MODULE 5

AUDIT EXECUTION: FINANCIAL STATEMENT ITEMS SUBSTANTIVE PROCEDURES

OUTLINE

- Application of specific substantive procedures to test the following categories of assertions:

  -Assertions relating to classes of transactions and events

  -Assertions relating to account balances

  -Assertions relating to presentation and disclosures
- Audit of statement of financial position, validation procedures, applied in audit of

  -tangible fixed assets

  -inventory

  -Accounts receivable

  -Prepayments & Sundry debtors

  -Investments & market securities.

  -Bank & cash balances

  -Accounts payable etc.
- Audit of statements of Profit or loss and other comprehensive income accounts, validation procedures applied in audit of; Revenue & Expenses, Sales/ purchases, Wages & Salaries and other statements of profit or loss

Application of specific substantive procedures to test the assertions:

As a basis for the preparation of financial statements, the directors make certain assertions. The assertions constitute representations of the directors that are embodied in the financial statements. -Assertions relating to classes of transactions and events, Assertions relating to account balances,

-Assertions relating to presentation and disclosures

- The directors, by approving the financial statements, are making representations about the information therein.

(a) Existence: An asset or a liability exists at a given date.

(b) Rights and Obligations: An asset or a liability pertains to the entity at a given date.

(c) Occurrence: A transaction or event took place which pertains to the entity during the particular period.

(d) Completeness: There are no unrecorded assets, liabilities, transactions or events, or undisclosed items.

(e) Valuation: An asset or liability is recorded at an appropriate carrying value.

(f) Measurement: A transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period.

(g) Presentation and Disclosure: An item is disclosed, classified and described in accordance with the applicable reporting framework (for example, relevant legislation and applicable accounting standards).

Validation procedures, applied in audit of -tangible fixed assets –inventory -Accounts receivable -Prepayments & Sundry debtors -Investments & market securities. -Bank & cash balances-Accounts payable etc.

Validation of Fixed Assets:

Auditors normally obtain audit evidence by:

(a) Inspection;

(b) Observation;

(c) Enquiry and confirmation;

(d) Computation; and

(e) Analytical procedures.

Verification Methods

Obtain a schedule of each asset showing:

(a) Opening Balance

Review previous year's working papers and the client's records to provide necessary understanding of the accounting principles, policies and methods employed.

(b) Additions

(i) Examine purchase order and other supporting documents;

(ii) Vouch the cost vide invoices, cost includes all expenditures necessary to make an asset ready for its intended use; and

(iii) Vouch the authority for acquisition by review of minutes of board of directors or other committees to confirm whether major additions were appropriately authorised.

(c) Disposals

(i) Vouch the authority;

(ii) Examine relevant documentation;

(iii) Compare acquisition cost with underlying records, re-compute accumulated depreciation and the resulting gain/loss and balancing charge/allowance;

(iv) Verify proceeds as reasonable;

(v) Pay attention to scrap value; and

(vi) Confirm proper accounting treatment.

- **(d) Depreciation and Other Write Downs**
  (i) Review client's methods and policies;
  (ii) Examine adequacy and appropriateness of policy;
  (iii) Vouch authorization policy;
  (iv) Vouch revaluations ;
  (v) Check calculations; and
  (vi) Consider changes in business condition that may warrant reviews of estimated useful life of the assets.

  (e) The stated procedure must agree the physical assets to the closing Naira value of the assets.

  (f) Internal control procedures as regards additions, disposals, accounting and maintenance of fixed assets are relevant. The auditor should also make use of fixed assets registers.

Validation of Inventory

The audit objectives applicable to inventories are:

- **(a) Completeness**

This is to ensure that:

(i) Inventories represent all raw materials, work-in-progress, and finished goods that the entity owns, including those on hand, in transit or on the premises of others.

(ii) All shipments of goods during the period covered by the financial statements.

(b) Accuracy

This is to ensure that:

(i) The detailed perpetual inventory records are correct and agree with the general ledger inventory control account.

(ii) Costs associated with inventories have been properly classified and accumulated.

(iii) Cost of sales is based on correct costs and quantities, is properly summarised and posted to the costs of sales and inventory control accounts, and, where appropriate, is credited in the perpetual inventory records.

- **(c) Existence/Occurrence**
  This is to ensure that:
  (i) Recorded inventories physically exist in saleable condition and represent property held for sale in the ordinary course of business.
  (ii) Recorded cost of sales relate specifically to goods actually shipped during the period covered by the financial statements.

