Audit procedures

Chapter learning objectives

When you have completed this chapter you will be able to:

• explain the purpose of substantive procedures in relation to financial statements assertions
• explain the substantive procedures used in auditing each balance, and
• tabulate those substantive procedures in a work program, for the following areas:
  – inventories
  – receivables
  – payables
  – bank and cash
  – non current assets
  – non current liabilities
  – accounting estimates
• explain the use of computer assisted audit techniques in the context of an audit
• discuss and provide relevant examples of the use of test data and audit software for the transaction cycles and balance sheet items
• discuss the use of computers in relation to the administration of the audit
• discuss and provide examples of how analytical procedures are used as substantive procedures
• compute and interpret key ratios used in analytical procedures
• discuss the problems associated with the audit of accounting estimates
• discuss the extent to which auditors are able to rely on the work of experts and internal audit
• discuss the audit considerations relating to entities using service organizations
• discuss why auditors rely on the work of others
• explain the extent to which reference to the work of others can be made in audit reports.

Audit procedures
1 General principles

A word of warning: Chapter 9 dealt with the principles of audit evidence. This chapter deals with how those principles are applied.

In the sections that follow, we will examine a number of specific audit areas and deal with how these are usually tested. You may be tempted to learn these by heart. Whatever you do,

**DO NOT DO THIS!!!!**

The audit of any item is based on:

- the risk of misstatement
- the nature of the item
- the assertion you are testing.

The examiner is not stupid. He or she knows that auditing is a matter of professional skill and judgement. If you can answer an exam question simply by learning a few pages of a book, it is not a very good test of whether you are a competent auditor.

So the questions may not ask about standard situations and you will have to apply your knowledge to the demands of the question.

**Things you always have to do**

Nevertheless, there are some things which, one way or another, will always apply (and which, if you mention them, will gain you marks):

- understand the system
- analytical procedures
- document your work.

**Things you will always have to consider**

**What are you being asked to test?**

- A transaction or event that took place during the year.
- An account balance at the period end.
- Presentation or disclosure.
What is the nature of the item you are testing?

- Asset
- Liability
- Revenue
- Expense

What assertion(s) are you testing?

- Existence
- Occurrence
- Valuation
- Cut-off, etc.

Things you may have to do

- If you rely on controls, you will have to test them.
- Management representations are required for some items by ISA 580 and by a number of other ISAs.
- If there are high volumes of transactions, consider using computer assisted audit techniques (CAATs).
2 Analytical procedures

Why do them?

Analytical Procedures as substantive evidence

ISA 520 states that analytical procedures must be used at the planning stage to identify risks, and at the completion stage of the audit as a final review of the FS.

They may also be used at the substantive stage when the auditor is auditing the draft financial statements.

Analytical procedures are not just the comparison of one year with another. AP’s can be used in the following ways:

- Ratio analysis
- Trend analysis
- Proof in total
In order to use analytical procedures the following process should be followed:

- Create your own expectation of what you think the figure should be
- Compare your expectation to the actual figure
- Investigate any significant differences
  - Example 1 - create an expectation of payroll costs for the year by taking last year’s cost and inflating for payrise and change in staff numbers – proof in total.
  - Example 2 – calculate the receivables day ratio and compare it with prior year and credit terms given to customers. If the figure is higher than expected it may indicate overstatement of receivables – ratio analysis.
  - Example 3 – plot monthly sales data for the prior year and plot against the current year and investigate any unusual trends. You would expect the business to follow the same pattern month on month especially if they have a seasonal business – trend analysis.
  - Example 4 – using the client’s depreciation policy, re-compute the expected depreciation charge and compare it with the actual depreciation charge. If there is a significant difference it should be investigated – proof in total.
How are analytical procedures used?

Calculating the ratios is just the start. Analytical procedures are audit procedures in their own right, designed to enable the auditor to reduce the risk of coming to the wrong opinion about the financial statements.

This means that the auditor needs to use analytical procedures to identify anomalies in the figures, which may indicate problems.

