

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.

3.1 Non-current assets

Assertions (to be verified)

Assertion	Audit objective
Existence	<ul style="list-style-type: none">• 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	<ul style="list-style-type: none">• All additions and disposals that occurred in the year have been recorded• Balances represent assets in use at the year end
Rights and obligations	<ul style="list-style-type: none">• The entity has rights to the assets purchased and those recorded at the year end
Accuracy, valuation and allocation	<ul style="list-style-type: none">• Non-current assets are correctly stated at cost less accumulated depreciation• Additions and disposals are correctly recorded
Classification	<ul style="list-style-type: none">• 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	<ul style="list-style-type: none">• 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 2025.

	Land and Buildings	Computers & Equipment	Fixtures & Fittings	Total
	Shs 000	Shs 000	Shs 000	Shs 000
Cost				
At 1 January 2025	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	<u>200,000</u>			
At 31 December 2025	<u>1,555,585</u>	<u>71,289</u>	<u>80,373</u>	<u>1,707,247</u>
Depreciation				
At 1 January 2025	27,808	58,976	20,044	106,828
Charge for year	67,779	16,770	12,056	96,605
Elimination on disposal	<u>0</u>	<u>(46,849)</u>	<u>(20,044)</u>	<u>(66,893)</u>
At 31 December 2025	<u>95,587</u>	<u>28,897</u>	<u>12,056</u>	<u>136,540</u>
Carrying amount				
At 31 December 2025	<u>1,459,998</u>	<u>42,392</u>	<u>68,317</u>	<u>1,570,707</u>
At 31 December 2024	<u>528,343</u>	<u>6,687</u>	<u>2,336</u>	<u>537,366</u>

The depreciation policy for Happy Fashions Co 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 2025. 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 2025.

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 2025 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.

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*):

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 2025.

Solution

<p>Completeness</p> <ul style="list-style-type: none"> 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: <ul style="list-style-type: none"> - 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.
<p>Existence</p> <ul style="list-style-type: none"> 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.
<p>Rights & Obligations</p> <ul style="list-style-type: none"> 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.
<p>Valuation</p> <ul style="list-style-type: none"> 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

<p>general ledger to ensure they have been recorded properly.</p> <p>f) Review the list of additions to confirm they are capital expenditure rather than repairs and maintenance.</p> <p>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.</p> <p>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.</p>
<p>Disposals (Rights and Obligations, Completeness & Accuracy)</p> <p>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.</p> <p>b) Confirm that all disposals have been removed the entity's non-current asset register to verify existence.</p> <p>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.</p> <p>d) Inspect minutes of board meetings for evidence of authorization of disposals of non-current assets.</p> <p>e) Recalculate profit or loss on disposal and agree the amount to the general ledger and financial statements.</p> <p>f) Consider whether disposal proceeds are reasonable and are not included in revenue.</p> <p>g) Recalculate the depreciation up to the date of disposal, based on the entity's accounting policy to ensure it has been calculated correctly.</p> <p>h) If the asset was used as security, confirm the removal of the asset from the mortgage register.</p> <p>i) Trace the proceeds from the sale to the cash book and bank statements.</p>
<p>Classification</p> <p>a) Review the non-current asset disclosures in the financial statements to ensure they meet IAS criteria.</p> <p>b) For a sample of fully depreciated assets, inspect the register to ensure no further depreciation is charged.</p>
<p>Presentation</p> <p>Review the non-current asset disclosures in the financial statements for compliance with relevant IAS 16.</p>

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

	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 2024. 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 in relation to the research and development expenditure of Humura Ltd.

3.2 Inventory

Assertions (to be verified)

Assertion	Audit objective
Existence and occurrence	<ul style="list-style-type: none"> Recorded purchases and sales represent inventories bought and sold. Inventory on the statement of financial position physically exists
Completeness	<ul style="list-style-type: none"> All purchases and sales are recorded. All inventory at year end is included on the SOFP.
Rights and obligations	<ul style="list-style-type: none"> The entity has rights to inventory recorded in the period and at the year-end.
Accuracy, valuation and allocation	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> Inventory is recorded in the proper accounts
Cut-off	<ul style="list-style-type: none"> All purchases and sales of inventories are recorded in the correct period.
Presentation	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • Systematic counting to ensure all inventory is counted • Teams of two counters, one counting & the other checking or two independent counts
Recording	<ul style="list-style-type: none"> • 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 2025 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

- Trace items that were **test counted** to final inventory sheets.
- Inspect whether **all count records** have been included in final inventory sheets.
- Inspect **final inventory sheets** to ensure they are supported by count records.
- Ensure that continuous inventory records have been **adjusted** to the amounts physically counted or measured, and that differences have been investigated.
- 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
- Review **replies from third parties** about inventory held by or for them.
- Confirm the client's **final valuation** of inventory has been calculated correctly.
- Follow up **queries** and notify problems to management.
- Confirm necessary **adjustments** to book inventories have been made by inspecting the client's ledgers.
- Verify the **presentation and disclosure** of inventory.

