ANSWERS TO TOPIC 3 QUESTIONS

PPE

Activity 1

a) The following are areas of concern to the auditor:

i) Depreciation on property = Shs 1,355,585,000 x 5% = Shs 67,779,000.
Shs 1,355,585,000 = Shs 556,151 + Shs 799,434 that includes land of Shs 500 m bought in the period.
Depreciation on land = Shs 500m x 5% = Shs 25m, this is overstatement in depreciation on property.

ii) Depreciation policies for land and buildings at a useful life of only 20 years appears aggressive as the standard useful life for buildings is 40 – 50 years.

iii) Computers depreciated at 15% is very high as the standard for computers 3 – 4 years.

iv) Depreciation on disposal for computers and equipment exceeds the amount disposed of. This indicates an error in the records or that assets have been depreciated even when fully written down to zero.

v) Depreciation on computers and equipment is based on 15% of opening cost plus additions
= Shs 111,801,000 x 15% = Shs 16,770,000.
This is against the policy of no depreciation on year of disposal.
Depreciation should be Shs 71,289,000 x 15% = Shs 10,693,350.
Depreciation over charged on the disposals = Shs 16,770,000 – Shs 10,693,350 = Shs 6,077,000.

vi) Depreciation on fixtures and fittings is at 15% straight line rather than the policy of 10%.

Depreciation at 15% = 80,373,000 x 15% =	Shs	12,056,000
Depreciation at 10% = 80,373,000 x 10% =	Shs	8,037,300
Overstatement in depreciation =	Shs	4,019,000

vii) Overstatement in deprecation of tangible assets = 25,000,000 + 6,077,000 + 4,019,000 =
Shs 35,096,000. However, the additional depreciation on computers would reduce this amount.

e) Specific substantive procedures for additions to equipment

i) Obtain the detailed breakdown of the costs incurred on the new equipment, cast the breakdown and confirm that it is included in the non-current asset register I order to confirm completeness of the addition.

ii) Confirm the purchase price of Shs 32m and delivery and installation costs of Shs 1m to supplier invoices and that the invoices are in the names of Happy Fashions Co in order to confirm valuation and rights and obligations.

iii) Discuss the treatment of the refundable VAT of Shs 5.4m with the finance manager as this should be excluded from cost. Agree to inclusion in the VAT account.

iv) Request that management expenses the Shs 600,000 training costs to profit or loss as they are not eligible for capitalization. Confirm to a journal entry that the adjustments have been made.

v) Select a sample from non-current asset register and physically inspect the new equipment to confirm existence.

f) Substantive procedures for computer additions and disposals

i) **Cast the schedule** of a**dditions** to computers, cast it and agree the total to the disclosure note for property, plant and equipment. Agree the cost of the computers given in part-exchange to the disclosure note to confirm that they have been removed from cost carried forward.

ii) For a sample of new computers on the schedule of additions agree the cost to the purchase invoice, ensuring that the recorded cost includes the cash amount paid plus the trade-in allowance for the old vehicle. Confirm that the invoice is made out to Happy Fashions Co.

iii) **Physically inspect** a sample of additions, confirming that the serial numbers of the computers agree to that on the non-current assets register.

iv) Review the **non-current assets register** to confirm that the 5 old computers were removed and that the new ones were included.

v) **Recalculate the loss on disposal** of Shs 11m (Shs 18m + Shs 39m) – Shs 46m) and agree to the trial balance and statement of profit or loss.

vi) Agree the cash payment of Shs 39m to the cash book and bank statement.

vii) **Recalculate the depreciation expense**, confirming that the depreciation expense was based on the old computers until 31 December 2023 and none in 2024.

viii) **Recalculate accumulated depreciation** on the computers disposed of and confirm that this has been removed from accumulated depreciation carried forward.

ix) In light of the loss on disposal, **review depreciation rates** on existing computers to establish if the carrying amount of other computers may be overstated.

x) Discuss with management of Happy Fashions Co's **history of computer replacement** to establish if computers are being used for the entire period of their estimated useful life.

xi) Discuss with management why **trade-in allowances** were so much lower than the carrying amounts of the computers to provide further evidence as to whether depreciation policies are reasonable.

xii) Review the notes to the financial statements to ensure that disclosure of the additions and disposals is in accordance with IAS 16 Property, Plant and Equipment.