To do this, the auditor will make comparisons:

- between the current year and previous year(s)
- between actual figures and budgets, forecasts or client’s expectations
- with similar companies

Analytical procedures as substantive procedures

- ISA 520 states that the auditor may use analytical procedures as substantive procedures.
The suitability of this approach depends on four factors:

- The suitability of using substantive analytical procedures given the assertions.
- The reliability of the data.
- The degree of precision possible.
- The amount of variation which is acceptable.

Some examples.

(1) Suitability
   - Analytical procedures are clearly unsuitable for testing the existence of inventories – to do this you need to go and count the items on the shelves in the warehouse.
   - Analytical procedures may well be suitable for testing the value of labour carried forward in inventory – by comparing direct labour costs for the year with value in inventory, in the context of the costs of raw materials and overheads in inventory.

(2) Reliability
   - If controls over sales order processing are weak, it will probably be necessary to rely on tests of details rather than analytical procedures.

(3) Precision
   - There is likely to be greater consistency in gross margins over time than in discretionary expenditure like advertising or R&D.

(4) Acceptable variation
   - Variations in sales revenue, which may have a minor impact on the results for the year, will be regarded differently from receivables, which, if uncollectible will have a proportionately greater impact.
3 The audit of receivables

Receivables circularisation

Purpose:

• Direct third party confirmation to give evidence of existence and valuation.

Advantages:

• Independent evidence.
• External evidence.
• Relatively efficient (if successful).
Disadvantage

• Those circularised may not reply.

Method

• Select sample of receivables to be circularised.
• Inform client of intended list of those to be circularised.
• Consider implications if client objects to any of the accounts selected being circularised.
• Record names and amounts circularised.
• Record replies received and consider implications of any accounts not agreed.
• For non-replies perform alternative procedures (see below).

Other evidence in relation to accounts receivable

• Obtain a list of the individual balances from the receivables ledger, check the cast and agree the total to the trade receivables figure in the draft financial statements
• Ensure that balances have been correctly extracted from the receivables ledger
• Obtain a list of credit balances in the receivables ledger and obtain explanations from management
• Agree brought forward figures to last year’s audit file

Recoverability/Provision for doubtful debts [Valuation]

• Discuss the assumptions underlying the general provision with management to ensure reasonable
• Recalculate the provision based on management’s assumptions and agree to the figure in the financial statements
• Compare the prior year provision to the amounts actually written off as bad in the year to test how accurate management usually are in estimating possible bad debts
• Obtain a list of aged receivables and investigate the recoverability of any old balances
• Check whether receivables have paid after the year-end to ensure recoverability
• Where overdue receivables have not paid, trace the balances to the provision for doubtful debts. Where the balances are not included in the provision discuss with management the basis on which they believe the debtor to be recoverable.

**Presentation and disclosure**

• Check that the figures disclosed in the financial statements agree to the audited figures.

**Analytical review**

• Calculate the trade receivables collection period and compare to last year to assess reasonableness.

**Cut-off**

• Select a sample of GDN’s immediately prior to the year-end and immediately after the year end and ensure that they have been recorded in the correct period.

• For prepayments review relevant invoices to check calculation of prepayment and ensure that payment has actually been made by agreeing it to the bank statements.

**Income statement entries related to accounts receivable**

Check postings and validity of:

• bad debt write offs
• movements on bad debt provision
• recoveries from receivables previously written off.

Ensure doubtful receivables and recoveries identified from other audit work are properly reflected in the income statement.
The audit of inventories is usually regarded as one of the higher risk areas of the audit:

- It is usually crucial to assurance about an entity’s profit.
- It may be complex.
- It is usually subject to a degree of estimation.

They can also be very varied, e.g.:

- sheep or cows on a farm
- jewellery
- the costs of developing a computer game
- cars
- food and drink
- chemicals
- petrol.

That’s probably enough to be going on with!

How are inventories valued?
Finished goods and raw materials

INVENTORIES

KEY PRINCIPLE

VALUED AT THE LOWER OF COST AND NET REALISABLE VALUE (NRV)

FINISHED GOODS AND RAW MATERIALS

OBJECTS ON SHELVES, IN BINS, IN CUPBOARDS IN SHOPS, WAREHOUSES, ON LORRIES, ETC.

