In the case of negative circularization, the debtor concerned is requested to reply only if he/she does not agree with the balance stated.

Positive circularization is used where weaknesses are detected in internal control procedures, where book-keeping errors are suspected, where there exists a small number of large accounts, etc. Negative circularization is suitable in those cases where there exist well formulated and well implemented internal control procedures, where there exist a large number of small accounts, etc. Both methods are usually used in conjunction.

A positive confirmation is a more reliable evidence because the auditor can perform follow-up procedures if a response is not received from the debtor. With a negative confirmation, failure to reply must be regarded as a correct response even though the debtor may have ignored the confirmation request.

1. **Review the year-end cutoff Sales transaction**

Oneofthemorecommon methods of falsifying accounting records is to inflate the sales for the year by holding open the sales journal beyond the balance sheet date. Shipments made in the first part of January may be covered by sales invoices bearing a December date and included in December sales. The purpose of such misleading entries is to present a more favorable financial picture than actually exists. To guard against errors in the cutoff of sales records (whether accidental or intentional), the auditors should compare the sales recorded for several days before and after the balance sheet date with the duplicate sales invoices and shipping documents.

1. **Perform analytical procedures for accounts receivable, sales, notes receivable, and interest revenue**

Several ratios and relationships can be computed to indicate the overall reasonableness of the accounts shown for accounts receivable, sales, notes receivable, and interest revenue. Examples include: (a) the gross profit rate, (b) accounts receivable turnover, (c) the ratio of accounts receivable to the year’s net credit sales, (c) the ratio of accounts written off during the year to the ending balance of accounts receivable, (e) the ratio of interest revenue to notes receivable. These ratios and relationships should be compared with corresponding data for the preceding years and with comparable industry averages.

**11. Verify interest earned on notes and accrued interest receivable**

The most effective verification of the interest earned account consists of an independent computation by the auditors of the interest earned during the year on notes receivable. The beginning balance of accrued interest receivable plus the interest earned during the year minus the interest collected should equal the accrued interest receivable at the end of the year.

**12. Determine adequacy of allowance for uncollectible accounts**

If the balance sheet is to reflect fairly the financial position of the business, the receivables must be stated at net realizable value, that is, at face value less an adequate allowance for doubtful notes and accounts receivable. Since one of the auditors’ objectives in the examination of notes and accounts receivable is the determination of their collectibility, it is important for the auditors to be aware of any collections on past-due accounts or matured notes during the period subsequent to the balance sheet date.

To appraise the collectibility of notes receivable, the auditors may investigate the credit standing of the makers of any large or doubtful notes. Reports from credit-rating agencies and financial statements from the makers of notes should be available in the client’s credit department. Evaluation of any collateral supplied by the makers of notes is another step in determining the collectibility of notes receivable.

**13. Ascertain whether any receivables have been pledged**

The auditors should inquire directly whether any notes or accounts receivable have been pledged or assigned.

**14. Investigate fully any notes or accounts receivable from related parties**

Loans by a corporation to its officers, directors, stockholders, or affiliates require particular attention from the auditors because these related party transactions are not the result of arm’s-length bargaining by parties of opposing interest. The independent auditors have an obligation to stockholders, creditors, and others who rely upon audited statements. It seems apparent that most loans to officers, directors, and stockholders are made for the convenience of the borrower rather than for the profit of the corporation. Because of the somewhat questionable character of such loans, they are sometimes paid off just before the balance sheet date and renewed shortly thereafter in an effort to avoid disclosure in financial statements. Under these circumstances, the renewed borrowing may be detected by the auditors through a scanning of notes and accounts receivable transactions subsequent to the balance sheet date.

**15. Evaluate financial statement Presentation and disclosure**

The auditors must ascertain that the financial presentation of accounts and notes receivable and the related disclosures are in accordance with generally accepted accounting principles. Related party receivables should be shown separately with disclosure of the nature of the relationships and the amounts of the transactions. Also, the amounts of allowances for uncollectible receivables should be shown as deductions from the related receivables.

**2.3 INVENTORIES AND COST OF GOODS SOLD**

**Sources and nature of inventories and cost of goods Sold**

The term inventory is used in this section to include:

1) goods on hand ready for sale, either the merchandise of a trading concern or the finished goods of a manufacturer; (2) goods in the process of production; and (3) goods to be consumed directly or indirectly in production, consisting of raw materials, purchased parts, and supplies.

Inventories have received much attention in both the accounting and auditing literature, as well as in discussions among professional accountants. The reasons for the special significance attached to inventories are readily apparent:

1. Inventories usually constitute the largest current asset of an enterprise and are very susceptible to major errors and irregularities.

2. Numerous alternative methods for valuation of inventories are sanctioned by the accounting profession, and different methods may be used for various classes of inventories.

3. The determination of inventory value directly affects the cost of goods sold and has a major impact upon net income for the year.

4. The determination of inventory quality, condition, and value is inherently a more complex and difficult task than is the case with most elements of financial position.

**The auditors’ approach in examination of inventories and cost of goods sold**

The auditors’ objectives in the examination of inventories (and cost of goods sold) are to determine that:

1. Internal control over inventories is adequate.
2. The recorded inventories are valid (existence and rights).
3. All inventory is recorded (completeness).
4. Inventory records and supporting schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).
5. The valuations of inventories approximate the lower-of-cost-or-market method.
6. The presentation and disclosure of inventories is adequate.

**Internal control over inventories and cost of goods sold.**

The importance of adequate internal control over inventories and cost of goods sold from the viewpoint of both management and the auditors can scarcely be overemphasized. In some companies, management stresses internal controls over cash and securities but pays little attention to control over inventories. Since many types of inventories are composed of items not particularly susceptible to theft, management may consider internal controls to be unnecessary in this area. Such thinking ignores the fact that an internal control performs other functions just as important as fraud prevention.

Good internal control is a means of providing accurate cost data for inventories and cost of goods sold as well as accuracy in reporting physical quantities. Inadequate internal control may cause losses by permitting erroneous cost data to be used by management in setting prices and in making other decisions based on reported profit margins. If the accounts do not furnish a realistic picture of the cost of inventories on hand, the cost of goods manufactured, and the cost of goods sold, the financial statements may be grossly misleading both as to earnings and as to financial position.

Purchasing, receiving, storing, issuing, processing, and shipping are the physical functions directly connected with inventories; the cost accounting system and the perpetual inventory records comprise the recording functions. Since the auditors are interested in the final products of the recording functions, it is necessary for them to understand and appraise the cost accounting system and the perpetual inventory records, as well as the various procedures and original documents underlying the preparation of financial data.

**The Purchasing function**

Adequate internal control over purchases requires, first of all, an organizational structure that delegates to a separate department of the company exclusive authority to make all purchases of materials and services. The purchasing, receiving, and recording functions should be clearly separated and lodged in separate departments.

Serially numbered purchase orders should be prepared for all purchases, and copies forwarded to the accounting and receiving department.

**The receiving function**

All goods received by the company-without exception- should be cleared through a receiving department that is independent of purchasing, storing, and shipping departments. The receiving department is responsible for

1) the determination of quantities of goods received,

2) the detection of damaged or defective merchandise,

3) the preparation of a receiving report, and

4) the prompt transmittal of goods received to the stores department.

**The storing function**

As goods are delivered to stores, they are counted, inspected, and receipted for. The stores department will then notify the accounting department of the amount received and placed in stock. In performing these functions, the stores department makes an important contribution to overall control of inventory. By signing for the goods, it fixes its own responsibility, and by notifying the accounting department of actual goods stored, it provides verification of the receiving department’s work.

**The issuing function**

The stores department, being responsible for all goods under its control, has reason to insist that for all items passing out of its hands it be given a prenumbered requisition, which serves as a signed receipt from the department accepting the goods. Requisitions are usually prepared in triplicate one copy is retained by the department making the request; another acts as the stores department’s receipt; and the third is a notice to the accounting department for cost distribution.

**The production function**

The system of internal control over goods in process may include regular inspection procedures to reveal defective work. This aids in disclosing inefficiencies in the productive system and also tends to prevent inflation of the goods in process inventory by the accumulation of cost for goods that will eventually be scrapped.

Control procedures should also assure that goods scrapped during the process of production are promptly reported to the accounting department So that the decrease in value of goods in process inventories may be recorded. Scrapped materials may have substantial salvage value, and this calls for segregation and control of scrap inventories.