Substantive procedures for the research and development expenditure of Humura Ltd

i) Obtain and cast a schedule of intangible assets, agree the closing balances to the general ledger, trial balance and draft financial statements.

ii) Discuss with the chief finance officer the rationale for the four-year useful life and consider its reasonableness.

iii) Recalculate the amortisation charge for a sample of intangible assets which have commenced production and confirm that it is in line with the amortisation policy of straight line over four years and that amortisation only commenced from the point of production.

iv) For the three new computing software projects, discuss with management the details of each project along with the stage of development and whether it has been capitalised or expensed.

v) For those expensed as research, agree the costs incurred to invoices and supporting documentation and to inclusion in profit or loss.

vi) For those capitalised as development, agree costs incurred to invoices.

vii) Confirm technically feasibility and intention to complete the project by discussion with development managers or review of feasibility reports.

viii) Review market research reports to confirm Humura Ltd has the ability to sell the product once complete and probable future economic benefits will arise.

ix) Review the costs, projected revenue and cash flow budgets for the each of the three projects to confirm Humura Ltd has adequate resources to complete the development stage and that probable future economic benefits exist. Agree the budgets to supporting documentation.
x) Review the disclosures for intangible assets in the draft financial statements to verify that they are in accordance with IAS 38 *Intangible Assets*.

INVENTORY

Activity 1

Inventory count deficiencies and recommendations

Control deficiency	Control recommendation
The warehouse manager is planning to supervise the inventory count. Whilst he is familiar with the inventory, he has overall responsibility for the inventory and so is not independent. He may want to hide inefficiencies and any issues that arise so that his department is not criticised.	An alternative supervisor who is not normally involved with the inventory, such as an internal audit manager, should supervise the inventory count. The warehouse manager and his team should not be involved in the count at all.
There are ten teams of counters, each team having two members of staff. However, there is no clear division of responsibilities within the team. Therefore, both members of staff could count together rather than checking each other's count; and errors in their count may not be identified.	Each team should be informed that both members are required to count their assigned inventory separately. Therefore, one counts and the second member checks that the inventory has been counted correctly.
The internal audit teams are undertaking inventory counts rather than reviewing the controls and performing sample test counts. Their role should be focused on confirming the accuracy of the inventory counting procedures.	The internal audit counters should sample check the counting undertaken by the ten teams to provide an extra control over the completeness and accuracy of the count.
Once areas are counted, the teams are not flagging the aisles as completed. Therefore there is the risk that some areas of the warehouse could be double counted or missed out.	All sections should be flagged as completed, once the inventory has been counted. In addition, internal audit or the count supervisor should check at the end of the count that all 20 sections have been flagged as completed.
Inventory not listed on the sheets is to be entered onto separate sheets, which are not sequentially numbered. Therefore the supervisor will be unable to ensure the completeness of all inventory sheets.	Each team should be given a blank sheet for entering any inventory count which is not on their sheets. This blank sheet should be sequentially numbered, any unused sheets should be returned at the end of the count, and the supervisor should check the sequence of all sheets at the end of the count.
The sheets are completed in ink and are sequentially numbered, however, there is no indication that they are signed by the counting team. Therefore if any issues arise with the counting in an aisle, it will be difficult to follow up	All inventory sheets should be signed by the relevant team upon completion of an aisle. When the sheets are returned, the supervisor should check that they have been signed.

