TOPIC 3 AUDIT OF FINANCIAL STATEMENTS

Exam tip on substantive procedures
Financial statements are audited using substantive procedures.

The best way to generate substantive procedures is to:
- Identify the risks associated with the balance in the financial statements.
- Identify the key assertions to be verified when collecting audit evidence.
- Use AEIOU to describe the substantive procedures.

When you are required to describe substantive procedures, you give an account of how you will perform the procedure, the records inspected and the assertion to be verified. You do not:
- Describe audit objectives e.g. 'ensure gross and net pay calculations are correct'.
- Be too generic e.g. 'check that payroll calculations are correct'.
- Describe tests of controls that detect the effectiveness of internal controls.

5.1 Non-current assets

Assertions (*to be verified*)

Assertion	Audit objective
Existence	• Additions represent assets acquired in the year and disposal represents assets sold or scrapped in the year • Recorded assets represent those in use at the year end
Completeness	• All additions and disposals that occurred in the year have been recorded • Balances represent assets in use at the year end
Rights and obligations	• The entity has rights to the assets purchased and those recorded at the year end
Accuracy, valuation and allocation	• Non-current assets are correctly stated at cost less accumulated depreciation • Additions and disposals are correctly recorded
Classification	• Tangible assets have been recorded in the correct accounts and expenses which are not of a capital nature are taken to profit or loss
Presentation	• Disclosures relating to cost, additions and disposals, depreciation policies, useful lives and assets held under finance leases are adequate and in accordance with accounting standards

Substantive procedures for tangible non-current assets
These are performed on the **lead schedule** for tangible non-current assets (see example below) and the asset register to verify the above assertions and opening balances, additions, disposals, revaluations and depreciation.

Activity 1

The following is a tangible assets schedule of Happy Fashions Co for the ended 31 December 2024.

	Land and Buildings	Computers & Equipment	Fixtures & Fittings	Total
	Shs 000	Shs 000	Shs 000	Shs 000
Cost				
At 1 January 2024	556,151	65,663	22,380	644,194
Additions	799,434	46,138	80,373	925,945
Disposals	0	(40,512)	(22,380)	(62,892)
Revaluation increase	200,000			
At 31 December 2024	1,555,585	71,289	80,373	1,707,247
Depreciation				
At 1 January 2024	27,808	58,976	20,044	106,828
Charge for year	67,779	16,770	12,056	96,605
Elimination on disposal	0	(46,849)	(20,044)	(66,893)
At 31 December 2024	95,587	28,897	12,056	136,540
Carrying amount				
At 31 December 2024	1,459,998	42,392	68,317	1,570,707
At 31 December 2023	528,343	6,687	2,336	537,366

The depreciation policy for Ken Ltd is as follows:

Buildings	5% straight line
Computers and equipment	15% straight line
Fixtures and fittings	10% straight line

It is company policy to charge a full year's depreciation in the year of addition and none in the year of disposal. Included in land and buildings is land which cost Shs 500 million when bought during the year ended 31 December 2024. Happy Fashions Co maintains a non-current asset register which you have checked and agreed to the disclosure note totals. No discrepancies have been noted. Property was revalued by BB Valuers at 31 December 2024.

Happy Fashions Co purchased new equipment. All costs incurred in the purchase and installations have been recognized as equipment. The amount of Shs 46,138,000 includes Shs 32 million for equipment cost that includes the purchase price of Shs 25 million, delivery and installation costs of Shs 1 million, refundable VAT of Shs 5.4 million and Shs 600,000 in training staff on how to operate the new plant and machinery.

On 1 October 2024 the company replaced 5 of its computers. The old computers had a carrying amount of Shs 18 million as recorded in the non-current assets register and were given in a part exchange against new computers costing Shs 46 million. The company also paid Shs 39 million cash.

18m + 39m = 57m - 46m = 11m

During the year, Happy Fashions Co engaged a specialist to revalue its factory and head office sites.

Required (*when obtaining sufficient and appropriate evidence on tangible non-current assets of Happy Fashions Co*):

Required:

a) Discuss matters arising from reviewing the non-current asset note that may be of concern to the auditor.
b) Describe substantive procedures on completeness of tangible non-current assets.
c) Describe substantive procedures on the existence of tangible non-current assets.
d) Describe substantive procedures on rights and obligations of tangible non-current assets.
e) Describe substantive procedures in relation to additions to equipment.
f) Describe substantive procedures in relation to the disposal of the old computers.
g) Describe substantive procedures in relation to the revaluation of property.
h) Describe substantive procedures on the depreciation charge for the year ended 31 December 2024.

Solution

Completeness

a) Obtain or prepare a **schedule** of tangible non-current assets showing how the following reconcile with the opening position in the signed financial statements or previous year's audit file (when it is not a first audit) to ensure opening balances have been carried forward accurately from the previous year:
   - Cost or valuation
   - Accumulated depreciation
   - Carrying amount
b) **Compare non-current assets** in the general ledger with the non-current **assets register*** and obtain explanations for differences.
c) **Physically inspect** a sample of PPE and trace each asset to the non-current asset register.
d) If a non-current asset register is not kept, **prepare a schedule** showing the original costs and present depreciated value of major non-current assets.
e) **Reconcile** the schedule of non-current assets with the general ledger and the SOFP.

Existence

a) Confirm that the company **physically inspects** all items in the non-current asset register each year.
b) **Inspect** assets in the asset register, concentrating on high value items and additions in-year to confirm that assets exist, are in use, are in good condition and have correct serial numbers.
c) Review records of **income-yielding** assets.
d) Reconcile **opening and closing vehicles** by numbers and amounts.

Rights & Obligations

a) Verify **title** to land and buildings by inspection of land titles, land transfer forms and leases.
b) Carry out a search of land titles at the lands office to verify their authenticity.
c) Obtain a **certificate from lawyers/bankers** stating that land certificates are held for custody only and are free from mortgage or lien.
d) Inspect **log books** for vehicles held, confirming that they are in the client's name.
e) Confirm all vehicles are used for the **client's business**.
f) Examine **documents of title** for other assets like purchase invoices, architects' certificates, contracts and lease agreements.
g) Inspect loan agreements and the **mortgage register** for assets used as security.
h) Review leases of leasehold properties to ensure that the company has fulfilled **covenants** therein.
i) Examine **invoices** received after year end, orders and minutes for evidence of **capital commitments**.

Valuation

a) Consider the **competence** of the valuer by assessing the qualification, membership of a professional body and experience in valuing these types of assets.
b) Review the assumptions and method adopted by the valuer in undertaking the revaluation to confirm the

reasonableness and compliance with principles of IAS 16.

c) Agree all non-current assets in the **non-current assets register** to the valuation report to ensure their completeness and that all assets in the same category have been revalued in line with IAS 16.

d) **Recalculate** the revaluation increases and decreases and check that they are accounted for in accordance with IAS 16 & 36 *Impairment of assets:*
   i) A revaluation gain is credited to OCI and to revaluation surplus in equity or to profit or loss to the extent of a reversal of a previous revaluation loss on the same asset.
   ii) A revaluation loss is debited to profit or loss or first deducted from the revaluation surplus on the same asset and the balance debited to profit or loss.

e) Recalculate the **depreciation charge** for the year and confirm that for non-current assets at the revaluation date, the depreciation was based on cost before the revaluation and based on the valuation after on a pro rata basis.

f) For a sample of non-current assets from the non-current assets register, physically verify to confirm **existence**.

g) For a sample of non-current assets trace back to the non-current assets register and general ledger to confirm **completeness**.

h) Confirm whether valuations of all revalued assets have been **updated regularly** by asking the finance director and inspecting the previous financial statements.

i) Review **insurance policies** and consider the adequacy of their insured values and check expiry dates.

j) Review the financial statements **disclosures** relating to land and buildings to ensure they comply with IAS 16.

Valuation – Depreciation

a) Obtain details of the **depreciation accounting policy** from the notes to the financial statements and confirm that there have been **no changes** to this policy.

b) Review the **depreciation rates** in the policy and consider whether they are reasonable considering:
   i) Asset lives by inspecting their physical condition and assets fully depreciated still in use.
   ii) Residual values.
   iii) Entity's replacement policy by reading board minutes.
   iv) Past experience of gains and losses on disposal of similar assets, a loss on disposal may indicate under-depreciation.
   v) Consistency with prior years, accounting policy and other entities in the industry.
   vi) Possible obsolescence

c) Review non-current assets register to ensure that depreciation has been **charged on all assets** with a limited useful life.

d) For revalued assets, ensure that depreciation is based on the **revalued amount** by recalculating it.
   to ensure its accuracy.

e) Compare the amount to depreciation charge in the asset register for each item in the sample.

f) **Compare ratios** of depreciation to non-current assets (by category) with previous years and depreciation policy rates.

g) Review draft financial statements to ensure that depreciation policies and rates are **disclosed** in accordance with IAS 16.

Additions (*Rights & Obligations, Valuation and Completeness*)

a) **Cast** the list of additions to check its accuracy and **agree the total** to the non-current asset note to the financial statements.

b) Select a sample of additions and **agree cost** to supplier invoices, architects' certificates to verify accuracy. Confirm that the amount capitalized excludes any refundable VAT.

c) Inspect the sample of additions to confirm that **supplier invoices** and contracts are in the names of the entity to verify rights and obligations for assets.

d) **Physically inspect** a sample of additions recorded in the asset register to confirm existence and

condition. e) For a sample of additions, confirm that they have been included in the non-current **asset register** and general ledger to ensure they have been recorded properly. f) Review the list of additions to confirm they are **capital expenditure** rather than repairs and maintenance. g) Review related **expense accounts** such as repairs, motor expenses and sundry expenses to ensure items have not been expensed that should have been capitalised to verify completeness of additions. h) Examine invoices received after year end, orders and board minutes for evidence of **capital commitments** which may not have been included in financial statements to verify completeness of non-current assets.
Disposals (*Rights and Obligations, Completeness & Accuracy*) a) Obtain a list of all disposals from the client and **cast** it to ensure its accuracy and **agree** the total of disposals list to the financial statements. b) Confirm that all disposals have been **removed** the entity's non-current asset register to verify existence. c) Verify the valuation of the disposals with **supporting documentation** such as invoices issued to the buyer, checking transfer of title, sales price and dates of completion and payment. d) Inspect minutes of board meetings for evidence of **authorization** of disposals of non-current assets. e) Recalculate **profit or loss** on disposal and agree the amount to the general ledger and financial statements. f) Consider whether disposal proceeds are reasonable and are not included in revenue. g) Recalculate the **depreciation** up to the date of disposal, based on the entity's accounting policy to ensure it has been calculated correctly. h) If the asset was used as **security**, confirm the removal of the asset from the mortgage register. i) Trace the **proceeds** from the sale to the cash book and bank statements.
Classification a) **Review** the non-current asset disclosures in the financial statements to ensure they meet IAS criteria. b) For a sample of **fully depreciated** assets, inspect the register to ensure no further depreciation is charged.
Presentation Review the non-current asset disclosures in the financial statements for compliance with relevant IAS 16.