**The shipping function**

Shipments of goods should be made only after proper authorization has been received. This authorization will normally be a sales order approved by the credit department; although the shipping function also includes the returning of defective goods to suppliers. In this latter case, the authorization may take the form of a shipping advice from a purchasing department executive.

**The cost accounting system**

To account for the usage of raw materials and supplies, to determine the content and value of goods in process inventories, and to compute the finished goods inventory, an adequate cost accounting system is necessary. This system comprises all the records, orders, requisitions, time tickets, and the like needed in a proper accounting for the disposition of materials as they enter the flow of production and as they continue through the factory in the process of becoming finished goods. The cost accounting system also serves to accumulate labor costs and indirect costs that contribute to the goods in process and the finished goods inventories. The cost accounting system thus forms an integral part of the internal control for inventories.

**The perpetual inventory system**

Perpetual inventory records constitute a most important part of internal control. These records, by showing at all times the quantity of goods on hand, provide information essential to intelligent purchasing, sales, and production-planning policies. With such a record it is possible to guide procurement by establishing points of minimum and maximum quantities for each standard item stocked.

The use of a perpetual inventory system allows companies to control the high costs of holding excessive inventory, while minimizing the risk of running out of stock. The company can control inventories through reorder points and economic order quantities, including just-in-time systems in which inventory levels are kept to a minimum.

**Audit procedures for inventories and cost of goods sold.**

The following audit procedures for the verification of inventories and cost of goods sold are appropriate for a manufacturing company.

**A) Consider internal control for inventories and cost of goods sold**

**1 Obtain an understanding of internal control.**

As previously indicated, the consideration of internal controls may involve the filling out of a questionnaire, the writing of descriptive memoranda, or the preparation of flowcharts depicting organizational structure and the flow of materials and documents. All these approaches utilize the same basic investigative techniques of interview and the conduct of a walk-through of the system to determine that the system is accurately described.

During the review of internal controls over inventory, the auditors should become thoroughly conversant with the procedures for purchasing, receiving, storing, and issuing goods and for controlling production, as well as acquiring an understanding of the cost accounting system and the perpetual inventory records. The auditors should also give consideration to the physical protection for inventories.

**2. Assess control risk and design additional tests of controls.**

Control risk for a financial statement assertion may be assessed below the maximum only when tests indicate that related controls are designed and operating effectively. The auditors must decide which additional tests of controls will likely result in cost justified restrictions of substantive tests.

**3. Perform additional tests of controls**

**a) Examine significant aspects of a sample of purchase transactions.**

The proper recording of purchase transactions and of cash disbursements is essential to reliable accounting records. Therefore, the auditors test the key control procedures in the client’s purchasing transaction cycle. Tests of this cycle may include the following steps:

1. Select a sample of purchase transactions.
2. Examine the purchase requisition or other authorization for each purchase transaction in the sample.
3. Examine the related vendor’s invoice, receiving report, and paid check for each purchase order in the sample. Trace transactions to the voucher register and check register.
4. Review invoices for approval of prices, extensions, footings, freight, and credit terms.
5. Compare quantities and prices in the invoice, purchase order, and receiving report.
6. Trace postings from voucher register to general ledger and any applicable subsidiary ledgers.

**b) Test the cost accounting system**

For a client in the manufacturing field, the auditors must become familiar with the cost accounting system in use as a part of their consideration of internal control.

In any cost accounting system, the three elements of manufacturing cost are direct materials costs, direct labor costs, and manufacturing overhead. Cost accounting systems may accumulate either actual costs or standard costs according to processes or jobs. The auditors’ tests of the client’s cost accounting system are designed to determine that costs allocated to specific jobs or processes are appropriately compiled.

To achieve this objective, the auditors test the appropriateness of direct materials quantities and unit costs, direct labor hours and hourly rates, and overhead rates and allocation bases.

**4. Reassess control risk and design substantive tests.**

The description and tests of controls of the client’s internal control for inventories and cost of goods sold provide the auditors with evidence as to weaknesses and strengths of the system. Based on this information, the auditors reassess control risk and design their substantive testing of inventories and cost of sales accordingly.

**B) Substantive tests**

**5. Obtain listings of inventory and reconcile to ledgers.**

The auditor will obtain a schedule of listings of inventory which will be reconciled to both the general ledger and appropriate subsidiary ledgers. The auditors’ goal in performing this step is to make sure the inventory records agree with what is recorded in the accounting system.

**6. Evaluate the client’s planning of physical inventory.**

Efficient and effective inventory taking requires careful planning in advance. Once the plan has been developed, it must be documented and communicated in the form of written instructions to the personnel taking the physical inventory. These instructions normally will be drafted by the client and reviewed by the auditors, who will judge their adequacy.

If the instructions for taking inventory are adequate, then the auditors’ responsibility during the count is largely a matter of seeing that the instructions are followed conscientiously.

**7. Observe the taking of physical inventory and make test counts.**

It is not the auditors’ function to take the inventory or to control or supervise the taking; this is the responsibility of management. The auditors observe the inventory taking in order to obtain sufficient competent evidence as to the existence and completeness of audit objectives.

Observation by the auditors also includes determining that all usable inventory owned by the client is included in the count and that the client’s employees comply with the written inventory instructions. As part of the process of observing the physical inventory, the auditors will be alert to detect any obsolete or damaged merchandise included in inventory. Such merchandise should be segregated by the client and written down to net realizable value. During their inventory observation, the auditors will make test counts of selected inventory items.

**8. Review the year-end cut off of purchases and sales transactions**

An accurate cut off of purchases is one of the most important factors in verifying the accuracy and completeness of the year-end inventory. Assume that a shipment of goods costing Br. 10,000 is received from a supplier on December 31, but the purchase invoice does not arrive until January 2 and is entered as a January transaction. If the goods are included in the December 31 Physical inventory but there is no December entry to record the purchase and the liability, the result will be an overstatement of both net income for the year and retained earnings and an understatement of accounts payable, each error being in the full amount of Br. 10, 000 (ignoring income taxes).

An opposite situation may arise if a purchase invoice is received and recorded on December 31, but the merchandise covered by the invoice is not received until several days later and is not included in the physical inventory taken at the year-end. How can the auditors determine that the liability to suppliers has been recorded for all goods included in inventory? Their approach is to examine on a test basis the purchase invoices and receiving reports for several days before and after the inventory date.

The sales cutoff is mentioned at this point to emphasize its importance in determining the fairness of the client’s inventory and cost of goods sold as well as accounts receivable and sales.

**9. Obtain a copy of the completed physical inventory, determine its clerical accuracy, and trace test counts.**

The testing of extensions and footings on the final inventory listing may disclose misstatements of physical inventories. In testing extensions, the auditors should be alert for two sources of substantial errors- misplaced decimal points and incorrect extension of count units by price units. For example, an inventory listing that extends 1,000 units times Br.1C (Per hundred) as Br.1,000 will be overstated by Br.990. An inventory extension of 1,000 sheets of steel times Br. 1 per pound will be substantially understated if each sheet of steel weighs more than one pound.

The auditors also should trace to the completed physical inventory their test counts made during the observation of physical inventory. Another test of the clerical accuracy of the completed physical inventory is the reconciliation of the physical counts to inventory records. Both the quantities and the values of the items should be compared to the company’s perpetual records.

**10. Review inventory quality and condition**

The auditors should also be alert during the course of their inventory observation for any inventory of questionable quality or condition. Excessive dust or rust on raw materials inventory items may be indicative of obsolescence or infrequent use.

The auditors should also review perpetual inventory records for indications of slow-moving inventory items. Then, during the course of observing inventory taking, the auditor should examine these slow-moving items and determine that the client has identified the items as obsolete if appropriate.

**11. Evaluate the bases and methods of inventory pricing.**

The auditors are responsible for determining that bases and methods of pricing inventory are in accordance with generally accepted accounting principles. The investigation of inventory pricing often will emphasize the following three questions:

1) What method of pricing does the client use?

2) is the method of pricing the same as that used in prior years?

3) Has the method officially selected by the client been applied consistently and accurately in practice?

For the first question a long list of alternatives is possible, including such methods as cost; cost or market, whichever is lower; the retail method; and quoted market price. The cost method, of course, includes many diverse systems, such as last-in, first-out (LIFO); first-in, first-out (FIFO); specific identification; weighted average.

