

Auditing A Practical Approach

Third Canadian Edition

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Chapter 10

AUDITING PURCHASES, PAYABLES, AND PAYROLL

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LEARNING OBJECTIVES (1 of 2)

1. Identify the audit objectives applicable to purchases, payables and payroll
2. Describe the functions and control procedures normally found in information systems for processing purchase, payment and purchase adjustment transactions
3. Describe the functions and control procedures normally found in information systems for payroll transactions

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LEARNING OBJECTIVES (2 of 2)

4. Discuss considerations relevant to determining the audit strategy for purchases, payables, and payroll
5. Indicate the factors relevant to determining an acceptable level of detection risk for the audit of purchases, payables, and payroll
6. Design a substantive audit program for purchases, payables, and payroll

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Key Issues

- Purchases are all recorded and not understated
- Payables that are derived from the purchases are fully recorded as a liability
- Payroll expenses and the associated deductions and related liabilities are properly recorded as liabilities

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Audit Objectives

- The audit objectives for purchases, payables, and payroll relate to obtaining sufficient appropriate evidence about each significant financial statement assertion for the applicable transactions and balances
- The next three slides show the main objectives for these transaction classes and account balances*

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Assertions (1 of 4)

Transaction and Related Disclosure Objectives	
Occurrence (OE)	Recorded purchase transactions represent goods and services received during the period under audit (OE1). Recorded payment transactions represent payments made during the period to suppliers and creditors (OE2). Recorded payroll expenses relate to employee services received in the period (OE3). Disclosed purchase and payroll events have occurred and pertain to the entity (OE4).
Completeness (C)	All purchase transactions that occurred during the period and that should have been recorded have been recorded (C1). All payments that occurred during the period and that should have been recorded have been recorded (C2). Recorded payroll expenses include all such expenses incurred during the year (C3).
Accuracy (AV)	Purchase, payment, and payroll transactions are properly (accurately) recorded (AV1). Purchase cycle and payroll information is disclosed accurately and at appropriate amounts (AV2).
Cut-off (CO)	Particularly relevant to transactions around the year end, all purchases, cash payments, purchase adjustments, and payroll transactions arising before the period end are recorded in the current period and those arising after the period end are included in the next accounting period (CO1).
Classification (D)	All purchases (D1), payments (D2), and payroll transactions (D3) are recorded in the correct accounts.
Presentation (D)	Purchase cycle and payroll transactions and events are appropriately aggregated or disaggregated, and related disclosures are clearly expressed, relevant and understandable (D4).

Selected specific audit objectives for purchases, payables, and payroll

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Assertions (2 of 4)

Account Balance and Related Disclosure Objectives	
Existence (OE)	Recorded accounts payable represent amounts owed by the entity at the end of the reporting period (OE5). Accrued payroll liability balances represent amounts owed at the end of the reporting period (OE6).
Rights and obligations (RO)	Accounts payable (RO1) and accrued payroll liabilities (RO2) are liabilities of the entity at the end of the reporting period.
Completeness (C)	Accounts payable include all amounts owed by the entity to suppliers of goods and services at the end of the reporting period (C4). Accrued payroll liabilities include all amounts owed in respect of payroll and deductions at the end of the reporting period (C5). Accounts payable, accrued payroll liabilities, and related expenses are properly identified and included in the financial statements (C6). Disclosures pertaining to commitments, contingent liabilities, and related party creditors are adequate (C7).

(continued)

Selected specific audit objectives for purchases, payables, and payroll

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Assertions (3 of 4)

Account Balance and Related Disclosure Objectives	
Accuracy, valuation and allocation (AV)	Accounts payable represent gross amounts due to suppliers and agree with the sum of the accounts payable in the accounts payable subsidiary ledger (AV3). Accrued payroll liabilities are stated at the appropriate amounts (AV4). Related expense balances conform to applicable accounting standards (AV5).
Classification (D)	Payables, accrued payroll liabilities, and related expenses are recorded in the correct accounts (D5).
Presentation (D)	Payables, accrued payroll liabilities, and related expenses are appropriately aggregated and disaggregated, disclosures are clearly expressed, relevant and understandable (D6).