THESE CAN BE COUNTED, MEASURED, WEIGHED, ETC.

CONSIDERATIONS:
- PRICING
- OBSOLESCEENCE
- SALEABILITY
- DAMAGE
- NET REALISABLE VALUE
- MATERIALS CONTENT
- LABOUR CONTENT
- OVERHEAD CONTENT
Work in progress

WORK IN PROGRESS

PARTLY-COMPLETED OBJECTS AT WORKSTATIONS, ON THE FACTORY FLOOR, OR STORED WAITING COMPLETION

CONSIDERATIONS: STAGE OF COMPLETION COSTS TO COMPLETION NET REALISABLE VALUE MATERIALS CONTENT LABOUR CONTENT OVERHEAD CONTENT

PARTLY-COMPLETED MAJOR CONTRACTS – ROADS, BUILDINGS, SHIPS, AIRCRAFT, ETC.

THESE CAN BE COUNTED AND ESTIMATES MADE OF STAGE OF COMPLETION

THESE CAN BE INSPECTED AND ESTIMATES MADE OF STAGE OF COMPLETION OR EXPERT OPINIONS SOUGHT

UNAMORTISED COSTS OF DEVELOPING SOFTWARE, BOOKS,_recorded music

CAN'T BE COUNTED, BUT COSTS CAN BE VERIFIED FROM INVOICES, TIMESHEETS, ETC.

CONSIDERATIONS: SALEABILITY AMORTISATION POLICY
The inventory count

Principles

• The inventory count is a ‘one off’. It is a single opportunity to establish what is and what is not in inventory.

• Because of the crucial impact of inventory levels on the results for the year, it must be tested both for existence and completeness. (For most other areas the emphasis is likely to be on one or other of these assertions rather than both.)

• Inventory can consist of almost anything with different properties (see the list above). It can therefore be quite complex and so needs to be well organised by the client. The auditor needs to be equally well organised to ensure that sufficient, appropriate evidence is gathered.
• It is the client’s responsibility to establish the correct value of the inventory. The auditor’s job is to form an opinion as to whether that value is materially correct or not. It is therefore not the auditor’s responsibility to count the inventory, only to check that it has been done correctly.

**Procedures**

• Obtain clients’ instructions for the count and review them:
  – for obvious flaws
  – to ensure that the logistics for the audit team have been thought through
  – to obtain awareness of where the most material or otherwise risky inventory lines are to be found.

• Observe the count as it proceeds to ensure:
  – the client’s instructions are being followed
  – everything is counted and recorded
  – there is no risk of anything being included more than once
  – evidence of damaged or slow moving inventory is being recorded
  – cut-off is observed – no despatches or deliveries occur while the count is taking place, and there is no movement of inventory within the client’s premises which may confuse the count
  – inventory sheets (or whatever method is used to record the count – handheld devices, barcode readers, etc.) are properly controlled.

• Conduct test counts on a suitably random basis whilst gearing the tests towards material items:
  – **Existence** – it will be necessary to check from the client’s inventory records to your test data, so you need to ensure that you record sufficient details of the location and the items to be able to trace them later.
  – **Completeness** – you will need to be able to trace the items from your counts, into the client’s inventory records and will therefore need to record sufficient details to enable you to do this.

**Note.** These aspects of the count are crucial – the auditor needs to know in advance:

  – the details of the inventory
  – how the inventory will be recorded in the client’s system.

• **Record cut-off information:**
  – the last goods received record of the year
  – the last despatch record of the year.
Audit procedures at the final audit stage

- Obtain a list showing each individual line of inventories categorised between finished goods, WIP and raw materials. Cast and agree the total to the inventories figures in the financial statements.

Presentation and disclosure

- Check that the figures disclosed in the financial statements agree to the audited figures and that inventories have been correctly analysed between finished goods, raw materials and work in progress.