For the second question the nature and justification of the change in method of valuing inventory and its effect on income should be disclosed. To answer the third question the auditors must test the pricing of a representative number of inventory items.

**12. Test the pricing of inventories.**

To determine whether the inventory valuation method used by the client has been properly applied, the auditors must make tests of the pricing of selected items of finished goods, goods in process and raw materials.

As a general rule, inventories should not be carried at an amount in excess of net realizable value. The lower-of-cost-or-market rule is a common means of measuring any loss of utility in the inventories. If the inventory includes any discontinued lines or obsolete or damaged goods, the client should reduce these items to net realizable value, which is often scrap value.

**13. Perform analytical procedures**

Material errors in counting, pricing, and calculating the physical inventory, as well as fictitious or obsolete inventory, may be disclosed by analytical procedures designed to establish the general reasonableness of the inventory figures.

A comparative summary of inventories classified by major types, such as raw materials, goods in process, finished goods, and supplies, should be obtained or prepared. Explanations should be obtained for all major increases or decreases from the prior year’s amounts.

**14. Determine whether any inventories have been pledged and review purchase and sales commitments.**

The verification of inventories includes a determination by the auditors as to whether any goods have been pledged. In some lines of business, it is customary to enter into firm contracts for the purchase of merchandise or materials well in advance of the scheduled delivery dates. Comparison by the auditors of the prices quoted in such commitments with the vendors’ prices prevailing at the balance sheet date may indicate substantial losses if firm purchase commitments are not protected by firm sales contracts. Such losses should be reflected in the financial statements.

**15. Evaluate financial statement presentation of inventories and cost of goods sold, including the adequacy of disclosure.**

One of the most important factors in proper presentation of inventories in the financial statements is disclosure of the inventory pricing method or methods in use. Other important points in presenting inventories in the financial statements include the following:

1. Changes in methods of valuing inventory should be disclosed and the dollar effect and justification for the change reported.
2. A separate listing is desirable for the various classifications of inventory, such as finished goods, goods in process, and raw materials.
3. If any portion of the inventory has been pledged to secure liabilities, full disclosure of the arrangement should be made.
4. Deduction of valuation allowance for inventory losses from the related inventory.
5. Disclosure of the existence and the terms of inventory purchase commitments.

**2.4 Property, Plant, and Equipment Including Depreciation**

The term property, plant, and equipment include all tangible assets with a service life of more than one year that are used in the operation of the business and are not acquired for the purpose of resale. Three major subgroups of such assets are generally recognized:

1. Land, it has the significant characteristic of not being subject to depreciation.
2. Buildings, machinery, equipment, and land improvements, such as fences and parking lots, have limited service lives and are subject to depreciation.
3. Natural resources (wasting assets), such as oil wells, coal mines, and tracts of timber, are subject to depletion as the natural resources are extracted or removed.

Acquisitions and disposals of property, plant, and equipment are usually large in dollar amount, but concentrated in only a few transactions. Individual items of plant and equipment may remain unchanged in the accounts for many years.

**The auditors’ approach in examination of property plant, and equipment**

The auditors’ objectives are to determine that:

1. Internal control over property, plant, and equipment is adequate.
2. The recorded property, plant, and equipments is valid (existence and rights).
3. All property, plant, and equipment is recorded (Completeness).
4. Property, plant, and equipment records and supporting schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).
5. The valuation of property, plant, and equipment, is proper.
6. The presentation and disclosure of plant, and equipment, including disclosure of depreciation methods, is adequate.

In conjunction with the audit of property, plant and equipment, the auditors also obtain evidence about the related accounts of depreciation expense, accumulated depreciation, and repairs and maintenance expense.

**Contrast with audit of current assets**

In many companies, the investment in plant and equipment amounts to 50 percent or more of the total assets. However, the audit work required to verify these properties is usually a much smaller proportion of the total audit time spent on the engagement.

The verification of plant and equipment is facilitated by several factors not applicable to audit work on current assets.

First, a typical unit of property or equipment has a high dollar value, and relatively few transactions may lie behind a large balance sheet amount. Second, there is usually little change in the property accounts from year to year. The land account often remains unchanged for a long span of years. The durable nature of buildings and equipment also tends to hold accounting activity to a minimum for these accounts. By way of contrast, such current assets as accounts receivable and inventory may have a complete turnover several times a year.

A third point of contrast between the audit of plant asset and the audit of current assets is the significance of the year-end cut off of transactions for current assets, the year end cutoff is a critical issue; for plant assets, it is generally not.

**Internal controls over plant and equipment**

The principal purpose of internal controls relating to plant and equipment is to obtain maximum efficiency from the dollars invested in plant assets.

The amounts invested in plant and equipment represent a large portion of the total assets of many industrial concerns. The expenses of maintenance, rearrangement, and depreciation of these assets are a major factor in the income statement. The sheer size of the amounts involved makes strong internal controls essential to the production of reliable financial statements.

**Major control devices**

Important controls applicable to plant and equipment are as follows:

1. There should be an annual plant budget used to forecast and to control acquisitions and retirements of plant and equipment.
2. A subsidiary ledger consisting of a separate record for each unit of property.
3. A system of authorization requiring advance executive approval of all plant and equipment acquisitions, whether by purchase, lease, or construction.
4. A reporting procedure assuring prompt disclosure and analysis of variances between authorized expenditures and actual costs.
5. An authoritative written statement of company policy distinguishing between capital and revenue expenditures. A dollar minimum ordinarily will be established for capitalization; any expenditures of lesser amount automatically are classified as charges against current revenue.
6. A policy requiring all purchases of plant and equipment to be handled through the purchasing department and subjected to standard routines for receiving, inspection, and payment.
7. Periodic physical inventories, designed to verify the existence, location, and condition of all property listed in the accounts and to disclose the existence of any unrecorded units.
8. A system of retirement procedures, including serially numbered retirement work orders, stating reasons for retirement and bearing appropriate approvals.

**Audit procedure for property, plant, and equipment.**

The following procedures are typical of the work required in many engagements for the verification of property, plant and equipment.

**A) Consider internal control for property, plant, and equipment**

**1. Obtain an understanding of the internal control.**

In the study of internal control for plant and equipment, the auditors may utilize a written description, flowcharts, or an internal control questionnaire. The following are typical of the questions included in a questionnaire; Are plant ledgers regularly reconciled with general ledger controlling accounts? Are periodic physical inventories of plant asset compared with the plant ledgers? Are variances between plant budgets and actual expenditures for plant assets subject to review and approval of executives? Does the sale, transfer, or dismantling of equipment require written executive approval on a serially numbered retirement work order? Is there a written policy for distinguishing between capital expenditures and revenue expenditures?

**2. Assess control risk and design additional tests of controls.**

Control risk for a financial statement assertion may be assessed below the maximum only when tests indicate that related controls are designed and operating effectively. The auditors must decide which additional tests of controls will likely result in cost justified restrictions of substantive tests.

**3. Perform additional tests of controls**

The purpose of tests of controls for plant assets is to determine whether the internal controls established by the client are being followed consistently in practice. For example, if the client uses serially numbered retirement work orders to authorize the disposal of plant assets, the auditors may test this control by matching known retirements with retirement work orders and by comparing individual work orders with entries in the subsidiary ledgers for plant and equipment. Another test is to examine copies of reconciliations of the subsidiary ledgers with general ledger controlling accounts to determine whether these reconciliations have, in fact, been regularly prepared and have been approved by an appropriate official.

**4. Reassess control risk and design substantive test**

The final step in the auditors’ consideration of internal control involves a reassessment of control risk based on the results of the tests of controls. The auditors then select the substantive tests necessary to provide sufficient competent evidence as to the audit objectives for the client’s property, plant, and equipment. The extent of the substantive tests is determined in relation to the auditors’ final assessment of control risk.

**B. Substantive tests**

**5. Obtain a summary analysis of changes in property owned and reconcile to ledgers.**

The auditors may verify the beginning balances of plant and equipment assets by reference to the prior year’s audit working papers. In addition to beginning balances, the summary analysis will show the additions and retirements of plant and equipment during the year under audit. As the audit progresses, the auditors will verify in detail these additions and retirements.