*An asset register has information on assets, their purchase dates, depreciation rates, costs/valuations, accumulated depreciation, carrying amounts etc. summarized in the asset schedule.

Substantive procedures for intangible non-current assets

Goodwill	a) Agree the **consideration** to the sales agreement by inspection. b) Check the reasonableness of **asset valuation**. c) **Recalculate** the goodwill to verify its accuracy. d) Review the impairment testing and discuss with management. e) Check that goodwill valuation is reasonable through discussion with management.
Research & development expenditure (R&D)	a) Confirm that development expenditure comply with the **IAS 38 capitalisation criteria** (PIRATE) by inspecting details of projects and discussion with technical managers: i) Probable future economic benefits ii) Intention to complete and use/sell the asset iii) Resources to complete and use/sell the asset iv) Ability to use/sell the asset v) Technical feasibility of completing the asset for use/sell vi) Expenditure can be measured reliably

	b) **Confirm feasibility and viability by inspection of budgets.** c) **Recalculate** the amortization expense to ensure it commences with production and is reasonable. d) Inspect invoices to verify **R & D expenditure**.
Other intangibles	a) **Agree** purchased intangibles to purchase agreements by inspection. b) Inspect **valuation** of intangible assets by experts to ensure it is reasonable. c) **Recalculate** amortization expense to verify their accuracy.

Activity 2

Humura Ltd develops and manufactures computer components and its year end was 31 December 2023. You are an audit supervisor of Trump & Co and the final audit is due to commence shortly. Draft financial statements show total assets of Shs 2,320m and profit before tax of Shs 640m. The following matter has been brought to your attention.

Humura Ltd includes expenditure incurred in developing new products within intangible assets once the recognition criteria under IAS 38 *Intangible Assets* have been met. Intangible assets are amortised on a straight line basis over four years once production commences. The amortisation policy is based on past experience of the likely useful lives of the products. The opening balance of intangible assets is Shs 190m. In the current year, Humura Ltd spent Shs 80m developing three new products which are all at different stages of development.

Required:

Describe substantive procedures the auditor would perform to obtain sufficient appropriate evidence in relation to the research and development expenditure of Humura Ltd.

5.2 Inventory

Assertions (*to be verified*)

Assertion	Audit objective
Existence and occurrence	• Recorded purchases and sales represent inventories bought and sold. • Inventory on the statement of financial position physically exists
Completeness	• All purchases and sales are recorded. • All inventory at year end is included on the SOFP.
Rights and obligations	• The entity has rights to inventory recorded in the period and at the year-end.
Accuracy, valuation and allocation	• Costs are accurately determined in accordance with accounting standards. • Inventory is recorded at year end at the lower of cost and net realisable value
Classification	• Inventory is recorded in the proper accounts
Cut-off	• All purchases and sales of inventories are recorded in the correct period.
Presentation	• Inventory is properly classified in the accounts. • Disclosures are adequate and in accordance with accounting standards.

Audit approach

Collect evidence on inventory:

- Quantity normally arrived at using the year-end inventory count or the perpetual inventory system
- Valuation in accordance with IAS 2
- Disclosure.

✓ Where an entity has a **perpetual** inventory system, a controls-based approach may be more efficient as long as the controls over the system are appropriately designed.

✓ Where an entity has an **inventory count at the year-end**, largely a substantive approach is taken.

✓ Substantive procedures and tests of controls are used in auditing inventory.

The physical inventory count

ISA 501 *Audit evidence – specific considerations for selected items* requires auditors to attend the physical inventory counting (unless it is impracticable) in order to obtain audit evidence about the **existence** and **condition** of inventory.

Audit procedures before the inventory count.

a) Review the prior year audit files to identify significant **inventory issues** from last year.
b) Discuss with management if any **new warehouses** or any sites have significant control issues.
c) Decide which of the warehouses the **audit team members** will attend i.e. the higher risk ones.
d) Obtain a copy of the **inventory count instructions** and review them to identify any control deficiencies, and if any are noted, discuss them with management before the count (see table below).
e) Arrange to obtain from any **third-parties** confirmation of inventory they hold.
f) Consider the need for **expert assistance**.

Reviewing inventory count instructions

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

Activity 1

You are the audit senior in Divine & Co who is responsible for the audit of inventory for Happy Fashions Co. You will be attending the year-end inventory count on 31 December 2024 and has been provided with the following inventory count instructions for the company.

The warehouse manager will supervise the count as he is most familiar with the inventory. There will be ten teams of counters and each team will contain two members of staff, one from the finance and another from the manufacturing department. None of the warehouse staff, other than the manager, will be involved in the count.
Each team will count a section of finished goods. As this process is systematic, it is not felt that the team will need to flag areas once counted. Once the team has finished counting a section, they will hand in their sheets and be given a set for another section of the warehouse. In addition to the above, to assist with the inventory counting, there will be two teams of counters from the internal audit department and they will perform inventory counts.
The count sheets are sequentially numbered and the product codes and descriptions are printed on them but without quantities. If the counters identify any inventory which is not on their sheets, then they are to enter the item on a separate sheet, which is not numbered. Once all counting is complete, the sequence of the sheets is checked and any additional sheets are also handed in at this stage. All sheets are completed in ink.

Any damaged goods identified by the counters that are too heavy to move to a central location, are to be left where they are but the counter is to make a note on the inventory sheets detailing the level of damage.

As the company undertakes continuous production, there will continue to be movements of raw materials and finished goods in and out of the warehouse during the count. These will be kept to a minimum where possible.

The level of work-in-progress in the manufacturing plant is to be assessed by the warehouse manager. It is likely that this will be an immaterial balance. In addition, the raw materials quantities are to be approximated. In the past this task has been undertaken by a specialist; however, the warehouse manager feels confident that he can perform this task.

Required:
Describe **FIVE** matters that will require action by management if the inventory count is to be effective. Describe how the matters may be rectified.

Audit procedures during attendance at the inventory count

a) **Observe** whether the client's staff are following instructions to ensure the count is complete and accurate.
b) Perform **test counts** (concentrating on high value items) to ensure internal controls are working properly:
    i) Select a sample of inventory (concentrating on high value items) from inventory sheets and physically inspect them to verify the existence of inventory.
    ii) Physically inspect a sample of inventory items and trace them to inventory sheets to verify the completeness of the inventory count.
c) Observe the counts in order to confirm that the procedures for identifying and segregating **damaged goods** are operating correctly and inspect inventory for evidence of any damaged or slow moving items.
d) Observe the procedures for **movements** of inventory during the count in order to confirm that all movements have ceased (where there has been no closure, goods received during the count is kept separately).
e) Obtain **copies** of inventory sheets for follow up testing to determine whether the entity's final inventory records accurately reflect actual inventory count results.
f) Obtain **copies of the last GRNs and GDNs** before the count date and the first **GRNs and GDNs** after the inventory count in order to perform cut-off procedures at the year end.
g) Observe the procedures carried out by the entity staff in identifying **third party** inventories are operating correctly and review the completed inventory count sheets to confirm no third inventory is included.

The auditors' working papers should include:

- Details of their observations and tests
- The manner in which points that are relevant and material to the inventory being counted or measured have been dealt with by the client

- Instances where the client's procedures have not been satisfactorily carried out
- Items for subsequent testing such as photocopies of (or extracts from) rough inventory sheets
- Details of the sequence of inventory sheets
- The auditors' conclusions

Audit procedures after the inventory count

a) Trace items that were **test counted** to final inventory sheets.
b) Inspect whether **all count records** have been included in final inventory sheets.
c) Inspect **final inventory sheets** to ensure they are supported by count records.
d) Ensure that continuous inventory records have been **adjusted** to the amounts physically counted or measured, and that differences have been investigated.
e) Confirm **cut-off** by using details of the last serial number of goods received notes and goods dispatch notes and details of movements during the count
f) Review **replies from third parties** about inventory held by or for them.
g) Confirm the client's **final valuation** of inventory has been calculated correctly.
h) Follow up **queries** and notify problems to management.
i) Confirm necessary **adjustments** to book inventories have been made by inspecting the client's ledgers.
j) Verify the **presentation and disclosure** of inventory.

Audit procedures for material inventory held by third parties

a) **Attend or arrange** for another auditor to attend the inventory count by the third party.
b) Obtain **another auditor's report** on the adequacy of the third party's internal control to ensure that inventory is properly counted and adequately safeguarded
c) Inspect **documentation** in respect of third-party inventory (e.g. warehouse receipts)
d) Request confirmation from other parties when inventory has been pledged as **collateral**

Cut-off testing

It is done after the inventory count using samples of GRNs and GDNs either side of the year obtained when attending the inventory count and matching them with purchase/sales invoices to ensure they have been recorded in the correct accounting period. Cut-off testing is often used to confirm the completeness of inventory, as well as the existence of receivables and payables (see diagram below).

	← **Year end**	→	
	GRNs before	**GRNs after**	
	Included in?	**Included in?**	
Purchases cut-off	Purchases √	Purchases X	**Purchases cut-off**
	Payables √	Payables X	
	Inventories √	Inventories X	
	GDNs before	**GDNs after**	
	Included in?	**Included in?**	
Revenue cut-off	Revenue √	Revenue X	**Revenue cut-off**
	Receivables √	Receivables X	
	Inventories X	Inventories √	

Purchases cut-off

- All goods received before year end must be included in financial statements a liability, expense and closing inventories. A schedule of 'goods received not invoiced' should be prepared and items on the list should be accrued for in the accounts.
- Goods received after the year end should not be included in financial statements.