  (d) Cut-off
  This is a procedure to ensure that production costs incurred are charged to work-in-progress and on completion are transferred to finished goods such that cost of goods sold are recorded in the period when the sales are made.

  (e) Valuation
  This is to ensure that:
  (i) Costs associated with inventories and costs of sales are determined and accumulated using generally accepted accounting principles consistently applied.
  (ii) Inventories are stated at cost or net realisable value, whichever is lower.

  (f) Rights and obligation
  This is to confirm that:
  The entity has legal title or ownership rights to the inventory; inventory excludes goods that are the property of others or have been billed to customers.
  (g) Presentation and Disclosure
  This is to ensure that:
  (i) Inventories and cost of sales are properly described and classified in the financial statements.
  (ii) All encumbrances against inventory are adequately disclosed.

Validation procedure of Cash Balances

The objectives of auditing cash are to obtain reasonable assurance that:

(a) Recorded cash on hand and in financial institutions, exists, and is accurate and complete, and the client has legal title to it at the balance sheet date;

(b) All items properly included as part of cash are realisable in the amounts stated; for example, foreign currency on hand or on deposit in foreign countries is properly valued;

(c) Cash restricted as to availability or use is properly identified and disclosed; and

(d) Cash receipts, disbursements, and transfers between bank accounts are recorded in the proper period.

Substantive tests are as follows:

(a) Testing completeness, accuracy, and existence of year-end balances so as to:

(i) Confirm balances and other information with banks and other financial institutions;

(ii) Prepare, review bank reconciliations; and

(iii) Cash count.

(b) Testing bank transfer cut-off.

(c) Review restrictions on cash balances and related disclosures.

Validation of Bank Balances

The auditor should ordinarily confirm balances at year-end by direct correspondence with all banks the client has conducted business with during the year, regardless of whether all year-end reconciliations are reviewed or tested. Usual practice is to confirm all bank accounts open at any time during the year under audit. The auditor should ask the client to request the financial institution to communicate directly with the auditor.

- Indebtedness and Other Arrangements
- A bank may have arrangements with or provide services to the client other than maintaining deposits or granting loans.
- Auditor should confirm:

(a) Amount(s) on deposit kept as a condition for a loan;

(b) Items held as agent or trustee, securities or other items in safekeeping or for collection for the account of the client; and

(c) Other arrangements - such as oral and written guarantees, commitments to buy foreign currencies, repurchase or reverse repurchased agreements, and letters of credit and lines of credit.

- **Bank Reconciliation Procedures**

  Periodic reconciliation of cash receipts and disbursements to the amounts shown on bank statements is key control procedure to meet the asset protection objective for cash. The reconciliation procedure will be more effective if in addition to reconciling the balances, the detailed items listed on the bank statements are reconciled to the detailed items recorded in the accounts during the period covered by the bank statement. Reconciling detailed items listed on the bank statements ensures that all items recorded in the accounts, including offsetting items within receipts or disbursements, are also recorded on the bank statement and vice versa.

- The client's reconciliation of bank accounts and the appropriate division of duties with respect to cash balances and transactions are important control procedures. The auditor's assessment of how effective the client's reconciliations are determined by the nature, timing, and extent of many of the substantive tests of cash. Other factors are:

  (a) Adequacy of the accounting system;

  (b) Competence of employees doing the reconciliations; and

  (c) Segregation of duties.

- **VERIFICATION OF PAYABLES**
  The auditor's validation process in examining payable transactions and accounts are to obtain reasonable assurance that:

  (a) All obligations for amounts payable, long-term debt, and capitalised leases and all equity accounts have been properly valued, classified, described, and disclosed;

  (b) All off-balance-sheet obligations have been identified and considered (e.g., operating leases, product financing arrangements, build and operate contracts, etc);

  (c) All liability and equity transactions, accounts, and changes therein have been properly authorised and are obligations of the entity or ownership rights in the entity;

  (d) Interest, discounts, premiums, dividends, and other debt-related and equity-related transactions and accounts have been properly valued, classified, described, and disclosed; and

  (e) All terms, requirements, instructions, commitments, and other debt related and equity-related matters have been identified, complied with and disclosed, as appropriate.