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Purchase Transactions (1 of 2)

- Purchase transactions relate to the purchase (from outside entities) of goods (including inventory and plant and equipment) and services (such as electricity and advertising)
- Payment transactions relate to the payment for such goods and services

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Purchase Transactions (2 of 2)

- The processing of purchase transactions involves the following functions:
 - requisitioning goods and services
 - preparing purchase orders
 - receiving the goods
 - storing goods received for inventory
 - checking and approving the supplier's invoice
 - recording the liability

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Requisitioning Goods & Services

- **Purchase requisition** – a document issued by an authorized person, detailing the goods and/or services required
- Requisitions are often pre-numbered, and indicate the general ledger code(s) for the purchase
- Once complete, the purchase requisition is then sent to the purchasing department

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Requisitioning and Ordering

- The requisition and ordering functions should be separate, to reduce the opportunity for fraudulent orders and to improve efficiency through a centralized purchasing department

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Purchase Orders

- Purchase orders typically contain:
 - Description of goods/services ordered
 - Quantities
 - Price
 - Delivery Instructions
 - Supplier information
- Copies are distributed to: the supplier, receiving, accounting, and the requisitioner

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Receiving the Goods (1 of 2)

- Receiving should record the goods received, the quantity received, and inspect the goods for damage
- Segregation of receiving from both the requisition and purchasing functions aids in preventing direct ordering from suppliers plus reduces the chance of unauthorized access to goods improperly ordered

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Receiving the Goods (2 of 2)

- A pre-numbered receiving report should be prepared for each delivery with a copy to accounts payable
- Independent checks should take place periodically on the sequence of receiving reports

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Recording the Liability

- Suppliers normally send the invoice directly to the accounting department
- Prior to recording the supplier's invoice, the invoice should be checked for accuracy and approved

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Checking and Approving Invoices (1 of 2)

- Common procedures include:
 - Numbering supplier invoices to check that all invoices are recorded
 - Three-way matching of supplier invoices – invoices should be matched to the details of the receiving reports and purchase; this ensures only approved orders in the quantity received are paid for
 - Check mathematical accuracy of invoice
 - Code the accounting distributions on the supplier invoice

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Checking and Approving Invoices (2 of 2)

- Common procedures include:
 - Approve invoices for payment by having the authorized person sign the invoice
 - Prepare a daily prelist of the suppliers' invoices approved for payment

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Recording the Liability (1 of 2)

- Approved suppliers' invoices are entered into the system
- Often computerized checks are made for supplier validity and reasonableness of amounts
- Once accepted the AP master file is updated and the invoice is added to the purchase journal

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Recording the Liability (2 of 2)

- The purchase journal then updates the applicable inventory and general ledger accounts
- Monthly supplier statements should be reconciled with the recorded supplier balances
- Periodic performance reviews by management should be made - comparing assets, liabilities, and expenses balances with budgeted amounts

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Payment Transactions (1 of 7)

- The two payments functions are:
 - paying the liability
 - recording the payments
- The same department or individual should not perform both these functions

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Payment Transactions (2 of 7)

- The AP department is responsible for payment of suppliers' invoices by their due date
- The computer system can be used to extract the payments due from the master file, produce cheques and a cheque register, and update the AP master file
- Cheques are reviewed by the AP department and matched with supporting documents prior to signing and then sending them out

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Payment Transactions (3 of 7)

- Common control related procedures include:
 - Authorized persons signing cheques should be segregated from those initiating or processing purchase transactions
 - Authorized signers should determine that each cheque/funds transfer is accompanied by proper documentation and that the payee and amount agree with the invoice

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Payment Transactions (4 of 7)

- Common control related procedures include (continued):
 - Suppliers' invoices and supporting documents should be cancelled to prevent payment resubmission
 - Cheque signers should control the mailing of the cheque or bank transfer initiation

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Payment Transactions (5 of 7)

- Common control related procedures include (continued):
 - No blank cheques or cheques payable to “cash” or “bearer” should be issued
 - Pre-numbered cheques should be used
 - Access to blank cheques and electronic signatures should be limited to authorized personnel

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Payment Transactions (6 of 7)

- When the cheque register in the computer system is updated, the program automatically produces the cash payments journal and a general ledger summary plus an update to the master files

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Payment Transactions (7 of 7)

- Payment recording procedures include:
 - Independent check by a supervisor of the agreement of the amount journalized/posted to the AP ledger with the cheque register received from the treasurer
 - Independently prepared bank reconciliations

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Payroll Transactions (1 of 11)

- The relevant functions for payroll are those of:
 - hiring employees
 - authorising payroll changes
 - preparing attendance and timekeeping data
 - preparing the payroll
 - recording the payroll
 - paying the payroll and protecting unclaimed wages

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Payroll Transactions (2 of 11)

- All approved positions are documented on a [personnel authorization form](#) including the position classification and starting wage level
- A copy of this form is forwarded to payroll
- Data on all employees is entered into the [personnel master file](#) which is restricted by password to authorized individuals in the personnel department

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Payroll Transactions (3 of 11)