Revenue cut-off

- Goods delivered should be included in revenue and trade receivables by the year end but not in closing inventory.
- Goods delivered after year end must not be included in revenue in financial statements but should be included in closing inventories.

Prior to the physical inventory count the auditor should consider whether management has made arrangements for proper cut-off:

a) Appropriate systems of recording of receipts and despatches of goods are in place, and also a system for documenting materials requisitions. GRNs and GDNs should be sequentially pre-numbered.
b) Final GRN and GDN and materials requisition numbers are noted. These numbers can then be used to subsequently check that purchases and sales have been recorded in the current period.
c) Arrangements should be made to ensure that the cut-off arrangement for inventories held by third parties is satisfactory.

There should ideally be no movement of inventory during the count. Preferably, receipts and despatches should be suspended for the full period of the count. It may not be practicable to suspend all deliveries, in which case any deliveries which are received during the count should be segregated from other inventory and carefully documented.

Inventory count methods

A client may count inventory by one or a combination of the following methods:

a) **Physical inventory count at the year-end** – this is the best as evidence is collected at the reporting date.
b) **Physical inventory count before or after the year-end** – this provides reliable evidence when the time between the count and year-end is small and proper records on inventory movement between the two dates are kept.
c) **Continuous (perpetual) inventory counting** – this is where counting is done throughout the year.
    i) This is the best in monitoring inventory levels throughout the year.
    ii) However, over time actual inventory level may differ from what the inventory records as a result of unrecorded transactions or theft.
    iii) Therefore, a physical inventory count of selected inventory lines should be performed throughout the year to determine the extent of the variances between recorded and actual inventory levels.

    The auditor should ensure that:

    - All inventory lines are counted **at least once** a year.
    - An entity maintains up-to-date inventory **records** for sales and purchase transactions.
    - An entity has satisfactory **procedures** for inventory counts and test-counting by reviewing count instructions and observing the counts.
    - Management **investigates and corrects** all material differences. Corrections should be authorised by a manager independent of the inventory count to guard against concealing shortages.

INVENTORY 28/12/24	100M
PURCHASES 30/12 /24	5M
SALES (PURCHASE COST) 31/12/24	10M
INVENTORY 31/12/24	

Audit procedures where there is a continuous inventory count

- **Attend** one of the inventory counts to observe and confirm that instructions are being adhered to.
- Perform test counts in both directions to get evidence on existence and completeness of inventory.
- **Follow up the inventory counts** attended to compare quantities counted by the auditors with the inventory records, obtaining and verifying explanations for any differences, and checking that the client has reconciled count records with book inventory records.
- **Review** the year's inventory counts to confirm the extent of counting, the treatment of discrepancies and the overall accuracy of records. If not satisfactory, advise the client to carry out a full count at the year-end and attend the count to collect sufficient appropriate evidence.
- Assuming a **full count is not necessary** at the year end, compare the listing of inventory with the detailed inventory records, and carry out other procedures (cut-off, analytical review) to gain further comfort.
- Perform substantive procedures on **completeness, existence and ownership** of inventory at year end.

8/1/25	Inventory	150 bags
1/1/25 – 8/1/25	Purchases	(20 bags)
	Sales (Cost)	60 bags
31/12/24	Closing Inventory	180 bags

Substantive procedures for inventory

Completeness a) **Physically count** inventory items and trace them to the final inventory lists. **b)** Physically inspect inventory held by **third parties** or review confirmations received from third parties and agree the amounts to the general ledger and confirm it is included in the year-end inventory. **c)** Compare the **gross profit percentage** to the previous year or industry average.
Existence a) **Observe** the physical inventory count (see details under the inventory count below). b) Select a sample of inventory items from records and **physically inspect** the inventory.
Rights and obligation a) Identify any **inventory held for third parties** (e.g. bill and hold inventory) and ensure it is separately located during the count and is not included in the year-end inventory figure. b) Confirm that any inventory **held at third-party locations** (e.g. goods in transit or on sale or return basis) is included in the year-end inventory figure by reviewing the inventory listing. c) Inquire of management, review loan agreements and directors' board minutes for **inventory pledged**.
Cut-off • Obtain the **GRNs** and **GDNs** before and after the year end during and after the count, match each to the purchases/sales invoices to ensure they have been recorded in the correct financial year.
Valuation, allocation & accuracy a) Obtain a copy of the final **inventory listing** and agree the total to the general ledger & financial statements. b) Vouch a sample of inventory items to **suppliers' invoices** to ensure it is correctly valued. c) Where **standard costs** are used, examine the basis of the standards, compare a sample of standard costs with actual costs and confirm that standard costs are approximately equal to actual costs. d) For a sample of **cost records** for finished goods, WIP and raw materials:

i) Agree raw material costs to recent purchase invoices and price lists
ii) Agree labour costs to wage records and reconcile labour hours to time summaries
iii) Agree overhead costs to supporting documentation like invoices for electricity and compare actual overhead costs with budgeted costs and that in the previous years.
iv) Confirm overheads are allocated based on the **normal level of production** and overheads arising from reduced levels of activity, idle time or inefficient production are written-off to profit or loss.

e) For **work-in-progress**, discuss the stage of completion with the production management, recalculate inventory values and consider the need for expert.
f) Confirm that an appropriate **basis of valuation** is being used by discussing with management.
g) Get a list of the **ageing of inventory** to identify slow moving or obsolete items that need writing down.
h) Confirm inventory is valued at the **lower of cost and net realizable value** (NRV*) by:
   i) Comparing **selling prices** per sales invoices after year end and purchase prices.
   ii) Reviewing the **order book** to determine at what price the goods are ordered.
   iii) Looking at **write downs in the previous year** and whether the goods are still in inventory.
   iv) Reviewing **gross profit margin post year end** as if it decreases it may be because goods are sold below cost.
i) Compare the **gross profit margin** to management accounts, the previous year and industry average.
j) Compare the **inventory turnover days** to the previous year and industry average.
k) **Recalculate** inventory amounts on the inventory listing **and cast** the list to verify its accuracy.
l) **Trace** test counts back to the inventory listing.
m) If the entity has adjusted the general ledger to agree with the physical inventory count amounts, **agree** the two amounts.
n) Where a **continuous** (perpetual) inventory system is maintained, agree the total on the inventory listing to the continuous inventory records using automated tools.

Classification

a) **Review** the inventory listing to ensure that inventory has been properly classified between raw materials, work-in-progress and finished goods.
b) Read the **notes** to the accounts relating to inventory to ensure they are understandable.

Presentation

a) Review financial statements to confirm whether inventory valuation methods are accurately disclosed.
b) Read the notes to the financial statements to ensure that the information is accurate and properly presented at the appropriate amounts.

*NRV is likely to be less than cost when there has been an increase in costs or a fall in selling price, physical deterioration, obsolescence of products, a marketing decision to manufacture and sell products at a loss and errors in production or purchasing.

Activity 2

Below are extracts from the inventory count sheets of Happy Fashions Co for the year ended 31.12.2023.

COUNT SHEET NO 20

Date: 4.1.2024
Counter: Otim
Approved by: Akello
Location: Warehouse 2

Inventory Code	Inventory Item	Description	Quantity per Inventory record	Quantity counted	Notes
121	Hima cement	Bags	407	407	
122	Simba cement	Bags	330	200	
130	Versatile sheets G28	Pieces	900	901	
131	Colored sheets G30	Pieces	278	278	Damaged
132	Galvanized sheets G32	Pieces	2,026	2,026	

a) Identify items from the inventory count sheet that require investigation and give reasons for your choice.
b) What audit procedures will be carried on the above items.

Activity 3

The audit associate has obtained the following extract of the aged inventory report:

Inventory code	*Days in inventory*	*Original cost*	*Selling price*	*Costs to sell*	*Carrying amount*
		Shs	Shs	Shs	Shs
C 800	98	120,000	200,000	20,000	120,000
C 600	127	145,000	160,000	25,000	145,000
C 500	109	180,000	260,000	30,000	230,000
					495,000

What is the impact on the value of inventory if no adjustments are made to the carrying amounts above?

Activity 4

The draft profit before tax of Happy Fashions Co is Shs 136 million. During the inventory count, the count supervisor noted that boxes of soap with a value of Shs 7.2 million were damaged. The finance director believes the soap can be sold at a discounted sum of Shs 4 million to slum dwellers in Katwe. Describe **FIVE** audit procedures you would perform during the audit of Happy Fashions Co to obtain sufficient appropriate audit evidence in relation to the valuation of the damaged soap.

Discussion question

It is 1 December 2024. You are an audit supervisor with Divine & Co and you are responsible for the final audit of Happy Fashions Co to commence in February 2025. The draft financial statements for the year ending 31 December 2024 show total assets of Shs 840 million and profit before tax of Shs 210 million. Year-end inventory is estimated at Shs 90 million and audit staff are expected to attend the inventory counting. Describe substantive procedures the auditor should perform BEFORE and DURING the inventory count.

5.3 Receivables and Revenue

Assertions for revenue and receivables

Receivables (trade receivables & prepayments) are usually audited together with revenue.