- **DEBENTURE LOANS AND BORROWINGS**
  The following are the verification procedures for debentures:
  (a) Request for a schedule of the amounts due at the beginning of the year, additions during the year, redemptions during the year, and the total sub due at the end of the year;

  (b) Make a record for the audit file the terms and conditions of the debenture loans as evidenced in the debenture deed;

  (c) Agree opening balances with previous years working papers;

  (d) Vouch new debenture loans with prospectus, board minutes, memorandum and articles of association, and register of debenture holders;

  (e) Vouch payments with debenture deeds, ensure that terms are correctly interpreted, check entries into cash book, and trace repayments to register of debenture holders;
  (f) Interest payments should be checked to debenture deeds, cash book and ensure that the amount paid is agreed to the percentage of the amount outstanding;
  (g) Agree total amount outstanding with register of debenture holders; and
  (h) Ensure that disclosure is in accordance with the Companies and Alied Matters Act.

Audit of statements of Profit or loss and other comprehensive income accounts, validation procedures applied in audit of; Revenue & Expenses, Sales/ purchases, Wages & Salaries and other statements of profit or loss

VALIDATION OF REVENUE AND EXPENDITURE

- Revenue is the gross inflow of economic benefits or service potentials during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners. Revenue includes only the gross inflows of economic benefits or service potential received and receivable by the entity on its own account.
- Substantive procedures for the verification of revenue lay more emphasis on recognition, measurement, classification, timing, and disclosures. Specific classes of revenue may be verified using substantive procedures more suitable for it.
- Rendering of Services
- When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be
- recognised by reference to the stage of completion of the transaction at the
- reporting date. Substantive procedures may include the following:

- (a) Verify that the amount of revenue is measured reliably;
- (b) Verify that it is probable that the economic benefits or service potential
- associated with the transaction will flow to the entity;
- (c) Verify that the stage of completion of the transaction at the reporting
- date is measured reliably; and
- (d) Verify that the costs incurred for the transaction and the costs to complete
- the transaction is measured reliably.

- Sale of Goods
- Substantive procedures may include the following:
- (a) Verify that the entity has transferred to the purchaser the significant
- risks and rewards of ownership of the goods;
- (b) Verify that the entity retains neither continuing managerial involvement
- to the degree usually associated with ownership nor effective control
- over the goods sold;
- (c) Verify that the amount of revenue has been measured reliably;
- (d) Verify that it is probable that the economic benefits or service potential
- associated with the transaction will flow to the entity; and
- (e) Verify that the costs incurred or to be incurred in respect of the transaction
- can be measured reliably.

- **Interest, Royalties and Dividends**

  The following substantive procedures may be used:

  (a) Verify that it is probable that the economic benefits or service potential associated with the transaction does flow to the entity;

  (b) Verify that the amount of the revenue has been measured reliably;

  (c) Verify that interest has been recognized on a time proportion basis that takes into account the effective yield on the asset;

  (d) Verify that royalties are recognized as they are earned in accordance with the substance of the relevant agreement; and

  (e) Verify that dividends or their equivalents are recognized when the entity's right to receive payment is established.

  Disclosure

  Substantive procedures should include the following:

  (a) Confirm consistency and disclosure of the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

  (b) Verify that there is disclosure of the amount of each significant category of revenue recognized during the period including revenue arising from:

  (i) The rendering of services;

  (ii) The sale of goods;

  (iii) Interest; and

  (iv) Royalties.

  (c) Verify that there is disclosure of the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

Expenses

- Expenses are the economic costs that a business incurs through its operations to earn revenue. Examples of expense include payments to suppliers.

- Substantive procedures for expenses aim at ensuring that assertions about expenses in financial statements are correct, properly recorded and properly disclosed. The following substantive procedures may be applied in the verification of expenses:

  (a) Obtain schedules of all expenses in their various classes;

  (b) Obtain specimen signatures of officials mandated to authorise and approve various classes of expenses;

  (c) Select a representative sample from each class of expenses for detail substantive test;

  (d) Verify that each expense is properly authorised and approved including approval limits for each authorising official;

  (e) Verify that expenses are properly classified;

  (f) Check calculations and additions for all invoices selected;

  (g) Check that value for the expense is received by inspecting delivery documents or performance reports;

  (h) Check entries in expenses register and verify that they are correctly analysed;

  (i) Check posting to the general ledger; and

  (j) Trace expense total to the final accounts.

SALES AND PURCHASES

<u>Sales</u>

The audit objective is to ensure that sales invoices are properly authorised, recorded in the books of accounts to avoid understatement or overstatement of sales, and delivery made to customers.