**6. Vouch additions to property during the year**

The vouching of additions to the property accounts during the period under audit is one of the most important substantive tests of plant and equipment. The extent of the vouching is dependent up on the auditors’ assessment of control for plant and equipment expenditures. The vouching process utilizes a working paper analysis of the general ledger controlling accounts and includes the tracing of entries through the journals to original documents, such as contracts, deeds, construction work orders, invoices, canceled checks, and authorization by directors.

**7. Make a Physical inspection of major acquisitions of plant and equipment**

The auditors usually make a physical inspection of major units of plant and equipment acquired during the year under audit. This step is helpful in maintaining a good working knowledge of the client’s operations and also in interpreting the accounting entries for both additions and retirements. Physical inspection is particularly appropriate if there appear to be weaknesses in the client’s internal controls over plant assets.

The audit procedure of Physical inspection may flow in either direction between the plant assets and the records of plant assets. By tracing items in the plant ledger to the Physical assets, the auditors prove that the assets shown in the accounting records actually exist and are in current use. The alternative testing procedure is to inspect selected assets in the plant and trace these assets to the detailed records. This test provides evidence that existing assets are recorded.

**8. Analyze repair and maintenance expense accounts**

The auditors’ principal objective in analyzing repair and maintenance expense accounts is to discover items that should have been capitalized. Many companies have a written policy setting the minimum expenditure to be capitalized. For example, company policy may prescribe that no expenditure for less than Br. 300 shall be capitalized regardless of the service life of the item purchased. In such cases, the auditors will analyze the repair and maintenance accounts with a view toward determining the consistency of application of this policy as well as compliance with generally accepted accounting principles.

**9. Investigate the status of property not in current use**

Land, buildings, and equipment not in current use should be investigated thoroughly to determine the prospects for their future use in operations. Plant assets that are temporarily idle need not be reclassified, and depreciation may be continued at normal rates. On the other hand, idle equipment that has been dismantled, or that for any reason appears unsuitable for future operating use, should be written down to an estimated realizable value and excluded from the plant and equipment classification.

**10. Test the client’s provision for depreciation**

See the separate depreciation program following this audit program.

**11. Verify retirements of property during the year**

The principal purpose of this procedure is to determine whether any property has been replaced, sold, dismantled, or abandoned without such action being reflected in the accounting records. Nearly every thorough Physical inventory of plant and equipment reveals missing units of property: units disposed of without a corresponding reduction of the accounts.

**12. Verify legal ownership of property, plant, and equipment**

To determine that plant assets are the property of the client, the auditors look for such evidence as a deed, property tax bills, receipts for payments to mortgagee, and fire insurance policies. Additionally, the fact that rental payments are not being made is supporting evidence of ownership.

**13. Review rental revenue from land, buildings, and equipment owned by the client but leased to others.**

Examination of leases will indicate whether tenants are responsible for the cost of electricity, water, gas, and telephone service. These provisions should be reconciled with utility expense accounts. Rental revenue accounts should be analyzed in all cases and the amount compared with lease agreements and cash records.

**14. Examine lease agreements on property, plant, and equipment leased to and from others.**

The preceding step addressed rental revenue from leases. Also related to leases, the auditors must be aware that generally accepted accounting principles require differing accounting treatments, depending up on whether they qualify as an operating or a capital lease. The auditors should carefully examine lease agreements to determine whether the accounting for the assets involved is proper. For example, the auditors must determine whether assets leased by the client should be capitalized.

**15. Perform analytical procedures for property, plant, and equipment**

The specific trends and ratios used in judging the overall reasonableness of recorded amounts for plant and equipment will vary with the nature of the client’s operations. Among the ratios and trends often used by auditors for this purpose are the following:

1. total cost of plant assets divided by annual output in dollars, pounds, or other units.
2. total cost of plant assets divided by cost of goods sold.
3. comparison of repairs and maintenance expense on a monthly basis and from year to year.
4. comparison of acquisitions for the current year with prior years.
5. comparison of retirements for the current year with prior years.

**16. Evaluate financial statements presentation and disclosure for plant assets and for related revenue and expenses.**

The balance sheet or accompanying notes should disclose balances of major classes of depreciable assets.

Accumulated depreciation may be shown by major class or in total, and the method or methods of computing depreciation should be stated. The total amount of depreciation should be disclosed in the income statement or supporting notes.

In addition, adequate financial statement presentation and disclosure will ordinarily reflect the following principles:

1. The basis of valuation should be explicitly stated. At present, cost is the generally accepted basis of valuation for plant and equipment; property not in use should be valued at estimated realizable value.
2. Property pledged to secure loans should be clearly identified.
3. Property not in current use should be segregated in the balance sheet.

**Testing the client’s provision for depreciation**

We have emphasized the importance of determining the overall reasonableness of the amount of depreciation expense, which is usually a very material amount on the income statement. An overall test of the annual provision for depreciation requires the auditors to perform the following steps:

1. List the balances in the various asset accounts at the beginning of the year.
2. Deduct any fully depreciated assets, since these items should no longer be subject to depreciation.
3. Add one half of the asset additions for the year.
4. Deduct one half of the asset retirements for the year (exclusive of any fully depreciated assets).

These four steps produce average amounts subject to depreciation at the regular rates in each of the major asset categories. By applying the appropriate rates to these amounts, the auditors determine on an overall average basis- the amount of the provision for depreciation. The computed amount is then compared with the client’s figures. Precise agreement is not to be expected, but any material difference between the depreciation expense computed in this manner and the amount set up by the client should be investigated fully.

**2.5 Accounts payable and other liabilities**

Now that the sections dealing with the verification of assets have been completed, we are ready to consider the examination of liability accounts.

**Accounts payable**

**Sources and nature of accounts payable**

The term accounts payable (often referred to as vouchers payable for a voucher system) is used to describe short-term obligations arising from the purchase of goods and services in the ordinary course of business. Typical transactions creating accounts payable include the acquisition on credit of merchandise, raw materials, plant assets, and office supplies. Other sources of accounts payable include the receipt of services, such as legal and accounting services, advertising, repairs, and utilities. Interest–bearing obligations should not be included in accounts payable but shown separately as bonds, notes, mortgages, or installment contracts.

**The auditors’ approach in examination of accounts payable**

The auditors’ objectives in the examination of accounts payable are to determine that:

1. Internal control over accounts payable and the acquisition and payment cycle is adequate.

2. the recorded accounts payable are valid(occurrence and obligations).

3. all accounts payable are recorded (completeness).

4. Accounts payable schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).

5. the valuation of accounts payable is proper.

6. the presentation and disclosure of payables is adequate.

**Internal control over accounts payable**

In thinking about internal control for accounts payable, it is important to recognize that the accounts payable of one company are the accounts receivable of other companies. It follows that there is little danger of errors being overlooked permanently since the client’s creditors will generally maintain complete records of their receivables and will inform the client if payment is not received. This feature also aids auditors in the discovery of irregularities, since the perpetrator must be able to obtain and respond to the demands for payment.

Discussion of internal control applicable to accounts payable may logically be extended to the entire purchase or acquisition cycle. In an effective purchasing system, a stores, or inventory control department will prepare and approve the issuance of a purchase requisition that will be sent to the purchasing department. A copy of the purchase requisition will be filed numerically and matched with the subsequently prepared purchase order and finally with a copy of receiving report.

The purchasing department, upon receiving the purchase requisition, will (1) determine that the item should be ordered and (2) select the appropriate vendor, quality, and price. Then, a serially numbered purchase order is issued to order the goods. Copies of the purchase order should be sent to stores, receiving, and the accounts payable department. The copy sent to receiving is generally “blind” in that the quantities are not included so as to encourage receiving department counting of quantities.

The receiving department should be independent of the purchasing department. When goods are received, they should be counted and inspected. Receiving reports should be prepared for all goods received. These documents should be serially numbered and prepared in a sufficient number of copies to permit prompt notification of the receipt of goods to the stores department, the purchasing department, and the accounts payable department.

Within the accounts (vouchers) payable department, all forms should be stamped with the date received. Vouchers and other documents originating within the department can be controlled through the use of serial numbers. Comparison of the quantities listed on the invoice with those shown on the receiving report and purchase order will prevent the payment of charges for goods in excess of those ordered and received. Comparison of the prices, discounts and terms of shipment as shown on the purchase order and on the vendor’s invoice provides a safeguard against the payment of excessive prices.