Assertions about classes of transactions and related disclosures	a) All sales transactions recorded have occurred and relate to the entity (occurrence) b) All sales transactions that should have been recorded have been recorded (completeness) c) Amounts relating to transactions have been recorded appropriately (accuracy) d) All transactions have been recorded in the correct period (cut-off) e) All transactions are recorded properly (classification) f) All disclosed events and transactions relating to receivables have occurred and pertain to the entity (occurrence, rights and obligations) g) All disclosures required have been included (completeness) h) Financial and other information is appropriately presented and described and disclosures clearly expressed at appropriate amounts (presentation)
Assertions about account balances at the period end and related disclosures	a) Recorded receivables exist (existence) b) The entity controls the rights to receivables and related accounts (rights and obligations) c) All receivables that should have been recorded have been recorded (completeness) d) Receivables are included in the accounts at the correct amounts (accuracy, valuation and allocation) e) Financial and other information is appropriately presented and described and disclosures clearly expressed at appropriate amounts (presentation)

Substantive procedures for receivables

Completeness	a) Obtain a **breakdown** of the trade receivables figure per customer for both the current and the previous period and compare the level of trade receivables year on year. Discuss any obvious omissions/ unusual trends with management. (Note that this procedure can also be carried out in relation to items such as prepayments). b) Select a **sample of GDNs** issued during the year and vouch them to the relevant sales invoices. Inspect the revenue and receivables accounts in the nominal ledger to ensure that the invoice has been accurately recorded in the correct accounting period. c) Obtain a copy of the **aged receivables listing**, re-cast the total to ensure it is accurate. Agree the balance on the aged receivables listing to the nominal ledger and trace through to the financial statements to ensure all balances are recorded.
Rights and obligations	a) Review money **received post year-end** for evidence of the balance owed being paid to the audit client, therefore confirming that the debt was due to them. b) Inspect the **responses from the direct confirmation** for evidence of the customer's name and address to verify that the customer has confirmed that the outstanding balance is due to the audit client. c) For a sample of balances due at the year-end vouch the outstanding balance **back to sales invoices and GDNs** to verify that the goods were delivered and that the amount is due to the audit client
Accuracy, valuation and allocation	a) Review the **aged receivables listing** to identify slow moving or old balances. Discuss the status of these balances with the credit controller to assess whether the customers are likely to pay or if an allowance for receivables is required (*Activity 1*). b) Review whether there are any **after-date cash receipts** for slow moving/old receivable balances (*Activity B*). c) Review **correspondence** with customers in order to identify any balances which are in

	dispute or unlikely to be paid and discuss with management whether any allowance is required. d) Review **board minutes** to identify whether there are any significant concerns in relation to outstanding receivables balances and assess whether the allowance is reasonable. e) Obtain a breakdown of the allowance for trade receivables. **Recalculate** it and compare it to any potentially irrecoverable balances to assess if the allowance is adequate. f) Discuss with the finance director the **rationale for decreasing the allowance** for receivables despite an increase in the collection period and the absence of the credit controller. g) Inspect **post year-end sales returns/credit notes** and consider whether an additional allowance against receivables is required.
Existence	a) For a sample of balances owed at the year-end, carry out a **direct confirmation** of receivables, investigate any balances which do not agree and vouch explanations to supporting documentation. b) Review **money received post year-end** to confirm that the balance existed at the year-end. c) Inspect **customer correspondence**/complaints files to identify any concerns over the existence of receivables.
Cut-off & accuracy	a) For a sample of **sales invoices** around the year end, inspect the dates and compare with the dates of despatch and the dates recorded in the ledger for correct cut-off. b) For **sales returns**, select a sample of returns documentation around the year end and trace to the related credit entries. c) Perform **analytical procedures** on sales returns, comparing the ratio of sales returns to sales. d) Review material **after-date invoices**, credit notes and adjustments to ensure they are recorded correctly in the relevant financial period. e) For a sample of sales invoices, compare the **prices and terms** to the authorised price list and terms of trade documentation. f) Test whether **discounts** have been properly applied by recalculating them for a sample of invoices. g) Test the correct **calculation of tax** on a sample of invoices.
Occurrence	Select a **sample of sales** in the general ledger/sales journal and inspect the supporting sales invoices, GDNs and customer orders to verify occurrence of credit sales.
Classification	a) Take a sample of sales invoices and examine for proper classification into revenue accounts. b) Review the aged analysis of receivables for any large credits, non-trade receivables and long-term receivables and consider whether such items require separate disclosure. c) Read the disclosure notes relevant to receivables in the draft financial statements and review for understandability.
Presentation	Read the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

Activity 1 Aged receivable listing of Happy Fashions Co as at 31 December 2023

Customer	Total	30 days	60 days	90 days	>90 days
	Shs million	Shs million	Shs million	Shs million	Shs million
Tesco Supermarket	11,800	3,100	2,800	3,600	2,300
All About Clothes	21	4	12	5	-
Clothing Terrain	33	26	5	-	2
Dress for the Occasion	92	41	39	12	-
Duncon's Dresses	3	3	-		
Every day Wear	(6)	-			(6)
Ewan Trading	29	14	15	-	-
Fred's Fashions	47	37	6	-	4
Freya's Threads	8	8	-		
Girls on the Go	13	4	9	-	-
Holly Aristocrat	73	41	19	1	12
Holiday Accessories	5	-	5	-	-
In all Weather	16	2	13	1	-
Ivory Gowns	2	-		-	2
Look the Part	124	79	38	7	1
Jim's Jumpers	38	30	8	-	-
Odd One Out	67	52	15	-	-
Safari School wear	28	-	28	-	
Skirts and all sorts	57	15	30	12	
Ties with a Difference	12	12	-		
Upward Trends	17	17	-		
Up and Out	9	-	9	-	
We're Going Exploring	12	5	-	7	
	12,500	3,490	3,051	3,645	2,314

The super market is allowed 60 days credit.

Required

a) What balances in the aged receivables listing require investigation and why?

b) Describe the substantive procedure you will perform on the above balances.

Activity 2 Money received by 28/2/2024 in the cash book from some debtors post year end

Customer	Amount received Shs m	Balance at year end Shs m
Tesco Supermarket	5,680	11,800
Every day Wear	0	(6)
Fred's Fashions	43	47
Holly Aristocrat	63	73
Ivory Gowns	0	2
Look the Part	124	124
Skirts and all sorts	57	57
We're Going Exploring	5	12

Required:

a) The above relates to balances owe at the end of the year. Which balances require further investigations?

b) Describe the substantive procedure you will perform on the above balances.

External confirmation of receivables

ISA 505 *External confirmations* requires auditors to carry out external confirmation of receivable balances to test **existence and rights and obligations** of receivables (also called **circularization**). This audit evidence is reliable since it is from an **independent source** and **in documentary** form.

There are two types of confirmation

- A **positive confirmation** request is where a confirming party responds directly to the auditor indicating whether they agree with the information in the request or provides the requested information.
- A **negative confirmation** request is where the confirming party responds directly to the auditor only if they disagree with the information in the request.

Positive confirmation is generally preferable as it encourages definite replies from customers.

Negative confirmation provides less reliable audit evidence and should not be used alone unless all of the following are present:

a) The risk of material misstatement has been assessed as low.
b) There is operating effectiveness of relevant controls
c) The population consists of a large number of small account balances.
d) A very low exception rate is expected.
e) The auditor is not aware of circumstances that would cause customers to disregard the requests.

Procedures for external confirmation

a) An auditor gets **permission** for confirmation from the client management.
b) Obtain **listing** of trade receivables as at confirmation date
c) **Agree total** to nominal ledger
d) Review for any obvious **omissions/misstatements** by comparing this year's list with the last years
e) Select a **sample** of accounts for confirmation. An aged receivables report may be used.
f) Send an **additional confirmation** request if no reply in a reasonable time
g) **Follow up** by phone/email/fax if still no reply
h) Where no reply is received obtain confirmation of outstanding invoices using **alternative procedures**
i) Further audit work is required where the confirmation response disagrees with the balance selected

Balances to be included in the sample of accounts for confirmation

a) **Old, unpaid** accounts
b) Accounts **written-off** during the period under review
c) Accounts with **credit balances**
d) Accounts settled by **round sum payments**
e) Accounts with **large balances**
f) Accounts with nil balances

Example of a positive confirmation letter

Quick Solutions
Date

Debtor's name & address

Dear ....,

In accordance with the request of our auditors, ABC & Co, we ask that you kindly confirm to them directly your indebtedness to us at [insert date] which, according to our records, amounted to Shs.......... as shown by the enclosed statement. If the above amount is in agreement with your records, please sign in the space provided below and return this letter direct to our auditors in the enclosed stamped addressed envelope. If the amount is not in agreement with your records, please notify our auditors directly of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully
For Quick Solutions
Reference No………………….

…..……

(Tear-off slip)
The amount shown above is/is not* in agreement with our records as at
Account No .... Signature ....
Date .... Title or position ....

* The position according to our records is shown overleaf.

Note the following:

- The confirmation letter is written on the clients headed paper and signed by the client with a copy of the current statement attached.
- It requests that the reply be sent directly to the auditor and a prepaid envelop is included for this purpose.

Where management does give permission for confirmation

a) Establish r**easons** for management's refusal and whether they are reasonable.
b) Evaluate **implications** on assessment of the risks of material misstatement of receivables
c) Perform **alternative audit procedures** similar to those for non-response to a confirmation.
d) Where the refusal is considered unreasonable or relevant and reliable audit evidence cannot be obtained from alternative audit procedures, **communicate** with those charged with governance and determine the **implications** for the auditor's report (any limitation of audit scope?).

Exceptions and non-responses

An **exception** is 'a response that indicates a difference between information requested to be confirmed or contained in the entity's records and information provided by the confirming party' .
A **non-response** is 'a failure of the confirming party to respond or fully respond to a positive confirmation request or a confirmation request returned undelivered'.

Exceptions may indicate:

- Misstatements or potential misstatements and must be investigated.
- A deficiency in internal control.
- Timing, measurement or clerical errors in the confirmation procedures.

Reasons for exceptions and the auditor's responses:

Exception	Auditor' response
Dispute between the client and the customer	Identify reasons for the dispute and make provision against the debt if appropriate.
Cut-off problems exist, because the client records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year.	Cut-off testing may have to be extended
Customer may have sent money before the year end that was received by the client after year end.	Detailed cut-off work may be required on cash receipts.

Money received may have been posted to the wrong account or a cash-in-transit account.	Check for evidence of other mis-posting and ensure the cash-in-transit account has been cleared promptly.
Customers who are also suppliers may net-off balances owed and owing.	Auditors should check that this is allowed.
Teeming and lading, stealing monies and incorrectly posting other receipts so that no particular customer is seriously in debt is a **fraud** that can arise in this area. Teeming and lading involves an employee first stealing the cash receipts from a receivable (receivable 1) and not recording the receipt against the customer account. Then the employee receives more cash from another receivable (receivable 2) and allocates it against receivable 1 in order to conceal the stolen funds. Similarly, they then allocate monies from receivable 3 against amounts owed from receivable 2, and so on. By allocating the funds in this way, there is only an apparent time lag on posting the receipt of cash, rather than an obvious uncollected debt.	Detailed testing is required on cash receipts, particularly on prompt posting of cash receipts.