as the identity of the counting team will not be known.	
Damaged goods are not being stored in a central area, and instead the counter is just noting on the inventory sheets the level of damage. However, it will be difficult for the finance team to decide on an appropriate level of write down if they are not able to see the damaged goods. In addition, if these goods are left in the various sections, they could be inadvertently sold to customers or moved to another section.	Damaged goods should be clearly flagged by the counting teams and at the end of the count appropriate machinery should be used to move all damaged items to a central location. This will avoid the risk of selling these goods. A senior member of the finance team should then inspect these goods to assess the level of any write down or allowance.
Happy Fashions Co undertakes continuous production and so there will be movements of goods during the count. Inventory records could be under/overstated if goods are missed or double counted due to movements in the warehouse.	It is not practical to stop all inventory movements as the production needs to continue. However, any raw materials required for 31 December should be estimated and put to one side. These will not be included as raw materials and instead will be work-in-progress. The goods which are manufactured on 31 December should be stored to one side, and at the end of the count should be counted once and included within finished goods. Any goods received from suppliers should be stored in one location and counted once at the end and included as part of raw materials. Goods to be despatched to customers should be kept to a minimum for the day of the count.
The warehouse manager is to assess the level of work-in-progress and raw materials. In the past, a specialist has undertaken this role. It is unlikely that the warehouse manager has the experience to assess the level of work-in-progress as this is something that the factory manager would be more familiar with. He may make a mistake in assessing the quantities then inventory could be materially misstated.	A specialist should be utilised to assess both work-in-progress and the quantities of raw materials. The warehouse manager could estimate the raw materials and the specialist could check it. This would give an indication as to whether he is able to accurately assess the quantities for subsequent inventory counts.

Activity 2

a) i) There are 330 bags of Simba cement per inventory record compared to 200 counted. This needs investigating as it may indicate an overstatement of inventory in the statement of financial position.

ii) An inventory count for Versatile sheets G28 shows 901 sheets compared to 900 in the inventory record. This small difference may be due to a counting error and should be examined to ensure completeness of the inventory balance.

i) The colored sheets G30 have been damaged. This requires investigating as the inventory may require to be written off if they cannot be sold or written down if they can be sold at lower price. In both cases, there may be an overstatement of inventory in the statement of financial position and an adjustment has to be made.

b) Inspect the inventory count sheets for any notes on damaged inventory sheets and inquire with management as to whether this inventory has been sold or scrapped since the year end. If any of this inventory has been sold, agree to sales invoices to ensure the accuracy of the valuation. If neither sold nor scrapped, discuss the saleability of the damaged inventory with management to ensure the valuation of inventory is the lower of cost and net realizable value.

Inspect the inventory count sheets and note any differences between the quantities par inventory records and the quantities par inventory count. Inquire whether management has followed up any differences and agree that any necessary adjustments have been made in the ledgers of Happy Fashions Co. This ensures the existence and completeness of the inventory balance.

Activity 3

IAS 2 requires inventory to be measured at the lower of cost and net realisable value (NRV).
NRV is the estimated selling price less estimated costs necessary to make the sale.

Inventory code	*Days in inventory*	*Original cost*	*Selling price*	*Costs to sell*	*Carrying amount*
		Shs	Shs	Shs	Shs
C 800	98	120,000	202,000	20,000	120,000
C 600	127	145,000	160,000	25,000	135,000
C 500	109	180,000	260,000	30,000	180,000
					435,000

Inventory is overstated by Shs 60,000 and should be written down to Shs 435,000.

Activity 4

Substantive procedures for inventory valuation:

i) For a sample of inventory items (finished goods and WIP), obtain the relevant cost sheets and confirm raw material costs to recent purchase invoices, labour costs to wage records and overheads allocated are of a production nature and based on the normal level of production.
ii) Select a sample of year-end finished goods and review post year-end sales invoices to ascertain if net realizable value (NRV) is above cost or if an adjustment is required.
iii) For the defective food item, discuss with management their plans for disposing of these goods, and why they believe these goods have a NRV of Shs 4m.
iv) If any of the defective items has been sold after the year-end, agree to the sales invoice to assess NRV.
v) Agree the cost of Shs 7.2m for the defective item to supporting documentation to confirm the raw material cost, labour cost and any overheads attributed to the cost.
vi) Confirm if the final adjustment for defective item Shs 3.2m (7.2m – 4m) and discuss with management if this adjustment has been made; if so confirm the write down.
vii) Review the financial statements disclosures relating to inventory write down to ensure they comply with IAS 2 *Inventories*.

RECEIVABLES

Activity A

a) The balance of Shs 11,800 million due from Tesco Supermarket is the largest balance owed and Shs. 5,900 million of this has been outstanding for 90 days or more. The supermarket gets 60 day credit any issues with recoverability of this amount could impact the financial statements.