- A log is kept of all changes to this file
- This log should be reviewed periodically by a personnel manager not involved in the data entry process

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Payroll Transactions (4 of 11)

- Segregation of the personnel and payroll functions aids in reducing the risk of payments to fictitious employees
- Any change to job classifications or a wage increase must be authorized and submitted to the personnel department in writing before the change can be entered into the master file

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Payroll Transactions (5 of 11)

- A termination notice is issued by the personnel department upon completion of an individual's employment
- A copy of this notice is promptly sent to the payroll department

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Payroll Transactions (6 of 11)

- Time-recording details such as hours are manually or electronically entered into the payroll file from approved sources
- These payroll transactions are often subject to supervisory review and approval

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Payroll Transactions (7 of 11)

- The payroll calculations are performed and recorded in detail in the payroll transaction files
- Using the calculated items (such as gross pay, deductions, and net pay) the employee payroll records and accumulated totals for the payroll journal entry are generated and entered in the general ledger master file

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Payroll Transactions (8 of 11)

- A payroll register is then produced containing details of wages paid, taxes withheld, and a cumulative record of wages paid

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Payroll Transactions (9 of 11)

- At regular intervals a review is conducted by appropriate personnel of:
 - Exception reports
 - Payroll register copy returned to the payroll department
 - Payroll register, payroll cheques/electronic transfers sent to the finance office
 - General ledger summary sent to accounting

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Payroll Transactions (10 of 11)

- Common control procedures include:
 - Finance officer reviews the agreement of names and amounts on cheques/bank transfers with payroll register entries
 - Payroll cheques/bank transfers should be signed/authorized by finance office personnel not involved with the preparation or recording of payroll

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Payroll Transactions (11 of 11)

- Common control procedures include (continued):
 - Payroll cheques if used should be distributed by finance office personnel who should require proper identification of employees
 - Unclaimed cheques should be safely stored
 - Use of an impressed payroll bank account

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Audit Strategy

- Need to obtain an understanding of the entity and its environment in order to assess inherent and control risk
- The auditor then determines the audit strategy and plans an appropriate mix of tests of controls and substantive procedures
- Tests of controls confirm (or otherwise) the auditor's preliminary assessment of control risk by testing operating effectiveness

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Entity and Environment

- Developing an understanding of the entity and its environment will assist the auditor in developing:
 - An understanding of cost of sales and gross margins
 - An understanding of levels of various types of expenses
 - Developing an expectation of payables levels

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Analytical Review

- Used during the risk assessment phase to help identify high risk areas
- Enables the auditor to compare expectations to actual financial statement elements
- Examples include investigation and comparison of:
 - Gross margins and net margins
 - Expected staffing costs
 - Payable days

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Inherent Risk (1 of 2)

- Purchase and payroll expenses account are major expenses incurred by a business
- Auditors need to consider:
 - Pressure to understate expenses in order to meet targets or industry norms
 - Pressure to understate payments in order to report a higher level of working capital due to liquidity problems or going concern doubts

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Inherent Risk (2 of 2)

- Auditors need to consider (continued):
 - High volume of transactions
 - Temptation for employees to make unauthorized purchases and payments or to misappropriate purchase assets for personal use
 - Contentious accounting issues (i.e., capitalization vs. expense of repairs)
 - Complexity of payroll calculations for those based upon time and/or productivity

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Internal Controls

- Factors relating to the control environment that auditors need to consider when evaluating control risk in this area include:
 - Integrity and ethical values
 - Pressure from suppliers such as offers of kickbacks
 - Management's commitment to competence of personnel
 - Assignment of authority and responsibility

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Control Risk (1 of 2)

- After obtaining an understanding of the internal control structure, the auditor forms a preliminary assessment of control risk
- If control risk is deemed low, tests of the operating effectiveness of controls are then done to confirm this preliminary assessment made.

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Control Risk (2 of 2)

- Computer testing may be used in performing tests of controls
- A few examples include: searching supplier invoices for invalid classifications, missing numbers or unreasonable amounts, and sample selection
- Samples of a few control risk programs are included on the next few slides for purchases and payroll

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CR Assessment - Purchase Transactions (1 of 2)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 10.1)					
				OEI	CI	AVI	CO	DI	
Requisitioning goods and services	Goods may be requisitioned for unauthorized purposes.	General and specific authorization procedures	Inquire about procedures. Review documents for evidence of approvals.	✓					
Preparing purchase orders	Purchases may be made for unauthorized purposes.	Approved purchase requisition for each order	Examine purchase orders for approved requisitions.	✓					
Receiving goods	Goods received may not have been ordered. Incorrect quantities, damaged goods, or incorrect items may be received.	Approved purchase order for each shipment Receiving clerks to count, inspect, and compare goods received with purchase order	Examine receiving report for matching purchase order. Observe the performance by receiving clerks.	✓					
Storing goods received for inventory	Inventory clerks may deny taking custody of purchased goods.	Signed receipt to be obtained on delivery of goods from receiving to inventory	Inspect signed receipts.	✓					