The separation of the function of invoice verification and approval from the function of cash disbursement is another step that tends to prevent errors and irregularities. Before invoices are approved for payment, written evidence must be presented to show that all aspects of the transaction have been verified. The official who signs checks should stamp or perforate the voucher and supporting documents so that they cannot be presented to support payment a second time.

Another control procedure that the auditors may expect to find in a well-managed accounts payable department is the regular monthly balancing of the detailed records of accounts payable (or vouchers) to the general ledger controlling account. These trial balances should be preserved as evidence of the performance of this procedure and as an aid in locating any subsequent errors.

**Audit Procedures**

The following procedures are typical of the work required in many engagements for the verifications of accounts payable.

**A. Consider internal control for accounts payable**

**1. Obtain an understanding of the internal control**

One approach used by auditors in becoming familiar with a client’s system of internal control for accounts payable is to prepare a flowchart or to use flowcharts prepared by the client. In some engagements, the auditors may choose to prepare a narrative description covering such matters as the independence of the accounts payable department and the receiving department from the purchasing department. The auditors might use a questionnaire to obtain a description of accounts payable controls. Typical of the questions are the following. Is an accounts payable trial balance prepared monthly and reconciled to the general ledger controlling account? Are monthly statements from vendors reconciled with accounts payable ledgers or unpaid vouchers?

**2. Assess control risk and design additional tests of controls**

Control risk for a financial statement assertion may be assessed below the maximum only when tests indicate that related controls are designed and operating effectively. The auditors must decide which additional tests of controls will likely result in cost-justified restrictions of substantive tests.

**3. Perform additional tests of controls**

A number of tests of controls relating to accounts payable have already been discussed in the previous sections. In this section we briefly recap several tests.

a) Verify a sample of postings to the accounts payable controlling account.

The validity of the amount in the general ledger controlling account for accounts payable is established by tracing postings for one or more months to the voucher register and cash payments journal. Any postings to the controlling account from the general journal during this test period should also be traced.

b) Vouch to supporting documents a sample of postings in selected accounts of the accounts payable subsidiary ledger.

Testing the accuracy of the voucher register or the accounts payable ledgers by tracing specific items back through the cash payments journal, purchases journal, and other journals to original documents (Such as purchase orders, receiving reports, invoices, and paid checks) is necessary to determine the adequacy of the internal control.

**4. Reassess Control risk and design Substantive tests**

Completion of the above audit procedures enables the auditors to perform a final assessment of control risk for each of the major financial statement assertions about accounts payable. The internal control assessment provides the basis for selecting the necessary substantive tests for verification of accounts payable at the balance sheet date.

**B. Substantive tests**

**5. Obtain or prepare a trial balance of accounts payable as of the balance sheet date and reconcile with the general ledger.**

One purpose of this procedure is to prove that the liability figure appearing in the balance sheet is in agreement with the individual items comprising the detail records. A second purpose is to provide a starting point for substantive testing. The auditors will use the list of vouchers or accounts payable to select a representative group of items for careful examination.

**6. Vouch balances Payable to Selected creditors by inspection of supporting documents**

Another substantive test of the validity of the client-prepared trial balance of accounts payable is the vouching of selected creditors’ balances to supporting vouchers, invoices, purchase orders, and receiving reports.

**7. Reconcile liabilities with monthly statements from creditors**

In some companies, it is a regular practice each month to reconcile vendor’s statements with the detailed records of payables. If the auditors find that this reconciliation is regularly performed by the client’s staff, they may limit their review of vendors’ statements to determining that the reconciliation work has been satisfactory. If the client’s staff has not reconciled vendors’ statements and accounts payable, the auditors may do so.

**8. Confirm accounts Payable by direct correspondence with vendors**

Confirmation requests should be mailed to vendors from whom substantial purchases have been made during the year, regardless of the size of their accounts at the balance sheet date. Even accounts payable with zero balances at year-end should be confirmed if they represent major suppliers.

Confirmation of accounts payable is not a mandatory procedure as is the confirmation of receivables. One reason is that the greatest hazard in the verification of liabilities is the existence of unrecorded liabilities. To confirm the recorded accounts payable does not prove whether any unrecorded accounts payable exist. Another factor to be noted in comparing the confirmation of accounts receivable and accounts payable is that the auditors will find in the client’s possession externally created evidence such as vendors’ invoices and statements that substantiate the accounts payable. No such external evidence is on hand to support accounts receivable.

**9. Perform analytical procedures for accounts Payable and related accounts**

To gain assurance as to the overall reasonableness of accounts payable, the auditor may compute ratios such as accounts payable divided by purchases and accounts payable divided by total current liabilities. These ratios are compared with ratios for prior years to disclose trends that warrant investigation.

**10. Search for unrecorded accounts Payable**

Throughout the audit the auditors must be alert for any unrecorded payables. For example, the preceding three steps of this program, reconciliation, confirmation, and analytical procedures, may disclose unrecorded liabilities.

In addition to the prior audit steps, when searching for unrecorded accounts payable the auditors will audit transactions that were recorded following year-end. A comparison of cash payments occurring after the balance sheet date with the accounts payable trial balance is an excellent means of disclosing unrecorded accounts payable. All liabilities must eventually be paid, and will, therefore, be reflected in the accounts at least by the time they are paid.

**11. Search for accounts payable to related parties**

Payables to a corporation’s officers, directors, stock-holders, or affiliates require particular attention by the auditors since they are not the result of arm’s length bargaining by parties of apposing interests. Here the auditors should consider the possibility that these payables relate to purchases of inventory or other asset items for which there may be valuation questions. The independent auditors must search for such payables. All material payables to related parties must be disclosed in the financial statements.

**12. Evaluate proper balance sheet presentation and disclosure of accounts payable**

Proper balance sheet presentation of accounts payable requires that any material amounts payable to related parties (directors, principal stockholders, officers, and employees) be listed separately from amounts payable to trade creditors.

**Other Liabilities**

Notes payable is discussed in the next section. In addition to the accounts payable previously considered, other items classified as current liabilities include.

1. Amounts withheld from employees’ pay.
2. Sales taxes payable.
3. Unclaimed wages.
4. Customer’s deposits
5. Accrued liabilities

**Amounts withheld from employees’ pay**

Income taxes withheld from employees’ pay and not remitted as of the balance sheet date constitute a liability to be verified by the auditors. Accrued employer payroll taxes may be audited at the same time. This verification usually consists of tracing the amounts withheld to the payroll summary sheets, testing computations of taxes withheld and accrued and determining that taxes have been deposited or paid in accordance with the federal and state laws and regulations.

**Sales taxes Payable**

In most sections of the country, business concerns are required to collect sales taxes imposed by state and local governments on retail sales. These taxes do not represent an expense to the business; the retailer merely acts as a collecting agent. Until the amounts collected from customers are remitted to the taxing authority, they constitute current liabilities of the business. The auditors’ verification of this liability includes a review of the client’s periodic tax returns. The reasonableness of the liability also is tested by a computation applying the tax rate to total taxable sales. In addition, the auditors should examine a number of sales invoices to ascertain that customers are being charged the correct amount of tax. Debits to the liability account for remittances to the taxing authority should be traced to copies of the tax returns and should be vouched to the paid checks.

**Unclaimed wages**

The auditors will analyze the unclaimed wages account for the purpose of determining that:

1. The credits represent all unclaimed wages after each payroll distribution and
2. the debits represent only authorized payments to employees, remittances to the state under unclaimed property laws, or transfers back to general cash funds through approved procedures.

**Customers’ deposits**

Many companies require that customers make deposits on returnable containers. A review of the procedures followed in accepting and returning deposits should be made by the auditors with a view to disclosing any shortcomings in internal control. In some instances, deposits shown by the records as refunded to customers may in fact have been abstracted by employees.

As a general rule, the auditors do not attempt to confirm deposits by direct communication with customers; but this procedure is desirable if the amounts involved are substantial or the internal control procedures are considered to be deficient.

**Accrued liabilities**

Most accrued liabilities represent obligations payable sometime during the succeeding period for services or privileges received before the balance sheet date. Examples include interest payable, accrued property taxes, accrued payrolls and payroll taxes and income taxes payable.