   There are old balances due from:
   - Clothing Terrain (Shs 2m)
   - Fred's Fashions (Shs 4m)
   - Holly Aristocrat (Shs 12m)
   - Ivory Gowns (Shs 2m)
   - Look the Part (Shs 1m)

   These balances would need to be investigated to assess the likelihood of payment being received.

   Every day wear has a credit balance of Shs 6m of their account. Why is this and shouldn't this amount be shown as a payable rather than a receivable?

b) See (a) under valuation above.

Activity 2

a)

- Tesco Supermarket should have paid Shs 5,900m in January and February (3,600m + 2300m as they have a 60 day credit. As the supermarket paid Shs 5,680, Shs 220m has not been paid (5,900m – 5,680m).
- Every day Wear, there been no movement on the credit balance
- Fred's Fashions has not paid Shs 4m due at the year end
- Holly Aristocrat has not paid Shs 10m due at the year end
- Ivory Gowns has not paid Shs 2m due at year end and it seems there is no more business with customer.
- We're Going Exploring has not paid Shs 7m

These should be investigated as the recoverability may be doubtful for balances more than 90 days old.

b) See (c) under valuation above.

Activity 3

Dress for the occasion

Trace the cash in transit of Shs 39m to the cash receipts book post year end. Vouch that it was received within a few days of the year end.

Ewan trading

Confirm whether the balance has been paid after year end.

Fred Fashions

a) Investigate the difference of Shs 4m and identify whether this relates to timing differences or whether there are possible errors in the records of Happy Fashions Co.
b) If the difference is due to timing, such as cash in transit, details of the difference should be agreed to post year-end cash receipts in the cash book.
c) If the difference relates to goods in transit, then details should be agreed to a pre year-end GDN.
d) The receivables ledger should be reviewed to identify any possible mis-postings as this could be a reason for the difference with Fred Fashions.

Upward trends

Inspect the GDNs number 127057 and determine the date on which the goods were dispatched. If the goods were not dispatched until after the year end, request that management removes the amount from revenue and receivables and record the goods as inventory at the year -end.

Jesco Supermarket

a) Discuss the reason for the disputed invoice with management and review the customer correspondences file for any additional information.
b) Enquire from management whether a credit note has been issued post year end in relation to this and physically verify the credit note.
c) If no credit note has been issued, discuss recoverability of the amount with credit control/management

Look the Part

a) The credit balance should be discussed with the finance department to understand how it has arisen.
b) Review the payables ledger to identify if Look the Part is a supplier as well as a customer; if so, a purchase invoice may have been posted in error to the receivables rather than payables ledger.
c) If the difference is due to credit notes, this should be agreed to pre year-end credit notes dispatched around the year-end date.
d) The receivables ledger should be reviewed to identify any possible mis-postings as this could be a reason for the difference with Look the Part.

Discussion qn

Substantive procedures for revenue

- Compare the **total revenue** against prior years and budget for the year and investigate any significant fluctuations to verify completeness of revenue.
- Obtain a **schedule of sales** for the year broken down on a month by month basis or into main product categories and compare to those for the previous year and discuss any unusual movements with management to verify completeness.
- Calculate the **gross profit margin** for the entity and compare this to the prior year and investigate any significant fluctuations to verify completeness of revenue.
- Select a sample of sales invoices from the sales journal and inspect the **relevant GDNs** and sales orders to verify the occurrence of revenue (consider exceptions for consignment and bill and hold arrangements).
- Carry out a **sequence check** on GDNs.
- Select a **sample of cash sales** in the cashbook and agree to receipts, daily sales reports/till roll, deposit slips and bank statements to verify occurrence of cash sales.

- Select a sample of sales invoices from the sales journal and agree the **prices and terms** to the price list to confirm the accuracy of invoices.
- For a sample of invoices, **recalculate** invoice totals including any discounts and VAT to verify the accuracy of invoices and trace each to the receivables ledger and general ledger accounts.
- Select a sample of **credit notes** raised, inspect the related invoice and goods received notes and ensure the invoice has been correctly removed from revenue.
- Select a **sample of GDNs** and agree these to sales invoices in the sales journal, revenue accounts in the general ledger and customer accounts in the receivables ledger to confirm completeness of revenue.
- Select a sample of **GDNs before and after the year end,** inspect the dates on the corresponding sales invoices and the dates they were recorded in the receivables and general ledgers to ensure they are recorded in the correct accounting period to verify cut-off of sales.