Audit procedures for material inventory held by third parties

- Attend or arrange** for another auditor to attend the inventory count by the third party.
- 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
- Inspect **documentation** in respect of third-party inventory (e.g. warehouse receipts)
- 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	✓	X	Purchases cut-off	
	Payables	✓	X		
	Inventories	✓	X		

		GDNs before	GDNs after		
		Included in?	Included in?		
Revenue cut-off	Revenue	✓	X	Revenue cut-off	
	Receivables	✓	X		
	Inventories	X	✓		

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 must not be included 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.

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.

Substantive procedures for inventory

<p>Completeness</p> <ul style="list-style-type: none"> 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.
<p>Existence</p> <ul style="list-style-type: none"> 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.
<p>Rights and obligation</p> <ul style="list-style-type: none"> 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.
<p>Cut-off</p> <ul style="list-style-type: none"> • 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.
<p>Valuation, allocation & accuracy</p> <ul style="list-style-type: none"> 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: <ul style="list-style-type: none"> 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: <ul style="list-style-type: none"> 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 31.12.2024.

COUNT SHEET NO 20

Date: 4.1.2025
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	202,000	20,000	120,000
C 600	127	145,000	160,000	25,000	145,000
C 500	109	180,000	260,000	30,000	<u>230,000</u>
					<u>495,000</u>

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 2025. You are an audit supervisor with Divine & Co and you are responsible for the final audit of Happy Fashions Co to commence in February 2026. The draft financial statements for the year ending 31 December 2025 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.

3.3 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 invoice. 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
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	through to the financial statements to ensure all balances are recorded.
Rights and obligations	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 (<i>Activity 1</i>). b) Review whether there are any after-date cash receipts for slow moving/old receivable balances (<i>Activity B</i>). 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<p>a) Take a sample of sales invoices and examine for proper classification into revenue accounts.</p> <p>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.</p> <p>c) Read the disclosure notes relevant to receivables in the draft financial statements and review for understandability.</p>
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 2024

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

- What balances in the aged receivables listing require investigation and why?
- Describe the substantive procedure you will perform on the above balances.

Activity 2 Money received by 28/2/2025 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:

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

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

Procedures for external confirmation

- An auditor gets permission for confirmation from the client management.
- Obtain listing of trade receivables as at confirmation date
- Agree total to nominal ledger
- Review for any obvious omissions/misstatements by comparing this year's list with the last years
- Select a sample of accounts for confirmation. An aged receivables report may be used.
- Send an additional confirmation request if no reply in a reasonable time
- Follow up by phone/email/fax if still no reply
- Where no reply is received obtain confirmation of outstanding invoices using alternative procedures
- 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 **reasons** 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 and .
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.

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 invoice, goods dispatched notes and customer orders.

Activity 3 External confirmation

Below are the results from the external confirmation carried out at 31 December 2024 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	11.8	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

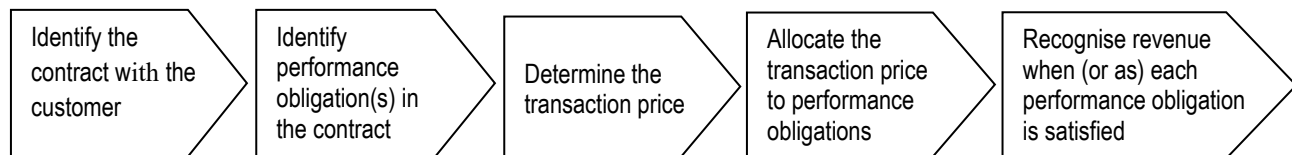
Where the reliability of the responses to the confirmation is doubted, the auditor should:

- Contact the confirming party.
- 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.



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	<ol style="list-style-type: none"> Trace the revenue on a sample of GDNs/cash sales/till rolls to sales summaries and sales ledger. Perform a sequence check on GDNs and cash sales. 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. Compare the gross profit percentage by product line with the previous year and/or industry data. Consider: <ol style="list-style-type: none"> The effect on sales value of changes in quantities sold The effect on sales value of changes in products or prices The level of goods returned, sales allowances and discounts 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
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	by product area and month or quarter. Discuss any significant differences with management.
Accuracy	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 2025. You are an audit supervisor with Divine & Co and you are responsible for the final audit of Happy Fashions Co to commence in February 2026. The draft financial statements for the year ending 31 December 2025 show revenue of Shs 400 million (Shs 300 million in 2024), profit before tax of Shs 54 million (42 million in 2024) and total assets of Shs 420 million (Shs 340 million in 2024). The following matters have been brought to your attention.

The credit controller left the company in July 2025 and has recently been replaced. The trade receivables collection period at 31 December 2025 was 68 days (48 days 2024) and the allowance for irrecoverable receivables was Shs 3 million (Shs 2 million in 2024). Yearend trade receivables amounted to Shs 92 million (Shs 70 million in 2024).

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.