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CR Assessment - Purchase Transactions (2 of 2)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 10.1)					
				OEI	CI	AVI	CO	DI	
Approving the invoice	Invoices may be recorded for goods not ordered or received.	Matching of purchase order and receiving report with the supplier's invoice	Examine supporting documentation for invoices.*	✓	✓	✓			
Recording the liability	Invoices may be recorded incorrectly or not recorded.	Independent check of agreement of prelist with amounts recorded in purchase journal Periodic accounting for pre-numbered receiving reports and purchase orders	Examine evidence of independent check; re-perform independent check.* Observe procedure; re-perform.	✓	✓	✓			✓
		Periodic performance reviews by management of reports, comparing actual asset, payable, and expense balances with budgeted amounts	Inquire of management about results of performance reviews; inspect reports.*	✓	✓	✓	✓	✓	✓

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CR Assessment – Credit Purchase Transactions (1 of 3)

Prepared by: _____ Date: _____
 Reviewed by: _____ Date: _____

Cload 9 Ltd.
 Planned tests of controls — Credit purchases transactions
 Year ending December 31, 2020

Assertion/Test of Controls	W/P Ref.	Auditor	Date
Occurrence 1. Observe procedures, including segregation of duties, for: <ul style="list-style-type: none"> • completing purchase orders from requisitions • receipt of goods • receipt of invoices • reconciliation of supplier statements 2. Select a sample of purchase transactions from the purchase journal and verify transaction dates, supplier names, and amounts by vouching entries to the following matching supporting documents: <ul style="list-style-type: none"> • purchase invoices • receiving reports • approved purchase orders • approved purchase requisition 			

Partial audit program for tests of controls—credit purchases

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CR Assessment – Credit Purchase Transactions (2 of 3)

Completeness
 3. Examine evidence of the use of and accounting for pre-numbered purchase requisitions, purchase orders, receiving reports, and sales invoices. Scan the sequence of sales invoice numbers in the sales journal.

4. Select a sample of approved purchase requisitions and trace to matching:

- approved purchase orders
- receiving reports
- purchase invoices
- entries in the purchase journal

Accuracy
 5. For the sample in step 2 above, examine evidence of:

- an independent check on proper pricing of invoices
- an independent check on the trade discounts received
- an independent check on the mathematical accuracy of invoices

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CR Assessment – Credit Purchase Transactions (3 of 3)

6. For purchase invoices processed in batches, examine evidence of an independent check on the agreement of totals for purchase journal entries and amounts posted to supplier accounts with batch totals.

Cut-off
 7. Obtain the number of the last receiving report for the last goods received for the year; select a sample of receiving reports before this number, and agree:

- to purchase invoices dated in the current period
- to entries in purchase journal before the period end

 8. Following on from step 7, select a sample of the receiving reports for the first goods received in the new fiscal period and agree:

- to purchase invoices dated in the next accounting period
- the purchase is not recorded in the purchase journal until the following accounting period

Partial audit program for tests of controls—credit purchases

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CR Assessment – Payment Transactions

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 30.3)				
				OE2	C2	AV1	CO	BE2
Paying the liability	Cheques may be issued for unauthorized purchases. An invoice may be paid twice. A cheque may be altered after being signed.	Cheque signers to review supporting documentation for completeness and approval. "Paid" stamp to be placed on the invoice and supporting documents when a cheque is issued. Cheque signers to mail cheques.	Observe cheque signers performing independent check of supporting documentation. Examine paid invoices for "paid" stamp. Inquire about mailing procedures; observe mailing.	✓				
Recording the payment	A cheque may not be recorded. Errors may be made in recording cheques. Cheques may not be recorded promptly.	Use of, and accounting for, pre-numbered cheques. Independent check of agreement of amounts journalized and posted to the cheque register. Periodic independent bank reconciliations. Independent check of dates on cheques with dates recorded.	Examine evidence of use of and accounting for pre-numbered cheques. Observe procedure; re-perform.* Examine bank reconciliations.* Re-perform independent check.		✓	✓	✓	✓

*Functions performed as a part of dual-purpose tests.