BANK

Activity 1

Solution

i) The bank balance has been reduced by Shs 3m in respect of cheques not posted until after the year end.
ii) The bank balance has been increased by Shs 7m in respect of deposits made the after year end.
iii) As the bank charges were not charged by the bank until January, these would have been recognized as an accrual at the year end and therefore would have no effect on the year end bank balance

Revised bank reconciliation:	Shs 000
Balance per bank statement at 31/12/2023	42,000
Adjusted for:	
Unpresented cheques (12m – 3m)	(9,000)
Outstanding deposits (32m – 7m)	25,000)
Balance per cashbook at 31/12/2023	58,000

The bank balance is overstated by Shs 4m (62m – 58m).

Discussion question

Solution

a) The bank letter is important because it is independent confirmation of a number of significant matters in the client's financial statements. It confirms cash and bank balances which may well be a significant asset. It also provides confirmation of customers' assets held as security, customers' other assets held (as custodian) and contingent liabilities. Auditors also ask the bank to give details of other banks and branches that the respondent bank is aware of having a relationship with the client. (Part 2 See notes)

b) Substantive procedures for bank reconciliation
i) Obtain a bank **confirmation letter** for the bank account from Happy Fashions Co's bank.
ii) Obtain the year end bank reconciliation and cast it to verify its **arithmetical** accuracy.
iii) Agree Shs 435,000,000 per cash book on the year-end bank reconciliation statement to the cash book, trial balance and financial statements.
iv) Agree Shs 351,090,000 **per bank reconciliation** statement to the bank confirmation letter and year-end bank statement.

v) Trace all **unpresented cheques** to the December 2024 cash book and the bank statement for January 2025. Obtain explanations from management for cheque No 2411 not cleared at the time of the audit and appears was raised much earlier in the year.

vi) Trace the **outstanding deposits** (Nos 1122 and 1123) to the pre year-end cash book, the bank statement for January 2025 and the bank deposit slips to confirm that they were deposited prior to the year end and cleared quickly after the year end. Any not cleared quickly after the year end should be investigated.

vii) 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.

viii) Examine the bank confirmation letter for details of any **security provided** by Happy Fashions Co for any legal right of set-off as this may require disclosure.

ix) Review **disclosures** related to bank and cash in the financial statements to ensure they are accurate and complete.

PAYABLES

Activity 2 Supplier statement reconciliation

A) Goods in transit only

The goods were received before the year end and have been recognised in inventory.
A liability should therefore be recognised in the current accounting period.

Cash in transit

Although the cheque was cleared after the year end it was issued before the year end and there is nothing to suggest that it has been deliberately held back. The cash in transit is therefore a legitimate reconciling item.

C) No further evidence is required in respect of this account as the supplier statement balance agrees with that on the purchase ledger.

Purchase orders made after the year end would not have any effect on current year liabilities.
As a supplier statement is available, there is no need to ask for a confirmation of the balance from Supplier 3.
Credit notes issued by the client would potentially affect receivables, not payables, balances.

Activity 3 Post year payments

a) Payment to Freda Fabrics relate to an invoice dated before year end but have not been included in the year end payables ledger. This means that the payables and purchase are understated by Shs 36m. An adjustment should be made to include Shs 36m.
b) Payment to Fabricated is correctly excluded from the payables ledger at the year end since it relates to an invoice received after the year end.
c) Payment of Shs 2m for water has not been included in the accrual listing as it relates an expense incurred in 2023. An adjustment should be made to include Shs 2m in accruals and water expense.

Activity 4 Analytical procedures on purchases and other expenses

a) There is an increase of 5.6% in the electricity expense. Determine whether this is due to an increase in the price of electricity or a slight increase in the use of electricity.
b) There is an increase of 50% in the fuel expense. Determine whether this is due to an increase in the price of fuel, increased travel, fraud or errors.
c) There is a decrease of 25% in vehicle repairs expense that looks unusual given the increase in fuel expense. Some expenses may have been classified wrongly and further investigation is required.