Because accrued items are based on client estimates of amounts which will subsequently become payable, subjective factors may make it difficult to establish control over them. As a result, these estimates may be particularly susceptible to misstatement, especially in circumstances in which management is under pressure to show increased earnings.

The basic auditing steps for accrued liabilities are:

1. Examine any contracts or other documents on hand that provide the basis for the accrual.

2. Appraise the accuracy of the detailed accounting records maintained for this category of liability.

3. Identify and evaluate the reasonableness of the assumptions made that underline the computation of the liability.

4. Test the computations made by the client in setting up the accrual.

5. Determine that accrued liabilities have been treated consistently at the beginning and end of the period.

6. Consider the need for accrual of other accrued liabilities not presently considered (that is, test completeness).

**2.6 Debt and Equity Capital; Loss Contingencies**

Business corporations obtain substantial amounts of their financial resources by incurring interest-bearing debt and by issuing capital stock. The acquisition and repayment of capital is sometimes referred to as the financing cycle. This transaction cycle includes the sequence of procedures for authorizing, executing, and recording transactions that involve bank loans, mortgages, bonds payable, and capital stock as well as the payment of interest and dividends. In this section we present material on the auditors’ approach to both debt and equity capital accounts. In addition, we present information on loss contingencies.

**Interest-Bearing Debt**

**Sources and nature of interest-bearing debt**

Nearly every business borrows. A business with an excellent credit reputation may find it possible to borrow from a bank on a simple unsecured note. A business of lesser financial standing may find that obtaining bank credit requires the pledging of specific assets as collateral or that it must agree to certain restrictive covenants, such as the suspension of dividends. Long-term debt usually is substantial in amount and often extends for periods of 20 years or more.

**The auditors’ approach in examination of interest-bearing debt**

The auditors’ objectives in the examination of interest-bearing debt are to determine that:

1. Internal control over interest-bearing debt is adequate.

2. The recorded interest-bearing debt is valid (occurrence and obligations).

3. All interest-bearing debt is recorded (completeness).

4. Interest-bearing debt schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).

5. The valuation of interest-bearing debt is proper.

6. The presentation and disclosure of interest bearing debt is adequate.

In conjunction with the audit of interest-bearing debt, the auditors will also obtain evidence about the adequate cutoff of cash receipts and disbursements related to debt, and the accounts of interest expense, interest payable, and bond discount and premium.

**Internal control over interest-bearing debt**

Effective internal control over interest-bearing debt begins with the authorization to incur the debt. The bylaws of a corporation usually require that borrowing be approved by the board of directors. The treasurer of the corporation will prepare a report on any proposed financing, explaining the need for funds, the estimated effect of borrowing upon future earnings, the estimated financial position of the company in comparison with others in the industry both before and after the borrowing, and alternative methods of raising the amount desired.

The auditors’ appraisal of internal controls relating to bonds and notes payable must extend to the handling of interest payments.

**Audit procedure for interest-bearing debt**

This audit procedure does not provide for the usual distinction between substantive testing and internal control testing. This is because individual transactions will generally be examined for all large debt agreements.

Because transactions are few in number, but large in dollar amount, the auditors are generally able to substantiate the individual transactions.

**Audit procedures appropriate for the verification of interest-bearing debt include the following:**

**1. Obtain or prepare analyses of interest-bearing debt accounts and related interest, premium, and discount accounts**

A notes payable analysis shows the beginning balance, if any, of each individual note, additional notes issued and payments on notes during the year, and the ending balance of each note. In addition, the beginning balances of interest payable or prepaid interest, interest expense, interest paid, and ending balances of interest payable or prepaid interest may be presented in the analysis working paper.

In the first audit of a client, the auditors will analyze the ledger accounts for Bonds payable, Bond Issue costs, and Bond Discount (or Bond premium) for the years since the bonds were issued. The working paper is placed in the auditors’ permanent file, in later audits, any further entries in these accounts may be added to the analysis.

**2. Examine Copies of notes payable and supporting documents**

The auditors should examine the client’s copies of notes payable and supporting documents such as mortgages and trust deeds. The original documents will be in the possession of the payees, but the auditors should make certain that the client has retained copies of the debt instruments.

**3. Confirm interest-bearing debt with payees or appropriate third parties**

Payees should be requested to confirm dates of origin, due dates, unpaid balances of notes, interest rates, dates to which interest has been paid, and collateral for the notes.

The auditors may also substantive the existence and amount of a mortgage liability outstanding by direct confirmation with the mortgagee. The information received should be compared with the client’s records and the audit working papers.

**4. Vouch borrowing and repayment transactions to supporting documents**

The auditors must obtain evidence that transactions in interest-bearing debt accounts were valid. To accomplish this objective, the auditors trace the cash received form the issuance of notes, bonds, or mortgages to the validated copy of the bank deposit slip and to the bank statement. Any remittance advices supporting these cash receipts are also examined.

Debits to a Note payable or a mortgages payable account generally represent payments in full or in installments. The auditors should examine paid checks for these payments; in so doing, they also will account for payments of accrued interest. The propriety of installment payments should be verified by reference to the repayment schedule set forth in the note or mortgage copy in the client’s possession.

**5. Perform analytical Procedures to determine the overall reasonableness of interest-bearing debt and interest expense.**

One of the most effective ways to verify the overall reasonableness of interest-bearing debt is to determine that the relationship between recorded interest expense and the principal amount of the debt is in line with the interest rate at which the client company should be able to borrow.

A second step is to compare the year-end amount of interest-bearing debt with the amount in the prior year’s balance sheet. A similar comparison should be made of interest expense for the current year and the preceding year.

**6. Verify computation of interest expense, interest payable, and amortization of discount or premium**

Interest expense is of special significance to auditors because it indicates the amount of outstanding liabilities. In other words, close study of interest payments is a means of bringing to light any unrecorded interest bearing liabilities.

The auditors test the accuracy of the client’s interest expense and interest payable computations. In addition, the auditors should examine paid checks supporting interest payments and review the confirmations received from the payees to verify the dates when interest on each or mortgage has been paid.

The total bond interest expense for the period usually reflects not only the interest actually paid and accrued but also amortization of bond premium or discount. The auditors will verify the amounts amortized by independent computations.

7. **Determine whether debt provisions have been met**

In the first audit of a client or upon the issuance of a new bond issue the auditor will obtain a copy of the bond indenture for the permanent file.

The indenture provisions frequently require maintenance of a sinking fund, maintenance of stipulated minimum levels of working capital, and insurance of pledged property. The indenture also may restrict dividends to a specified proportion of earnings, limit management compensation and prohibit additional long term borrowing, except under stipulated conditions. Adequate comments should appear in the audit working papers as to the company’s compliance with the provisions of the indenture. If the company has not complied fully with the requirements, the auditors should inform both the client and the client’s legal counsel of the violation. An explanation of the extent of noncompliance should also be included in the client’s financial statement, and possibly in the audit report.

8. **Trace authority for issuance of interest- bearing debt to the corporate minutes**

The authority to issue interest-bearing debt generally lies with the board of directors. To determine that the bonds outstanding were properly authorized, the auditors should read the passages in the minutes of directors’ (and stockholders’) meetings concerning the issuance of debt.

**9. Review notes payable paid or renewed after the balance sheet date**

If any of the notes payable outstanding at the balance sheet date are paid before completion of the audit engagement, such cash payments will provide the auditors with additional evidence on the liability. Renewal of notes maturing shortly after the balance sheet date may alter the auditors’ thinking as to the proper classification of these liabilities.

The auditors should scan the notes payable records for the period between the balance sheet date and the completion of examination so that they may be aware of any unusual transactions, such as the reestablishment of an insider note that had been paid just prior to the balance sheet date.

10. **Search for notes payable to related parties**

As has been the case in other portions of the audit, the auditors must make certain that any related party debt is properly disclosed. Note here that the lower number of transactions makes discovery of such transactions less difficult than in accounts with a large number of transactions such as accounts payable.

11. **Evaluate proper financial statement presentation and disclosure of interest-bearing debt and related transactions.**

Classification of notes by types of payees, as well as by current or long term maturity, is desirable. Separate listing is needed for notes payable to banks, notes payable to trade creditors, and notes payable to officers, directors, stockholders, and affiliates.

**Equity Capital**

**Sources and nature of owners’ equity**

Most of this section is concerned with the audit of stockholders’ equity account of corporate clients.