Valuation

- Trace some items of inventory in the inventory sheets back to original purchase invoices to agree the cost.
- Trace the same items of inventory to post-year-end sales to determine the net realisable value of inventory.
- For items that have not yet been sold trace to the provision for slow-moving inventory or discuss with management why these have not been provided for.
- Ensure that inventory is stated in the accounts at the lower of cost and net realisable value.

Analytical review

- Calculate inventory turnover and compare to last year to assess reasonableness.
- Calculate gross profit percentage and compare to prior year to assess reasonableness.

Cut-off

- Select a sample of GRN’s from immediately prior to the year end and included in year-end payables, and ensure that the goods are included in year-end inventories.
- Select a sample of GDN’s from immediately prior to the year end and included in year-end receivables, and ensure that the goods are not included in year-end inventories and that the invoice was raised in the correct period.

Year end counts and continuous inventory systems

The procedures suggested above apply to all inventory counts whether as a one-off year end exercise or where inventory is counted on a rolling basis throughout the year.
The objective is the same:

- To know what the client has in inventory at the time the count took place.

**Continuous inventory systems**

Where the client has a continuous inventory system, where a theoretical ‘book inventory figure’ is always known, there are both advantages and disadvantages for the auditor.

**Advantages**

- The auditor is less time constrained and can pick and choose particular locations and inventory lines at any time to ensure the system is working properly.
- Slow moving and damaged inventory should be identified and adjusted for in the clients’ records on a continuous basis therefore the inventory valuation should be more reliable.

**Disadvantages**

- The auditor will need to gain sufficient evidence that the system operates correctly at all times, not just at the time of the count.
- Additional procedures will need to be devised to ensure that the year end inventory figure is reliable, even though it may not have been counted at that date.

**Inventory held at third parties**

- Where the client has inventory at locations not visited by the auditor, the auditor normally obtains confirmation of the quantities, value and condition from the holder. The auditor needs to consider whether the holder is sufficiently independent to be able to provide relevant, reliable evidence.
- As with confirmations from receivables, the auditor requests details from the party holding the inventory on behalf of the client to confirm its existence.
- The confirmation request will be sent by the client to those parties identified by the auditor.
- The reply should be sent directly to the auditor to prevent it being tampered with by the client.
- Problems can occur if the third party uses a different description to that of the client and as always, a response is not guaranteed.
Other audit evidence about inventory

- For specialised inventory – livestock, property, food in restaurants, significant work in progress – it will be necessary to obtain evidence from experts – see section 12 of this chapter.
- The auditor needs to obtain evidence of the value of the inventory.
  - Cost information can be obtained from invoices and price lists.
  - The costs of manufactured inventory can be obtained from invoices and costing records.
  - The opinion of independent experts may be obtained.

Test your understanding 1

(1) **State three things the auditor should consider when reviewing a client's instructions for the inventory count.**

(2) **How would you test inventories for existence?**

(3) **How would you test inventories for completeness?**

(4) **Saxophone Ltd runs a petrol filling station. How would you test the quantities of petrol in inventory?**

(5) **Flute Ltd makes large machines out of very heavy lumps of steel. How would you assess its inventory of sheet and bar steel?**

(6) **Piccolo Ltd has a sheep farming business. How would you verify the number of animals it owns at the year end?**
5 The audit of payables and accruals

Principles

- The main thrust of the testing of payables is usually to test for completeness.
- Testing for existence, valuation, etc. is still important, but the major consideration, is for the auditor to gain assurance that all liabilities which should be included, are included.

You therefore have to think of the best indicators that additional liabilities may exist. If as a result of this, none are revealed, the testing of the values, rights and obligations of the payables we know about is relatively straightforward.

Possible indicators of additional liabilities

Does the list of payables at the year end:

- include all the major suppliers the client dealt with during the year?
- include all significant suppliers from the equivalent list last year?
- include all expected accruals? Rent, utilities, telephone, etc.
- include expected sources of financing for non-current assets? leasing, hire purchase, mortgages, etc.
• include all expected tax balances? Profits/corporation tax, payroll taxes, sales taxes, etc.
• include all suppliers revealed by a review of payments after the year end?
• include all suppliers revealed by a review of unpaid invoices at and after the year end?

