

### 3.4 Bank and cash

#### Assertions

Assertion	Objective	Procedure
<b>Existence</b>	Recorded cash balances exist at the reporting date	Bank confirmation letter
<b>Completeness</b>	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
<b>Rights and obligations</b>	The entity has legal title to all cash balances shown at the period end	Bank confirmation letter
<b>Accuracy, valuation and allocation</b>	Recorded cash balances are realisable at the amounts stated	Bank confirmation letter Cash count Bank reconciliation
<b>Presentation</b>	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	<u>32,000</u>
Balance per cashbook at 31/12/2023	<u>62,000</u>

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	
		<u>268,310</u>
		703,310
Less: Outstanding deposits		
30 December (ref 1122)	102,220	
31 December (ref 1123)	<u>250,000</u>	<u>352,220</u>
Balance per bank statement at 31/12/2024		<u>351,090</u>

- 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.

## 3.5 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) **Recalculate** 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 items in **goods or cash 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 Shs 000	Cash in transit Shs 000	Goods in transit Shs 000	Balance per supplier statement Shs 000
Supplier 1	40,000	–	10,000 (i)	50,000
Supplier 2	65,000	5,000 (ii)	–	70,000
Supplier 3	<u>10,000</u>	–	–	<u>10,000</u>
	<u>115,000</u>			<u>130,000</u>

**Notes**

- i) Agreed to GRN dated 31 December 2023
- ii) Agreed to cheque posted in the cash book 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 is 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 Wilbur 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 of 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 verify 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 **have 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	<ul style="list-style-type: none"> <li>• Agree the <b>authorised share capital</b> with the memorandum and articles of association of the company.</li> <li>• Agree <b>changes</b> in authorised share capital with properly authorised shareholder resolutions.</li> </ul>
Issue of or changes in shares	<ul style="list-style-type: none"> <li>• Inspect minutes of <b>shareholder meetings</b> for company resolutions and <b>board minutes</b> authorizing the issue of or change in shares during the year.</li> <li>• Agree the <b>cash received</b> 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.</li> <li>• Recalculate the <b>split of proceeds</b> and confirm it is correctly recorded in the share capital and share premium accounts.</li> </ul>
Transfer of shares	<ul style="list-style-type: none"> <li>• Verify the <b>transfer of shares</b> by inspection of completed transfer forms, canceled share certificates and minutes of directors' meetings.</li> <li>• Agree the <b>balances on shareholder accounts</b> in the share register and total list with the issued share capital in the general ledger.</li> </ul>
Dividends	<ul style="list-style-type: none"> <li>• <b>Recalculate</b> 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.</li> <li>• Check that dividend payments do not <b>contravene</b> the Companies Act and IAS 1 and capital reserves like share premium and revaluation reserves are not distributable.</li> </ul>
Reserves	<ul style="list-style-type: none"> <li>• Agree <b>movements</b> on reserves to the non-current asset register and valuation reports and confirm they do not contravene the Companies Act and IFRSs.</li> <li>• Confirm that equity balances, dividends and restrictions on dividends are <b>properly disclosed</b> in the financial statements and comply with the Companies Act and IAS 1.</li> </ul>

## 3.6 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 20<sup>th</sup> 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	<ul style="list-style-type: none"><li>• If the auditor assesses inherent risk and control risk as high, the detection risk needs to be below in order to reduce audit risk to an acceptably low level.</li><li>• Detection risk includes sampling and non-sampling risk.</li><li>• In order for sampling risk to be low, a larger sample size is needed.</li></ul>
Required confidence level	<ul style="list-style-type: none"><li>• This is how confident the auditor needs to be that the sample results are representative of the population as a whole.</li><li>• The greater the confidence level, the larger the sample size.</li></ul>
Expected error	<ul style="list-style-type: none"><li>• This relates to the level of errors the auditor expects to find in the population.</li><li>• 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.</li></ul>
Tolerable error /misstatement	<ul style="list-style-type: none"><li>• 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.</li><li>• The lower the tolerable error/misstatement that, the larger the sample size.</li></ul>

## 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 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 =  $\frac{\text{Misstatement in the sample} \times \text{Population value}}{\text{Sample value}}$ .

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	<u>700m</u>		
Total trade receivables	<u>12,500m</u>		
Number of trade receivables tested	7		
Total for balances tested	407m	387m	20m

Required:

- Assuming the errors are not anomalous, calculate the expected error in trade receivables.
- Assuming the tolerable misstatement was set at Shs 60m, explain what action should be taken.

Solution

- Projected misstatements =  $\frac{\text{Misstatement}}{\text{Sample amount}} \times \text{Book value} = \frac{20\text{m}}{407\text{m}} \times 700\text{m} = \text{Shs } 34,398,034$

Actual overstatement in Tesco Supermarket	<u>Shs 50,000,000</u>
Expected total misstatements	<u>Shs 84,398,034</u>

- 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:

- Assuming the errors are not anomalous ones, calculate the error rate in the sample.
- 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
						<b>207,295,000</b>	

## 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:

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

\*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 =  $(99,730,000 \times 2) \div 9m = 22$ .

### 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
<u>14</u> balances in stratum 3	<u>24,595,000</u>	<u>23,140,000</u>	<u>1,455,000</u>
<u>27</u>	<u>184,785,000</u>	<u>185,209,000</u>	<u>576,000</u>

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	<u>2,786,655</u>

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	<u>2,786,655</u>
	<u>1,907,655</u>

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.