Owners’ equity for corporate clients consists of capital stock accounts (preferred and common) and retained earnings. Balances in the capital stock accounts change when the corporation issues or repurchases stock. The account balances are not affected by transfer of ownership of shares from one shareholder to another. Retained earnings are normally increased by earnings and decreased by dividend payments. Additionally, a few journal entries (e.g., prior period adjustments) may directly affect retained earnings. Transactions in the owners’ equity accounts are generally few in number, but material in amount. Often no change will occur during the year in the capital stock accounts, and perhaps only one or two entries will be made to the retained earnings account.

**The auditors’ approach in examination of owners’ equity**

The auditors’ objectives in the examination of owners’ equity are to determine that:

1. Internal control over owners’ equity is adequate.
2. The recorded owners’ equity is valid (occurrence and obligations).
3. All owners’ equity transactions are recorded(completeness)
4. Owners’ equity schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).
5. The valuation of owners’ equity is proper.
6. The presentation and disclosure of owners’ equity is adequate.

In conjunction with the audit of owners’ equity accounts, the auditors will also obtain evidences about the related accounts of dividends payable and capital stock discounts and premiums. Evidence is also gathered regarding the proper cutoff cash receipts and disbursements relating to the equity accounts.

**Internal control for Owners’ equity**

There are three principal elements of strong internal control over capital stock and dividends. These three elements are: 1) the proper authorization of transactions by the board of directors and corporate officers; 2) the segregation of duties in handling these transactions (especially the use of independent agents for stock registration and transfer and for dividend payments); and 3) the maintenance of adequate record.

**Audit Procedures-Capital Stock**

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

1. **Obtain an understanding of internal control over capital stock transactions**

Even though the examination of capital stock consists primarily of substantive tests, the auditors must acquire an understanding of the clients’ procedures for authorizing, executing, and recording capital stock transactions. This may be achieved by preparing a written description or flow chart of the system, or by filling in an internal control questionnaire. If the questionnaire approach is employed, typical questions to be answered might include the following: Does the company utilize the services of an independent registrar and stock transfer agent? Are stockholder ledgers and transfer journals maintained? Are entries in owners’ equity accounts reviewed periodically by the controller?

**2. Review articles of incorporation, bylaws, and minutes for provisions relating to capital stock**

In a first audit, copies of the articles of incorporation, bylaws, and minutes of the meetings of directors and stockholders obtained for the permanent file should be read carefully. The information required by the auditors for each issue of capital stock includes the number of shares authorized and issued, the par or stated value if any, dividend rates, call and conversion provisions, stock splits and stock options. By gathering evidence on these points, the auditors will have some assurance that capital stock transactions and dividend payments have been in accordance with legal requirements and specific authorization by stockholders and directors. Also, they will be able to judge whether the balance sheet contains all necessary information to describe adequately the various stock issues and other elements of corporate capital.

**3. Obtain or prepare analyses of the capital stock accounts**

In an initial audit engagement, capital stock accounts should be analyzed from the beginning of the corporation to provide the auditors with a complete historical picture of corporate capital. Analysis of capital stock includes an appraisal of the nature of all changes and the Vouching of these changes to the supporting documents and records. All changes in capital stock should bear the authorization of the board of directions.

After the initial audit, if the analyses are kept in the auditors’ permanent file, all that will be necessary is to record the current period’s increases and decreases and to Vouch these transactions. The auditors then will have working papers showing all changes in capital stock from the inception of the corporation.

**4. Account for all proceeds from stock issues**

Closely related to the analyses of capital stock accounts is the audit procedure of accounting for the receipt and proper disposition of all funds derived from the issuance of capital stock. The proceeds should be traced to the cash records and bank statements.

When assets other than cash are received as consideration for the issuance of capital stock, the entire transaction requires careful study. Generally the value of asset and services received in exchange for capital share is established by action of the board of directors. The auditors must determine that these accounting estimates made by the client result in a proper valuation.

**5. Confirm shares outstanding with the independent registrar and stock transfer agent**

The number of shares issued and outstanding on the balance sheet date may be confirmed by direct communication with the independent registrar and stock transfer agent. The confirmation request should be written by the client’s letterhead, but it should be mailed by the auditors. Confirmation replies should be sent directly to the auditors, not to the client. All information contained in these replies should be traced to the corporate records.

6.  **For a corporation acting as its own stock registrar and transfer agent, reconcile the stockholder records with the general ledger.**

When a corporation acts as its own transfer agent and registrar, the auditors must adopt alternative procedures as nearly as possible equivalent to direct confirmation with outside parties. These procedures include (a) accounting for stock certificate numbers, (b) examining canceled certificates, and (c) reconciling the stockholder and stock certificate book with the general ledger.

**7. Determine compliance with stock option plans and with other restrictions and preferences pertaining to capital stock**

Many corporations grant stock options to officers and key employees as an incentive-type compensation plan. When stock options are granted, a portion of the authorized but an issued stock must be held in reserve by the corporation so that it will be in a position to fulfill the option agreements. Similarly, corporations with convertible preferred stocks outstanding must hold in reserve a sufficient number of common shares to meet the demands of preferred stockholders who may elect to convert their securities into common stock.

**Retained Earnings and Dividends**

Audit work on retained earnings and dividends includes two major steps: (1) the analysis of retained earnings and any appropriations of retained earnings, and (2) the review of dividend procedures for both cash and stock dividends.

The analysis of retained earnings and any appropriations of retained earnings should cover the entire history of these accounts. Credits to the retained earnings account ordinarily represent amounts of net income transferred from the income summary account. Debits to the retained earnings account may include entries for net losses, cash and stock dividends, and for the creation or enlargement of appropriated reserves. Appropriations of retained earnings require specific authorization by the board of directors. The only verification necessary for these entries is to ascertain that the dates and amounts correspond to the actions of the board.

In the verification of cash dividends, the auditors usually will perform the following steps:

1. determine the dates and amounts of dividends authorized
2. Verify the amounts paid
3. Determine the amount of any preferred dividends in arrears.
4. Review the treatment of unclaimed dividend checks.

When reviewing minutes of the directors’ meetings, the auditors should note the date and amount of each dividend declaration. This serves to establish the authority for dividend disbursements. The dividend payment may then be verified by multiplying the total number of shares as shown by the general ledger controlling accounts by the dividend per share.

In the verification of stock dividends, there is as additional responsibility of determining that the proper amounts have been transferred from retained earnings to capital stock and paid-in capital accounts for both large and small stock dividends.

**Disclosure of contingencies**

A loss contingency may be defined as a possible loss, stemming from past events that will be resolved as to existence and amount by some future event. Central to the concept of a contingent loss is the idea of uncertainty-uncertainty both as to the amount of loss and whether, in fact, any loss has been incurred. This uncertainty is resolved when some future event occurs or fails to occur.

The audit problem with respect to loss contingencies is two-fold. First, the auditors must determine the existence of the loss contingencies. Because of the uncertainty factor, most loss contingencies do not appear in the accounting records, and a systematic search is required if the auditors are to have reasonable assurance that no important loss contingencies have been overlooked. Second, the auditors must appraise the probability that a loss has been incurred. This is made difficult both by the uncertainty factor and also by the tendency of the client management to maintain at least an outward appearance of optimism.

**Audit procedures for loss contingencies**

Although audit procedures vary with the individual type of loss contingency, the following steps are taken in most audits as means of discovering these conditions:

1. Review the minutes of directors’ meetings to the date of completion of field work. Important contracts, lawsuits, and dealing with subsidiaries are typical of matters discussed in board meetings that may involve loss contingencies.
2. send a letter of inquiry to the client’s legal council requesting:
   1. a description ( or evaluation of management’s description) of the nature of pending and threatened litigation and of tax disputes.
   2. An evaluation of the likelihood of an unfavorable outcome in the matters described.
   3. An estimate of the probable loss or range of loss, or a statement that an estimate cannot be made.
   4. An evaluation of management’s description of any unasserted claims that, if asserted, have a reasonable possibility of an adverse outcome.
   5. A statement of the amount of any unbilled legal fees.
3. Send a standard bank confirmation request to each bank with which the client has done business during the year. This standard form includes a request for information on any indirect or contingent liabilities of he client.
4. Review correspondence with financial institutions for evidence of assignments of accounts receivable.
5. Obtain a representations letter from the client indicating that all liabilities known to officers are recorded or disclosed.