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CR Assessment – Payroll Transactions (1 of 2)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 10.1)				
				OE3	C3	AV1	CO	D3
Hiring employees	Fictitious employees may be added to the payroll.	Personnel department authorization for all hirings of new employees	Examine authorization forms for hirings of new employees.	✓				
Authorizing payroll changes	Employees may receive unauthorized rate increases.	Personnel department authorization for all rate changes	Inquire about procedures for authorizing rate changes.			✓		
	Terminated employees may remain on the payroll.	Personnel department notification to payroll department of all terminations	Examine termination notices in payroll department.	✓				
Preparing attendance and timekeeping data	Employees may be paid for hours not worked.	Use of time clock or electronic recording procedures and supervisory approval of time recorded	Observe time-recording procedures; examine supervisory approval procedures.	✓	✓	✓		✓

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CR Assessment – Payroll Transactions (2 of 2)

Preparing the payroll	Payroll data may be lost during submission to computer department.	Batch totals of hours worked prepared by payroll department and verified by data control	Examine evidence of the preparation and use of batch totals.	✓				
	Payroll transactions file may include incorrectly keyed or invalid data.	Edit checks of data on payroll transactions file	Observe data entry procedures; examine the exceptions and control report.*	✓	✓	✓		✓
Recording the payroll	Processing errors may occur in recording the payroll.	Exceptions and control report to be reviewed by data control	Inquire about the preparation and use of the exceptions and control report.*	✓	✓	✓	✓	✓
	Unauthorized changes may be made to payroll data in computer department.	Payroll department comparison of payroll register with original batch transmittal data	Re-perform comparison.*	✓	✓	✓		✓
Paying the payroll and protecting unclaimed wages	Payroll cheques may be distributed to unauthorized recipients.	Employee identification on distribution	Witness distribution of payroll.	✓	✓	✓		✓

*Sometimes performed as a part of dual-purpose tests.

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Determining An Acceptable Level of Detection Risk

- After assessing the IR and CR, detection risk is set to achieve the required audit risk
- Detection risk is then used to determine the nature, timing, and extent of substantive procedures
- If detection risk is set at low, then extensive substantive testing will take place
- If detection risk is set at high, then a combined approach will be used

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Substantive Procedures (1 of 2)

- Accounts payable is usually the largest current liability in a balance sheet and a significant factor in the evaluation of an entity's short-term solvency
- Is generally affected by a high volume of transactions and thus is susceptible to misstatements
- *The auditor is primarily concerned with understatement of payables*

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Substantive Procedures (2 of 2)

- Considerations
 - Management may understate payables in order to report a more favourable financial position
 - Thus, the audit of payables places more emphasis on gathering evidence about the completeness assertion than the existence assertion

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Initial Procedures (1 of 2)

The auditor performs initial procedures on payables balances and records by:

- Tracing the opening balance for payables to the previous year's working papers
- Reviewing activity in the general ledger account for payables, and investigating entries that appear unusual in amount or source

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Initial Procedures (2 of 2)

- The auditor obtains a listing of accounts payable at balance date:
 - adds the listing and determines agreement with the total of the subsidiary ledger and the general ledger control account balance
 - tests the agreement of suppliers and balances on the listing with those included in the underlying accounting records

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Analytical Procedures (1 of 2)

- Compare current and previous year balances
- Calculate significant ratios; potential examples include:
 - gross profit
 - accounts payable turnover
 - each expense compared to sales
 - average wage per employee
- Obtain explanations for unexpected changes

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Analytical Procedures (2 of 2)

- Corroborate explanations
- *Analytical procedures are significant in achieving the desired level of detection risk for payroll balances*
 - *e.g., average wage per employee and payroll expenses as a percentage of sales*

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Tests of Details of Transactions (1 of 2)

Procedures followed by the auditor include:

- Vouching a sample of purchase transactions to supporting documentation
- Vouching credits to supporting suppliers' invoices, receiving reports and purchase orders, or other supporting documents
- Vouching debits to payments

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Tests of Details of Transactions (2 of 2)

Performing purchases and payments cut-off tests

- Checking subsequent payments between the balance date and the end of fieldwork
- Investigating unmatched purchase orders, receiving reports and suppliers' invoices at the year end

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Tests of Details of Balances (1 of 2)

- The three tests included in this category for payables are:
 - reconciling payables to monthly statements received by the entity from suppliers
 - confirming accounts payable
 - searching for unrecorded liabilities

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Tests of Details of Balances (2 of 2)

- The two tests for payroll balances are:
 - recalculating payroll liabilities
 - verifying directors' and executive officers' remuneration
 - *executive remuneration will be reviewed by reference to employment contracts and board minutes*

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