The following substantive procedures may be applied:

(a) Verify sales with customer orders;

(b) Check that invoices are properly authorised;

(c) Check price charged with official price list;

(d) Check entries in sales day book with invoices and credit notes;

(e) Verify that the functions of recording sales, maintaining customer accounts, and preparing statements are well segregated;

(f) Match sales invoices with dispatch notes;

(g) Check that all sales invoices are recorded;

(h) Match cash receipts with invoices;

(i) Verify that sales returns and adjustments are properly recorded and authorised;

(j) Verify that there are proper cut-off procedures and duly complied with;

(k) Verify that there are proper safeguards to ensure that debtors statements cannot be altered before despatch;

(l) Verify that writing-off of bad debts are properly authorised;

(m) Trace sales invoices to summaries;

(n) Check summary totals to sales ledger control accounts; and

(o) Check additions in the sales ledger control accounts.

- **Purchases**

The audit objective is to ensure that all purchases are accounted for, authorised and properly presented. The auditor should adopt the following procedures:

(a) Randomly select a number of invoices and credit notes for detailed checking;

(b) Obtain specimen signatures of all officials authorised to approve purchases;

(c) Compile a schedule of the items selected and also the test to be applied;

(d) Verify that each invoice is supported by a properly signed requisition;

(e) Verify that each invoice is supported by an authorised copy order;

(f) Verify that each invoice is backed by a goods received notes as evidence of delivery;

(g) Verify that prices are authorised by the appropriate signatories;

(h) Recompute the entries in the invoice;

(i) Check calculations, extensions, and additions;

(j) Check that invoices are correctly coded for ledger accounts classification;

(k) Verify that appropriate acknowledgments such as initials or signatures appear on each purchase document;

(l) Verify that each correct invoice has been passed for payment;

(m) Check that each invoice is entered in the invoice register;

(n) Check that each invoice has been posted to the purchase ledger account;

(o) Check for completeness of purchase orders by enquiring into missing numbers;

(p) Investigate outstanding orders;

(q) Enquire into unmarked Goods Received notes;

(r) Enquire into unprocessed invoices;

- **WAGES AND SALARIES**

  Substantive tests may be conducted, as follows:

  Wages

  (a) Check gross pay with approved pay rate;

  (b) Check calculation of gross pay with number of hours worked;

  (c) Check that extra hours such as overtime is properly authorised;

  (d) Check calculation of approved deductions;

  (e) Trace deductions to check-off ledgers;

  (f) Check totals of wage sheets to wages summary;

  (g) Check additions in the summary sheet;

  (h) Check posting of summary sheet total to wages nominal ledger;

  (i) Check net cash payments to cash book;

  (j) Check that there is proper approval for wage payment; and

  (k) Verify that there is adequate procedure for the treatment of unclaimed wages and ensure that this is properly complied with.

- **Salaries**

(a) Verify that the engagement of new employees and discharges have been carried out in line with the organisation.s policies;

(b) Check gross salaries to employee records;

(c) Verify proper authorisation of overtime;

(d) Check calculation of employee salaries including re-computation of deductions;

(e) Confirm receipt of cash paid to employees;

(f) Confirm payment of salaries through bank transfers to employees;

(g) Re-compute payroll sheet;

(h) Trace totals of salary sheets to summaries;

(i) Check additions of summary sheet;

(j) Trace summary sheet total to nominal ledger;

(k) Trace total of net pay to cash book;

(l) Trace total of deductions to check-off accounts; and

(m) Verify that there is proper approval for the payment of salaries.

OTHER INCOME AND EXPENDITURE ACCOUNT ITEMS

Other income refers to income derived from activities not in the normal course of business of an entity; sometimes called other revenue. Examples are interest on customers. notes, dividends and interest from investments.

Substantive procedures to verify other income may include the following:

(a) Obtain schedule of classes of other income;

(b) Verify the sources of the income;

(c) Verify that the income is properly lodged in the bank and classified;

(d) Verify that the entity has right to the receipt of the income;

(e) Check posting to the General Ledger; and

(f) Verify that the income is properly disclosed in the financial statement.

Review Questions

1) Highlight the Assertions relating to presentation and disclosures
2) Highlight audit objectives applicable to inventories when carrying out substantive test
3) Highlight the substantive procedures for validating sales
4) Highlight the verification procedures for debentures
5) Highlight the validation procedure for assets and laibilities

References

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