	Paid	**Credited**	**Unbanked**
A	**50M**	**40M +10m**	**10M**
B	**30M**	**20M +10m**	
C	**20M**	**15M**	

In the case of **non-responses,** the auditor performs the following audit procedures:

a) With the client's permission, the auditor should arrange to send a **follow-up confirmation** request.
b) If the customer does not respond to the follow up, then with the client's permission, the auditor should **telephone** the customer and ask whether they are able to respond in writing to the confirmation request.
c) If there is no response, the auditor undertakes **alternative procedures** to confirm the balance including:
   i) Detailed testing of the balance by a review of after date cash receipts
   ii) Agreeing to sales invoices, goods dispatched notes and customer orders.

Activity 3 External confirmation

Below are the results from the external confirmation carried out at 31 December 2023 for Happy Fashions Co

Customer	Balance per ledger Shs m	Balance per response Shs m	Reason for the difference
Dress for the occasion	92	53	Cash in transit Shs 39m
Ewan trading	29	29	-
Fred's Fashions	47	43	
Upward trends	17	8	Goods not received at year end (GDN 127058)
Jasco Supermarket	11.80	11.58	Disputed invoice (Invoice No 126425)
Look the Part	(5)	3	

Required:

Describe the substantive procedures you would perform on each of the responses.

Reliability of responses

Where the reliability of the responses to the confirmation is doubted, the auditor should:

a) Contact the confirming party.
b) Evaluate the impact on the assessment of the risk of material misstatement and the nature, timing and extent of other audit procedures.

Revenue

Receivables will often be tested in conjunction with revenue.

The audit of revenue requires knowledge of IFRS 15 Revenue from Contracts with Customers which uses the following five steps in revenue recognition.

Identify the contract with the customer → Identify performance obligation(s) in the contract → Determine the transaction price → Allocate the transaction price to performance obligations → Recognise revenue when (or as) each performance obligation is satisfied

Auditors obtain evidence that revenue was earned by the entity (**occurrence**), is completely and accurately recorded (**completeness and accuracy**) and is recorded in the correct period (**cut-off**).

Substantive procedures for revenue

Completeness	a) Trace the revenue on a **sample of GDNs/cash sales**/till rolls to sales summaries and sales ledger. b) Perform a **sequence check** on GDNs and cash sales. c) Obtain a **breakdown of revenue** for the period on a month-by-month basis, quarterly basis, a product-by-product basis and/or per customer and compare to prior period/budget. d) Compare the **gross profit percentage** by product line with the previous year and/or industry data. Consider: i) The effect on sales value of changes in quantities sold ii) The effect on sales value of changes in products or prices iii) The level of goods returned, sales allowances and discounts iv) The efficiency of labour as expressed in sales or profit before tax per employee Reasons for changes in the gross profit margin should be detailed, ideally broken down by product area and month or quarter. Discuss any significant differences with management.
Accuracy	a) For a sample of sales invoices, compare the **prices and terms** to the authorized price list and terms of trade documentation b) Test whether **discounts** have been properly applied by recalculating them for a sample of invoices. c) Test the correct **calculation** of tax on a sample of invoices
Cut-off	a) For a sample of invoices around the year end, inspect the dates and compare with the dates of dispatch and the dates recorded in the ledger for application of correct cut-off. b) For **sales returns**, select a sample of returns documentation around the year end and trace to the related credit entries. c) Compare the **ratio of sales returns** to sales
Occurrence	For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and dispatch documentation

Substantive procedures for prepayments

Completeness	a) **Compare** the level of prepayments to the previous year to ensure the figure is reasonable and complete b) Review detailed statement of financial position to ensure all likely prepayments have been included
Accuracy, valuation and allocation	For a sample of prepayments from the prepayments listing, **recalculate** the amount prepaid to ensure that it has been accurately calculated
Existence	Verify by reference to invoices, cashbook and correspondence

Discussion question

It is 1 December 2024. You are an audit supervisor with Divine & Co and you are responsible for the final audit of Happy Fashions Co to commence in February 2025. The draft financial statements for the year ending 31 December 2024 show revenue of Shs 400 million (Shs 300 million in 2023), profit before tax of Shs 54 million (42 million in 2023) and total assets of Shs 420 million (Shs 340 million in 2023). The following matters have been brought to your attention.

The credit controller left the company in July 2024 and has recently been replaced. The trade receivables collection period at 31 December 2024 was 68 days (48 days 2023) and the allowance for irrecoverable receivables was Shs 3 million (Shs 2 million in 2023).Year-end trade receivables amounted to Shs 92 million (Shs 70 million in 2023).

Required:

a) Describe the substantive procedures the auditor should perform to collect sufficient appropriate evidence on the VALUATION of trade receivables of Happy Fashions Co**.**

b) Describe the substantive procedures the auditor should perform to collect sufficient appropriate evidence on the REVENUE of Happy Fashions Co**.**

5.4 Bank and cash

Assertions

Assertion	Objective	Procedure
Existence	Recorded cash balances exist at the reporting date	Bank confirmation letter
Completeness	Recorded cash balances include the effects of all transactions that have occurred	Bank confirmation letter Cash count Bank reconciliation Review of cash book for unusual items
Rights and obligations	The entity has legal title to all cash balances shown at the period end	Bank confirmation letter
Accuracy, valuation and allocation	Recorded cash balances are realisable at the amounts stated	Bank confirmation letter Cash count Bank reconciliation
Presentation	Disclosures relating to cash are adequate and in accordance with IFRSs and laws	Review disclosures in the financial statements

Audit of bank balances

Bank confirmation letter

ISA 505 *External Confirmation* requires an auditor to obtain bank confirmation about bank balances and other information directly from the bank. As this is an **independent source**, the evidence is more reliable than that from the clients own records. The following are procedures for bank confirmation.

a) The auditors **choose bank(s)** from which to obtain confirmation based on factors like the size of balance, volume of activity, degree of reliance on internal control and materiality.
b) The audit client provides **written authority** to disclose information requested in the confirmation to the auditors.
c) The bank confirmation letter is produced on the **auditor's headed paper** and sent by the auditor to the bank at least one month in advance of the clients' year end. Two approaches are used:
    i) Listing balances and other information and requesting confirmation of their accuracy and completeness,
    ii) Requesting details of balances and other information which can then be compared with the requesting client's records
d) Auditors receive the **reply** to the letter from the bank.
e) Auditors **agree the balance** in the bank letter to the bank balance as per the clients' records and any differences are investigated.

Contents of confirmation requests include the following:

a) Bank balances due to or from the client entity on current, deposit, loan and other accounts.
b) Account description number and the type of currency for the account.
c) Nil balances on accounts
d) Accounts which were closed in the 12 months prior to the confirmation date.
e) Maturity and interest terms on loans and overdrafts
f) Unused facilities, lines of credit/standby facilities
g) Any offset or other rights or encumbrances
h) Details of any collateral given or received.
i) Confirmation of contingent liabilities such as those arising on guarantees, comfort letters and bills.
j) Securities and other items in safe custody on behalf of customers.

Cut-off testing

Auditors must perform cut-off testing for cash transactions at the year end to ensure that there is no **window dressing** in order to overstate the liquidity of the company by:

a) **Keeping the cash book open** to include remittances received after the year end therefore increasing the balance at bank and reducing receivables.
    - Auditors should **examine the paying-in slip** to ensure that the amounts were actually paid into the bank on or before the period-end date.

b) **Recording cheques paid in the period** under review which are not actually despatched until after the year end, thus decreasing the balance at bank and reducing liabilities. This leads to a **large number of outstanding cheques** at the year end.
    - Auditors should check whether these were **cleared within a reasonable time** in the new period as this may indicate that despatch occurred after the year end.

Performing cut-off testing gives assurance over **completeness** and **existence** of cash balances at year end.

Activity 1

You have been given the following bank reconciliation prepared by Happy Fashions Co for their Centenary Bank account.

	Shs 000
Balance per bank statement at 31/12/2023	42,000
Adjusted for:	
Unpresented cheques	(12,000)
Outstanding deposits	32,000
Balance per cashbook at 31/12/2023	62,000

The following issues have been identified during the testing of the bank reconciliation:

a) Cheques totaling Shs 3,000,000 written on 2 January 2024 are included in the bank ledger account at the year end.
b) Customer payments totaling Shs 7,000,000 which were paid into the bank on 3 January 2024 are included in the bank ledger account at the year end.
c) Bank charges for December 2023 totaling Shs 1,000,000 were not charged by the bank until January 2024.

What are the effects of the above issues on the bank balance of Happy Fashions Co at 31/12/2023?

Substantive procedures for bank balances

a) Obtain **bank confirmation** letter for all its bank accounts from the client's banks.
b) Agree **all accounts** listed on the bank confirmations to the entity's bank reconciliations or the trial balance/general ledger to ensure completeness of bank balances.
c) Obtain the year end bank reconciliation statements and cast them to verify their **arithmetical** accuracy.
d) Agree the **balance per cash book** on the year end bank reconciliation statements to the cash book, trial balance and financial statements.
e) Agree the balance **per bank reconciliation** statements to the bank confirmation letters and year-end bank statements.
f) Trace all **unpresented cheques** to pre year end cash book and post year end bank statements. Obtain explanations from management any unusual delays.
g) Examine any **old unpresented cheques** that need to be reversed in the payables ledger.
h) Trace all **outstanding deposits** to the pre year-end cash book, bank statements and post year end and bank deposit slips pre year end. Any not cleared quickly after the year end should be investigated.
i) Review the cash book and bank statements for any **unusual items or large transfers** around the year end as this could be evidence of window dressing.
j) Examine the bank confirmation letter for details of any **security provided** for any legal right of set-off as this may require disclosure.
k) Review **disclosures** related to bank and cash in the financial statements to ensure they are accurate and complete.