**2.7 Further Verification of revenue and expenses**

Throughout the previous sections on balance sheet accounts we have discussed related procedures for income statement accounts. In this section we provide further information on the audit of revenues and expenses.

**Nature of revenue and expenses**

Today with greater emphasis being placed upon corporate earnings as an indicator of the health and well-being of corporations as well as of the overall economy, the income statement is of fundamental importance to management, stockholders, creditors, employees, and government.

Throughout the previous sections, we have emphasized the relationships of revenues and expenses to the various balance sheet accounts. Put briefly, the principles used in making accounting decisions for balance sheet accounts often have a direct effect upon the measurement of income.

**The Auditors’ Approach in Examination of Revenues and Expenses**

The auditors’ objective in the examination of revenues and expenses are to determine that:

1. Internal control over revenues and expenses is adequate.
2. The recorded transactions for revenues and expenses are valid (existence and rights).
3. All revenue and expense transactions are recorded (completeness).
4. Revenue and expense schedules are mathematically correct and agree with general ledger accounts (clerical accuracy).
5. The valuation of revenue and expense accounts is proper.
6. The presentation and disclosure of revenue and expense accounts is adequate.

**Revenue**

The auditors’ review of sales activities was considered in connection with accounts receivable in the previous section. In this section we discuss (1) the relationship of revenue to balance sheet accounts and (2) the miscellaneous revenue account**.**

**Relationship of revenue to balance sheet accounts**

As pointed out previously, most revenue accounts are verified by the auditor in conjunction with the audit of a related asset or liability. The following list summarizes the revenue verified in this manner:

|  |  |
| --- | --- |
| **Balance sheet item**  Accounts receivable  Notes receivable  Securities and other investments  Property, plant, and equipment  Intangible assets | **Revenue**  Sales  Interest  Interest, dividends, gains on sales, share of investee’s income  Rent, gains on sale  Royalties |

**Miscellaneous Revenue**

One category of revenue not included in the above listing, but of interest to the auditors, is miscellaneous revenue. Miscellaneous revenue by its very nature, is a mixture of minor items, some nonrecurring and others likely to be received at irregular intervals. Consequently many companies do not accrue such revenue, but merely debit cash and credit miscellaneous revenue when cash is received. The weakness inherent in this procedure is not of particular significance if the amounts involved are minor and infrequent. However, the weaknesses can become serious if revenue of substantial amount is misclassified as miscellaneous revenue, a practice sometimes followed because of its convenience.

The auditors should obtain an analysis of the miscellaneous revenue account and determine whether items have been improperly included as miscellaneous revenue.

The auditors should propose adjusting journal entries to classify correctly any material items that have been improperly included in miscellaneous revenue by the client.

**Expenses**

The auditors’ work relating to purchases and cost of goods sold was covered, along with inventories, in the previous section. We are now concerned with audit procedures for other types of expenses.

**Relationship of expenses to balance sheet accounts**

Let us consider for the moment the number of expense accounts for which we have already outlined verification procedures in the previous sections.

|  |  |
| --- | --- |
| **Balance sheet item**  Accounts and notes receivable  Inventories  Property, plant, and equipment  Prepaid expenses and deferred charges  Intangible assets  Accrued liabilities  Interest-bearing dept | **Expenses(and costs)**  Uncollectible accounts and notes expense.  Purchase and cost of goods sold  Depreciation, repairs and maintenance, and depletion  Various related expenses, such as rent property taxes, advertising, postage, and others  Amortization  Commissions, fees ,bonuses, product warranty expenses, and others  Interest |

**Audit procedure for selling, general, and administrative expenses**

For other expenses not verified in the audit of balance sheet accounts, the following substantive tests are appropriate:

**1. Perform analytical procedures related to the accounts**

**a) Develop an expectation of the account balance**

Auditors develop an expectation of the account balance by considering factors such as budgeted levels, the prior year audited balances, industry averages, relationships among financial data, and relevant nonfinancial data.

**b) Determine the amount of difference from the expectation that can be accepted without investigation.**

The auditors use their estimates of materiality and tolerable error for the account to arrive at which differences are to be investigated and which might be expected to occur by chance.

**c) Compare the company’s account balance with the expected account balance**

The expense accounts may be compared to the auditor’s expected values developed in (a) above. For example, the current year’s selling expenses as a percentage of sales may be compared with the percentage for the preceding year, with industry averages, or with budget percentages. Significant differences may then be identified.

**d) Investigate significant deviations from the expected account balance**.

The starting point for investigating significant variations in expenses is inquiry of management. The auditors substantiate management’s explanations for significant variations by various means, including analyses of accounts. Analyses of expense accounts involves tracing entries in the accounts back to the voucher register or to the cash disbursement journal. From accounting records references may be made to invoices, receiving reports, purchase orders, or other supporting evidence.

**2. Obtain or prepare analyses of selected expense accounts**

As a result of the above procedures, the auditors will have chosen certain expense accounts for further verification. The client should be requested to furnish analyses of the accounts selected, together with related vouchers and other supporting documents, for the auditor’s review.

**3. Obtain or prepare analyses of critical expenses in income tax returns.**

Income tax returns generally require schedules for officers’ salaries, taxes, travel and entertainment, contributions, and causality losses. Accordingly, the auditor’s should obtain or prepare analyses of any of these expenses that were not analyzed when performing other audit steps. The auditors should bear in mind that details of these expenses will probably be closely scrutinized when the state or federal revenue agents examine the client’s tax returns.

**The audit of payroll**

The payroll in many companies is by far the largest operating cost, and therefore, deserves the close attention of the auditors. In the past, payroll frauds were common and often substantial. Today, however, such frauds may be more difficult to conceal for several reasons :( 1) extensive subdivision of duties relating to payroll; (2) use of computers, with proper controls, for preparation of payrolls; and (3) necessity of filing frequent reports to the government, listing employees’ earnings and tax withholdings.

In addition to the objectives for expenses (and revenues) presented earlier in this section the auditors have the following additional objectives relating to payroll.

1. To determine that the client has complied with government regulations such as income tax withholding.
2. To determine that the company is complying with terms of union agreements as to wage rates, vacation pay, and similar items.

**Internal control**

The establishment of strong internal control over payrolls is particularly important for several reasons. Although payrolls frauds are less frequent today, the possibility of large-scale payroll fraud still exists. Such frauds may involve listing fictitious persons on the payroll after their separation from the company. A second reason for emphasizing internal control over payrolls is that a great mass of detailed information concerning hours worked and rates of pay must be processed quickly and accurately if workers are to be paid promptly and without error. Good employee relations demand that pay checks be ready on time and be free from error. Internal control is a means of securing accuracy and dependability in accounting data as well as a means of preventing fraud.

**Audit procedures for payrolls**

1. Obtain an understanding of internal control for payroll
2. Perform tests of controls over payroll transactions for selected pay periods, including the following specific procedures:
   1. Trace names and wage or salary rates to records maintained by the personnel department.
   2. Trace time shown on payroll to timecards and time reports approved by supervisors.
   3. If payroll is based on piecework rates rather than hourly rates, reconcile earnings with production records.
   4. Determine basis of deductions from payroll and compare with records of deduction authorized by employees.
   5. Test extensions and footings of payroll.
   6. Compare total of payroll with total of payroll checks issued.
   7. Compare total of payroll with total of labor cost summary prepared by cost accounting department.
   8. If wages are paid in cash, compare receipts obtained from employees with payroll.
   9. If wages are paid by check, compare paid checks with payroll.
   10. Review subsequent payments of unclaimed wages, comparing receipts with payroll records, wage rates and time reports.
3. Observe the use of time clocks by employees reporting for work, and investigate timecards not used.
4. Plan a surprise observation of one of the paycheck distributions.
5. Determine that payrolls for the year do not exceed the number of weekly or monthly pay periods and that all payrolls have been properly approved.
6. Obtain or prepare a summary of compensation of officers for the year and trace to contracts, minutes of directors’ meetings, or other authorization.
7. Investigate any extraordinary fluctuations in salaries, wages, and commissions.
8. Test commissions of compensation earned under profit sharing plans.
9. Test commission earnings by examination of contracts and detailed supporting records.
10. Test pension payments by reference to authorized pension plans and to supporting records.