Discussion question

You are an external auditor of Happy Fashions Co assigned to audit bank and cash during final audit. It is now 5 February 2025 and below is the company's bank reconciliation for the year ended 31 December 2024.

Happy Fashions Co – Bank reconciliation at 31 December 2024

	Shs 000	Shs 000
Balance per bank in the general ledger at 31/12/2024		435,000
Add: Outstanding cheques		
2411	102,500	
2721	23,000	
2722	50,000	
2723	13,450	
2724	19,000	
2726	22,000	
2728	10,050	
2729	15,760	
2730	12,550	268,310
		703,310
Less: Outstanding deposits		
30 December (ref 1122)	102,220	
31 December (ref 1123)	250,000	352,220
Balance per bank statement at 31/12/2024		351,090

a) Explain the importance of the bank letter and describe the procedures used to obtain confirmations from the bank.
b) Describe the substantive procedures the auditor would perform to obtain sufficient appropriate evidence in relation to the bank reconciliation.

Audit of cash balances

Cash includes unbanked cheques received, IOUs and credit card slips, in addition to notes and coins.
Auditors should conduct a cash count where cash balances are material as in retail businesses.
Auditors collect evidence on whether the cash **exists**, is **complete,** belongs to the company (**rights and obligations**) and is stated at the correct **value**.

Planning the cash count

Auditors need to determine the **locations** where cash is held and which of these locations warrant a count.
Where a location is not visited it may be appropriate to obtain a letter from the client confirming the balance.
Planning decisions will need to be recorded on the current audit file, including:

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

Performing a cash count

a) **Count cash balances** held and agree to petty cash book or other record.
b) All cash/petty cash books should be **written up** to date in **ink** (or other permanent form) at the time of the count.
c) All **balances** must be **counted** at the **same time and** in the presence of the individuals responsible.
d) Obtain **certificates** of cash-in-hand from responsible officials.
e) Inquire into any IOUs or cashed cheques outstanding for a long time.

f) **All negotiable securities** should be counted at the time the cash balances are counted.
g) At no time should there be **left alone** with the cash and negotiable securities.
h) **All cash** and securities **counted** must be **recorded** on working papers subsequently filed on the current audit file. **Reconciliations** should be prepared where applicable (e.g. imprest petty cash float).
i) Confirm that bank and cash balances as reconciled above are **correctly stated** in the financial statements.

Follow up procedures

a) Obtain **certificates** of cash-in-hand as appropriate.
b) Verify **unbanked cheques/cash receipts** have subsequently been **paid in** and agree to the bank reconciliation by **inspection** of the relevant documentation.
c) Ensure **IOUs** and cheques cashed for employees have been **reimbursed**.
d) Review whether **IOUs or cashed cheques outstanding** for **unreasonable periods** of time have been provided for.
e) Verify the **balances** as counted are reflected in the accounts (subject to any agreed amendments because of shortages and so on) by **inspection** of draft financial statements.

5.5 Payables, purchases, payroll, non-current liabilities, provisions and equity

Internal control considerations and focus on understatement

- The audit of payables is closely linked to the purchases system.
- Payables (trade payables and accruals) are audited together with purchases and other expenses.
- Liabilities and expenses may be understated in order to improve **liquidity and profits**.
- Therefore, the focus of the auditor is on **understatement** of liabilities by checking whether those at year end have been completely and accurately recorded**.**
- The audit objectives are to determine whether:
  - There is **proper cut-off** between goods received and invoices received so as to recognize purchases and trade payables in the correct period.
  - Trade payables represent **bona fide** amounts owed by the entity.

Assertions about transactions and related disclosures

a) **Occurrence** – all purchase transactions recorded have occurred and relate to the entity.
b) **Completeness** – all purchase transactions have been recorded.
c) **Accuracy** – amounts relating to transactions have been recorded appropriately.
d) **Cut-off** – purchase transactions have been recorded in the correct period.
e) **Classification** – purchase transactions are recorded properly in the accounts.
f) **Presentation** – all disclosures required are included, are accurate and properly presented.

Assertions about account balances and related disclosures at the period end

a) **Existence** – trade payables and accruals are valid liabilities.
b) **Completeness** – all liabilities have been recorded.
c) **Rights and obligations –** trade payables and accruals are obligations of the entity.
d) **Valuation** & allocation – trade payables and accruals are included in FS at appropriate amounts.
e) **Presentation** – all disclosures required are included, are accurate and properly presented.

Substantive procedures for payables and accruals

a) Obtain a **list of trade payables**, cast the list and agree the total to the general ledger and the statement of financial position.
b) Perform **analytical procedures** comparing payables and accruals against those of the previous year, budget and industry average e.g. calculating the **payables payment period** or compare the accruals listing to prior year and investigate any significant differences.
c) For a sample of suppliers (with material balances at year end, with a high volume of business, major suppliers with nil balances), reconcile the year-end balance on the payables ledger to the relevant **supplier statement** and investigate any reconciling items (*See Activity 2 below*).
d) For a sample of **post year end payments** in the cashbook and bank statements, determine whether they relate to the current year liabilities. If they do, vouch that these amounts are included in the purchases ledger or accruals listing to test for unrecorded liabilities (*See Activity 3 below*).
e) Select a sample of payable balances and perform a **trade payables' confirmation**, follow up any non-replies and investigate any reconciling items between the balance confirmed and the trade payables' balance (*See section on confirmation below*).
f) For a sample of **goods received notes** before the year end and after the year end, ensure the related invoices have been recorded in the correct period for proper cut-off.
g) **Vouch** a sample of amounts from the trade payables listing and accruals listing to supporting suppliers' invoices, goods received notes, purchase orders etc to verify rights and obligations.
h) R**ecalculate** a sample of accruals to ensure the amount accrued is accurate.
i) **Review** the trade payables listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately.
j) Read the **disclosure notes** relevant to payables and accruals in the draft financial statements and ensure information is accurate and properly presented at the appropriate amounts

Reconciliation of trade payables with supplier statements

a) The reconciliation also provides evidence on **existence and valuation** of trade payables.
b) Supplier statements are **reliable sources of evidence** as they are from outside the entity. **Photocopies** should not be used and in case they are tampered with, a copy should be requested for directly from the supplier or the balance should be confirmed with the supplier.
c) When selecting accounts for testing, the auditor should consider the **volume of business** during the year, not the balance outstanding at the year end, because the risk is understatement of balances.
d) All differences between balances on suppliers' statements and the year-end trade payables listing are either due to **goods or cash** in **transit or other reasons like disputes or errors**.

e) **Goods-in-transit**
   i) Inspect GRNs to ascertain whether the goods were received before year end.
   ii) Check whether the goods are included year-end inventory and purchase accruals. If not, there is a cut-off error that should be investigated.

f) **Cash-in-transit** received by the supplier after year end
   i) Inspect the cash book for the date the cheque was raised, the bank statement after the year end for the date for its subsequent clearing.
   ii) If cheques cleared after year-end were not sent to the supplier until after year end, the amounts should be added back to year-end trade payables and bank balance.

g) **Other reasons**
   i) Differences due to **disputed invoices** not posted by the client should be investigated and appropriate adjustments made where necessary.

ii) Differences due to **invoices held back** in order to reduce year-end balances should be added to trade payables.

- Where significant unexplained differences are discovered, it may be necessary to extend the testing.
- Where a sufficient number of statements is not available, consider alternative procedures like confirmation.

Activity 2 Supplier statement reconciliation

You are an audit associate in Divine & Co and has been allocated to the audit of trade payables of Happy Fashions Co for the year ended 31 December 2023. You have performed a reconciliation of key trade payables balances as follows and has concluded that no further work is required:

	Balance per Payables ledger	Cash in transit	Goods in transit	Balance per supplier statement
	Shs 000	Shs 000	Shs 000	Shs 000
Supplier 1	40,000	–	10,000 (i)	50,000
Supplier 2	65,000	5,000 (ii)	–	70,000
Supplier 3	10,000	–	–	10,000
	115,000			130,000

Notes

i) Agreed to GRN dated 31 December 2023

ii) Agreed to cheque posted in the cash book on 30 December 2023

Your follow-up work on this identifies that:

- The goods in transit received from Supplier 1 were recognised in inventory at 31 December 2023.
- The cheque payment to Supplier 2 appeared on the bank statement on 2 January 2024.
- There is a nil balance on the purchase accruals account.

1) Which of the in-transit items included in the supplier statement reconciliations indicate that there is a cut-off problem?
   A) Only (i) B) Only (ii) C) (i) & (ii) D) Neither (i) nor (ii)

2) What further evidence, if any, is required in relation to the balance due to Supplier 3 to determine if trade payables are understated?
   A) A review of post year end purchase orders from Supplier 3
   B) A confirmation request must be sent to Supplier 3
   C) No further evidence is required
   D) A review of credit notes issued by the Co should be performed

Activity 3 Post year payments

Below is a schedule of work performed on post year end payments by the audit team of Happy Fashions Co.

Date of payment	Amount paid (Shs)	Explanation	Included in payables ledger or accrual?
2/1/2024	25,000,000		Yes
3/1/2024	36,000,000	Payment for invoice to Freda Fabrics dated 15/12/2023	No
6/1/2024	50,000,000	Payment for invoice to Fabricated dated 2/1/2024	No
10/1/2024	2,000,000	Payment for December water bill	No

What evidence does the information in the above schedule provide about the payables balance at year end?

Confirmation of trade payables

- Not widely used as independent evidence can be obtained from supplier invoices and statements.
- However, confirmation may be used where supplier statements are not available and the client's internal controls are assessed as ineffective.
- Where an entity has an effective system to ensure all liabilities are recorded, confirm **large balances**.
- Where an entity does not have an effective system to ensure all liabilities are recorded, confirm:
  - Large balances
  - Other suppliers with a small or zero balance
  - A sample of other balances randomly selected
- A **positive confirmation** should be used and procedures are similar to those for trade receivables.

Substantive procedures for purchases and other expenses

Auditing payables provide some evidence over purchases but other procedures are performed include:

a) Calculate **gross profit margin and net profit margin** and compare to the previous year and budget and investigate any significant differences.
b) Review **monthly purchases and other expenses** to identify any significant fluctuations and discuss with management.
c) Review **annual purchases and other expenses on a line by line basis** and compare to the previous year and budgeted and investigate differences (*See example below*).
d) Select a sample of **purchase invoices** from the purchase journal and inspect the supporting GRNs, supplier invoices, delivery notes and authorised purchase orders to very occurrence.
e) For a sample of purchase invoices **recalculate** the purchase invoices totals and taxes and agree the amount to the general ledger to verify their accuracy.
f) Recalculate the year end **prepayments and accruals** to verify the accuracy of expenses in profit or loss.
g) Select a sample of **expense payments** from the cash book and trace to the relevant expense account in the general ledger to ensure the expense has been included and classified correctly.
h) Select a sample of **GRNs immediately before and after** the year end and agree the purchase to the purchase listing to ensure the expense is recorded in the correct period.
i) Enquire of management whether there are any **unsettled claims or obligations** at the year end and confirm they are included in profit or loss.

Activity 4 Analytical procedures on purchases and other expenses

Auditors of Divine & Co have prepared the following schedule which compares purchases of Happy Fashions Co. Identify areas that require further audit procedures.

Purchase	31/12/2024	31/12/2023	Difference (Shs)	Difference
	Shs 000	Shs 000	Shs 000	%
Electricity	20,000	19,000	(1,000)	5.6
Fuel	300,000	200,000	100,000	50
Vehicle repairs	50,000	40,000	(10,000)	(25)

Substantive procedures for payroll expenses

- **Agree the** wages and salaries expense per payroll to general ledger accounts and financial statements and investigate any differences to verify completeness and accuracy.
- Compare the **total payroll expense** to the prior year and budget and investigate any significant differences.
- Review **monthly payroll charges**, compare this to the prior year and budgets and discuss with management for any significant variances.

- Perform a **proof in total** of total wages and salaries, incorporating joiners and leavers and the annual pay increase to verify accuracy of the payroll expenses.
- Select a **sample of employees' wages and salaries** from the payroll and agree each to human resource records, records of hours worked, production records to verify occurrence and accuracy of remuneration.
- Trace a sample of time sheets/clock cards/production records and **overtime sheets** to the payrolls to verify completeness of the payrolls.
- Select a sample of **joiners and leavers**, agree their start/leaving date to supporting documentation, recalculate that their first/last pay was accurately calculated and recorded.
- **Re-perform calculations** on a sample of employees' gross pay and net pay on payrolls to verify the accuracy of the payroll expense.
- Verify the validity and accuracy of **deductions** by inspecting supporting documentation.
- Verify the **existence** of employees on the payroll by performing a head count, attending a wages payout, inspecting human resource records, PAYE and NSSF returns and staff lists signed by managers.
- Inspect payroll for **unusual items** and investigate them further by discussion with management.
- Confirm **net pay** per payroll to cash book, cheques or bank transfer summary to confirm completeness and accuracy.
- Agree **year-end liabilities** in the SOFP to payrolls and subsequent payment after the year-end in the cash book. Confirm that deductions were remitted on time by reviewing correspondence for any disputes.

NO	NAME	SCALE	BP	ALLOW	GP	DED	NP	ACC

GP	**100M**
PAYE	**20M**
NSSF	**5M**
NP	**75M**

Substantive procedures for non-current liabilities

a) Obtain or prepare a **schedule** of loans outstanding at the year end showing for each loan the name of the lender, date of loan, maturity date, interest date, interest rate, balance at the period end and security provided. Cast the schedule for verify accuracy and agree the balances to the trial balance/general ledger and draft financial statements.
b) For **new loans** in the year, review the loan agreements to confirm the amounts borrowed, the repayment terms and the interest rates applicable and agree the loan proceeds per loan agreements to the cash book and bank statements.
c) Review **board minutes** for any new borrowings which might not be recorded.
d) For **loans repaid**, agree the final settlement amount per bank correspondence to payments out during the year in the cash book and bank statements.
e) **Recalculate** finance charges for the period on the outstanding balances using interest rates per loan agreements and compare with the amounts charged in profit or loss.
f) Obtain **direct confirmation** from banks and other lenders of the amounts outstanding, accrued interest and any security held, agree confirmed amounts to the loans schedule to verify rights and obligations for loans.
g) Review all loan agreements for **details of covenants** to identify any potential or actual breaches.
h) Review the **disclosure** of non-current liabilities in the draft financial statements, including any security provided and assess whether these are in accordance with accounting standards and laws. Additionally, confirm that the split of current and non-current loans in the financial statements is correct.

Substantive procedures for provisions and contingencies

a) Obtain **details** of all provisions (opening balances, movements and closing balances) and all contingencies disclosed in financial statements as per IAS 37.
b) Consider the nature of the client's **business** and determine whether all expected provisions have been included for product warranty, legal claims and guarantees for loans etc.
c) Obtain **written representations** from directors on material provisions and contingencies.

d) Check that appropriate **disclosures** have been made in accordance with IAS 37 (nature, factors affecting future outcome and an estimate of the financial effect or a statement that such an estimate cannot be made).

e) For all material provisions:

i) Determine whether the company has a **present obligation** as a result of past events at the year end by:
- **Review** of **correspondence** relating to the item.
- **Discussion** with the directors to determine whether they **h**ave **created a valid expectation** in other parties that they will discharge the obligation.

ii) Determine for each material provision whether it is **probable** that a transfer of economic benefits will be required to settle the obligation by:
- Checking whether any **payments** have been made in the post year end period in respect of the item by reviewing after-date cash.
- Review of **correspondence** with lawyers, banks, customers, insurance company and suppliers both pre and post year end.
- Sending a **letter to the lawyer** to obtain their views (where relevant).
- Discussing the position of similar **past provisions** with the directors and whether these provisions were eventually settled.
- Considering the likelihood of **reimbursement**

iii) Determine whether provisions represent the **best estimate** of the liability by:
- **Recalculating** all provisions made.
- Comparing **amount** provided with any post year end payments and with any amount paid in the past for similar items and considering the opinion given by independent experts.
- In the event that it is **not possible to estimate the amount** of the provision, check that a contingent liability is disclosed in the accounts.

Substantive procedures for equity

Share capital	• Agree the **authorised share capital** with the memorandum and articles of association of the company. • Agree **changes** in authorised share capital with properly authorised shareholder resolutions.
Issue of or changes in shares	• Inspect minutes of **shareholder meetings** for company resolutions and **board minutes** authorizing the issue of or change in shares during the year. • Agree the **cash received** from the sale of shares with the amount in the cash book and bank statements and confirm the unpaid amount is included in called up share capital not paid in the financial statements. • Recalculate the **split of proceeds** and confirm it is correctly recorded in the share capital and share premium accounts.
Transfer of shares	• Verify the **transfer of shares** by inspection of completed transfer forms, canceled share certificates and minutes of directors' meetings. • Agree the **balances on shareholder accounts** in the share register and total list with the issued share capital in the general ledger.
Dividends	• **Recalculate** total dividends using issued share capital and the authorized dividends per as per board minutes, agree dividends paid before year end to the cashbook and bank statements and dividends declared before the year end to dividends payable in the SOFP. • Check that dividend payments do not **contravene** the Companies Act and IAS 1 and capital reserves like share premium and revaluation reserves are not distributable.
Reserves	• Agree **movements** on reserves to the non-current asset register and valuation reports and confirm they do not contravene the Companies Act and IFRSs. • Confirm that equity balances, dividends and restrictions on dividends are **properly disclosed** in the financial statements and comply with the Companies Act and IAS 1.

5.6 Audit sampling

Selecting items for testing in ISA 500

a) Selecting all items (100% testing)
More common for substantive procedures.
Is appropriate for:
- A population of a small number of **high value** items.
- Where there is a high risk of material misstatement and other procedures do not provide sufficient appropriate audit evidence.
- Repetitive calculations performed using automated tools and techniques.

b) Selecting specific items
Is appropriate for:
- High value or key items e.g. suspicious, risky or prone to error.
- All items over a certain amount.
- Items to obtain information e.g. about the nature of the entity's transactions.
- **Stratification** (the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics, (often monetary value).

c) Audit sampling – this the application of audit procedures to less than 100% of the items within the population of audit relevance such that all sampling units have equal chances of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
ISA 530 *Audit Sampling* gives guidance.

Type of sampling

There are two types of sampling: statistical sampling or non-statistical sampling.

a) **Non-statistical sampling** is where the auditor does not use any mathematical basis for selecting the sample. Non-statistical sampling methods include:

i) **Haphazard selection** where sample is selected without following a structured technique but which avoids any conscious bias or predictability like selecting two receipts from each page in a cash book. However, the auditor should not exclude items from the sample simply because they are difficult to locate. Auditors commonly use larger sample sizes to compensate for the biased selection of items.

ii) **Block selection** is where blocks of contiguous items in a day, week or month or numerical sequence from the population are selected to check whether they have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year. Block sampling may produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and therefore the errors found cannot be projected onto the rest of the population.

b) **Statistical sampling** uses:
- Mathematical number of tables to select a sample which is free from bias.
- Probability theory to measure sampling risk and evaluate sample results.

Statistical sampling methods include:

i) **Random selection** that uses random number tables or a computerized random number generator to select items in the sample. It ensures that all items in the population have an equal chance of selection.

ii) **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. For example, if the auditor has a population of 800 GRNs and requires a sample of 40, then the sample interval is 20 (800/40). A random starting point between 0 and 20, let us say 5 is determined using a random number generator or random number table. The auditor then tests every 20th item after 5, the second is No 25 (5 + 20), the third is No 45 (25 + 20), up to the last interval. The auditor should check that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.

iii) **Value weighted selection (or monetary unit sampling** (**MUS**) is where the population is randomly ordered and items are selected by weighting them in proportion to their monetary value. MUS increases the likelihood of selecting material items for testing. However, it does not cope with negative values.

Activity 1

Divine & Co is to confirm trade receivables (Shs 12,500 million) of Happy Fashions Co as at 31 December 2023. They have decided to stratify the population when selecting the sample. They are to confirm Shs 11,800 million owed by Tesco Supermarket and a sample of seven trade receivables to be selected from the following remaining receivables owing Shs 700 million (12,500m – 11,800m). The overall materiality for the audit is Shs 100m. Which of the following receivable balances will be selected for sampling using monetary unit sampling?

Customer	Balance Shs million	Cumulative total Shs million	Selected (Y/N)
Safari School wear	28	28	N
Clothing Terrain	33	61	N
Every day Wear	(6)	55	N
All About Clothes	21	76	N
Jim's Jumpers	38	114	Y
Look the Part	124	238	Y
Freya's Threads	8	246	N
Holly Aristocrat	73	319	Y
Girls on the Go	13	332	N
Odd One Out	67	399	N
Upward Trends	17	416	Y
Ivory Gowns	2	418	N
Skirts and all sorts	57	475	N
Dress for the Occasion	92	567	Y
Holiday Accessories	5	572	N
Ties with a Difference	12	584	N
Up and Out	9	593	N
In all Weather	16	609	Y
Duncan's Dresses	3	612	N
Ewan Trading	29	641	N
We're Going Exploring	12	653	N
Fred's Fashions	47	700	Y
	700		

Sampling risk

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

- The auditor must design a sample size sufficient to reduce sampling risk to an **acceptably low level.**
- The higher the sampling risk, the larger the sample size in order to obtain reasonable assurance.

Other factors influencing sample size

Risk of material misstatement	• If the auditor assesses inherent risk and control risk as high, the detection risk needs to below in order to reduce audit risk to an acceptably low level. • Detection risk includes sampling and non-sampling risk. • In order for sampling risk to be low, a larger sample size is needed.
Required confidence level	• This is how confident the auditor needs to be that the sample results are representative of the population as a whole. • The greater the confidence level, the larger the sample size.
Expected error	• This relates to the level of errors the auditor expects to find in the population. • The higher the expected error, the larger the sample size in order to make a reasonable estimate of the actual amount of the error in the population.
Tolerable error /misstatement	• This relates to the level of error or misstatement that the auditor can accept in the population before concluding that there is a material misstatement. • The lower the tolerable error/misstatement that, the larger the sample size.

Evaluation of sample results

After performing audit procedures on the sample, the auditor evaluates the sample results to determine whether they are satisfactory or whether further work is required. Where there are errors in the sample, the auditor should consider:

- The nature and cause of the error
- Whether the error is a one-off error (anomaly) or is a recurrent issue.
- Whether the error affects the objective of the audit procedure.
- Whether the error affects other arrears of the audit.

- An **anomaly** is misstatement or deviation that is not representative of misstatements or deviations in a population.

- If the audit procedure is not applicable to the selected item, the test must be performed on a **replacement item** e.g. when is cancelled when testing for evidence of authorisation of payment.

- If the auditor cannot apply the designed audit procedures (e.g. if documentation relating to the item has been lost), that item must be treated as a **deviation** from the prescribed control (for tests of controls) or a **misstatement** (for tests of details)

- **Tolerable misstatement** is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

- **Tolerable rate of deviation** is a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Tests of details

Where sampling has been used to perform test of details, the auditor **projects** misstatements found in the sample to the population and compare this to the tolerable misstatement.

Misstatements in **anomalies are** excluded when projecting sample errors to the population.

The total estimated misstatement in the population = Projected misstatement + Misstatements in anomalies and high value items examined 100%.

Using the ratio method, the projected misstatement = $\frac{\text{Misstatement in the sample x Population value.}}{\text{Sample value}}$

If the total estimated misstatement is higher than the tolerable misstatement in tests of details, the actual misstatement in the population may exceed the tolerable misstatement.

Activity 2 (*Continuation of Activity 1*)

You have obtained the following results:

Category	Recorded amount (Shs)	Audited amount (Shs)	Misstatements (Shs)
Tesco Supermarket	11,800m	11,750	50m
Other trade receivables	700m		
Total trade receivables	12,500m		
Number of trade receivables tested	7		
Total for balances tested	407m	387m	20m

Required:

a) Assuming the errors are not anomalous, calculate the expected error in trade receivables.

b) Assuming the tolerable misstatement was set at Shs 60m, explain what action should be taken.

Solution

a) Projected misstatements = $\frac{\text{Misstatement}}{\text{Sample amount}}$ x Book value = (20m/407m) x 700m = Shs 34,398,034

Actual overstatement in Tesco Supermarket	Shs 50,000,000
Expected total misstatements	Shs 84,398,034

b) As the expected total misstatement is higher than the tolerable misstatement, more evidence should be collected by:
- Extending the sample tested and then re-performing the projection.
- Designing and performing additional substantive procedures.

If further evidence allows the auditor to conclude that the actual misstatement in the population does not exceed tolerable misstatement, then the auditor will conclude that no adjustment is necessary. However the misstatement of Shs 84,398,034 will be note in the schedule of uncorrected misstatements.

If further evidence indicates that there is a misstatement that exceeds tolerable misstatement, then the auditor will ask the client to adjust the financial statements.

Tests of controls

For **tests of controls**, no explicit projection of errors is necessary because the sample deviation rate is also the projected deviation rate for the population as a whole. When there is one deviation in a sample of 40, the projected rate of deviation in the population is 1/40 = 2.5%. The auditor then decides whether the error rate is acceptable.

Activity 3

You are auditing the internal controls relating to the authorization of adjustments made to Happy Fashions Co's inventory system in to determine the accuracy of the adjustments. You have obtained the following results based on your sample.

Total number of adjustments made to inventory records during the year	1,500
Number of adjustments tested in the sample	225
Number of occasions when adjustments tested were not authorized	18

Required:
a) Assuming the errors are not anomalous ones, calculate the error rate in the sample.
b) Assuming the tolerable rate of deviation was set at 13%, explain what action should be taken.

Solution
Error rate in sample = 18/225 = 8%.

- This means the internal control operated effectively throughout the period and the auditor can rely on it when assessing the accuracy of adjustments made to the inventory records.
- No further testing is required. However, any monetary errors resulting from the 18 failures on internal control should be noted on the schedule on uncorrected misstatements.

Discussion question

You are to perform substantive tests of details on the following receivables balances to verify whether they are not materially misstated. Show how you would perform the tests using sampling.

	Amount (Shs)		Amount (Shs)		Amount (Shs)		Amount (Shs)
1	1,410,000	11	2,270,000	21	4,865,000	31	935,000
2	9,130,000	12	50,000	22	770,000	32	5,595,000
3	660,000	13	5,785,000	23	2,305,000	33	930,000
4	3,355,000	14	940,000	24	2,665,000	34	4,045,000
5	5,725,000	15	1,820,000	25	1,000,000	35	9,480,000
6	8,210,000	16	3,380,000	26	6,225,000	36	360,000
7	580,000	17	530,000	27	3,675,000	37	1,145,000
8	44,110,000	18	955,000	28	6,250,000	38	6,400,000
9	825,000	19	4,490,000	29	1,890,000	39	100,000
10	1,155,000	20	17,140,000	30	27,705,000	40	8,435,000
							207,295,000

Solution

a) Sample design

- Audit objective – to verify whether trade receivables in the SOFP are not misstated.
- Population: 40 trade receivables totaling Shs 207,295,000 for the period ended 31/12/2023.
  The population may be stratified as follows:

Stratum range (Shs)	No in population	Amount (Shs)
More than 15m	3	88,955,000
5m – 15m	10	71,235,000
Less than 5m	27	47,105,000

- Sampling unit – is the trade receivable balance

- Misstatement – is where the audit amount in the sample is different from the recorded amount.
- Sample size – this is determined using judgement, MUS tables or a formula based on audit guides:

Sample size = $\frac{\text{Population recorded amount* x Confidence Factor.}}{\text{Tolerable misstatement}}$

*High risk items and those exceeding TM are usually removed and tested 100%.

Three assurance levels are used:

Assurance level from test	Confidence level	Confidence factor
High	95%	3
Medium	86%	2
Low	63%	1

Assume the following:

- TM is set at Shs 9m (which is 4.3% of population value) and the five balances exceeding TM (totaling Shs 107,565,000) are tested 100%, the sample will be selected from the remaining 35 balances totaling Shs 99,730,000.
- The risk of material misstatement is moderate and substantive tests of transactions and substantive analytical procedures have not detected a material misstatement.

Confidence level is set at 86% and using the table above, the confidence factor is 2.
Therefore, sample size = (99,730,000 x 2) ÷ 9m = 22.

b) Sample selection and performance of audit procedures:

- As the population is stratified, a higher proportion of the sample is allocated to larger strata balances. All the remaining eight balances in stratum 2 are selected together with 14 balances from stratum 3. The sample may be selected haphazardly from stratum 3, e.g. selecting every other balance.

- Assume positive confirmation letters are sent to the 5 big and the 22 customers and misstatements are checked in each balance confirmed and using alternative procedures on those not confirmed.

- Assume the following are the results from the audit procedures:

Category	Recorded amount (Shs)	Audited amount (Shs)	Misstatement (Shs)
5 balances above TM	107,565,000	109,234,000	(1,669,000)
8 balances in stratum 2	52,625,000	51,835,000	790,000
14 balances in stratum 3	24,595,000	23,140,000	1,455,000
27	184,785,000	185,209,000	576,000

Projecting the misstatements using the ratio method:

Category	(Misstatement ÷ Sample amount) x Book value	Projected amount
14 balances in stratum 3	(1,455,000 ÷ 24,595,000) x 47,105,000	2,786,655

Total misstatements:

Actual understatement in the 5 balances above TM	(1,669,000)
Actual overstatement in the 8 balances in stratum 2	790,000
Projected overstatement in sampled items from stratum 3	2,786,655
	1,907,655

c) Evaluation of results

- The population is estimated to be overestimated by Shs 1,907,655.
- As the misstatement of Shs 1,907,655 is lower than tolerable misstatement of Shs 8m, trade receivables may not be materially misstated.
- Even if the amount of the likely misstatement is not considered material, the auditor must wait to make a final evaluation until the entire audit is completed. The auditor should request the client to correct the misstatements identified, unless they are considered trivial.