Supplier statement reconciliations

For those suppliers’ balances selected for testing:

• obtain supplier statements at the balance sheet date
• compare with balance according to the client’s records
• seek explanation for differences from client staff.

There are generally two main explanations for differences:

(1) Timing differences:
   – Invoices not yet received by the client.
   – Payments not yet received by the supplier.
   – Returns and credit notes not yet appearing on the supplier’s statement.

(2) Errors
   – Supplier errors that will remain as part of the reconciliation until the supplier corrects them.
   – Client errors, which the client needs to adjust.

Note. It is possible that there are administrative reasons at the client for some of the differences:

• **Goods received accrual**— invoices received but not yet processed – perhaps awaiting authorisation, or perhaps ‘Mary does the postings on Tuesdays’ which means that invoices arriving between Wednesday and Monday are known about but not yet entered on the system.

• **Goods received not invoiced**— the client accrues for all goods received but does not post to the purchase ledger until the invoice is received.
- **Cheques in the drawer**—not a good idea to have signed cheques lying around, but sometimes for relatively short periods there may be a delay in sending out the cheque. Sometimes, with systems with automated payment runs, the accounts staff do not know how to prevent cheques being produced and the number of ‘cheques in the drawer’ can be quite substantial for long periods. This is a very bad idea, raises questions about the accounting staff’s competence, and, on the assumption the amounts are material, will mean the amounts will have to be added back to both bank and payables.

### Suggested layout for a supplier’s statement reconciliation

<table>
<thead>
<tr>
<th>Supplier’s statement reconciliation</th>
<th>Year end date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplier Limited</td>
<td>$  $</td>
</tr>
<tr>
<td>Balance per supplier statement</td>
<td>xxxx</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Returns/credit notes not yet credited</td>
<td>xx</td>
</tr>
<tr>
<td>Payments not yet received by supplier</td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>(xx)</td>
</tr>
<tr>
<td></td>
<td>XXX</td>
</tr>
<tr>
<td>Balance per purchase ledger</td>
<td></td>
</tr>
<tr>
<td>Invoices not yet posted</td>
<td>xxx</td>
</tr>
<tr>
<td>Goods received not invoiced</td>
<td>xxx</td>
</tr>
<tr>
<td>Reconciled balance</td>
<td>xxx</td>
</tr>
</tbody>
</table>

These figures should be the same!

### Accounts payable and accruals – other evidence

- Obtain a list of the individual balances from the payables ledger, check the cast and agree the total to the trade payables figure in the draft financial statements
- Ensure that balances have been correctly extracted from the payables ledger
- Obtain a list of debit balances in the payables ledger and obtain explanations from management
- Agree brought forward figures to last year’s audit file
Presentation and disclosure

- Check that the figures disclosed in the financial statements agree to the audited figures

Existence

- Circularise a sample of trade payables to confirm the balance at the end of the year [this is not a usual audit test, and is more or less the same format as for receivables confirmations except that negative confirmations are more acceptable]

Completeness

- Investigate any supplier names that were shown on last year's payables listing but do not have a balance showing in this year's list of balances
- Review after date invoices and payments and ensure they have been provided for at the year-end as appropriate
- Analytical review
- Calculate the trade payables payment period and compare to last year to assess reasonableness

Cut-off

- Select a sample of GRN's immediately prior to the year end and included in year-end payables, and ensure that the goods are included in year-end inventories

Accruals

- Review relevant invoices when received after the balance sheet date. If none are received, compare with previous periods.
- Obtain the list of accruals from the client, cast it to confirm arithmetical accuracy.
- Agree the figure per the schedule to the general ledger and financial statements.
- Agree the calculation of the accrual by reference to supporting documentation e.g. previous period invoice

Tax balances

- Corporation/Profits taxes – agree computations.
- Payroll taxes – agree to payroll records.
**Overdrafts, loans, etc.**

- Agree to bank confirmations.

**Leases, hire purchase creditors**

- Agree details to underlying agreement.

**Income statement entries related to accounts payable**

- Accruals will have a direct impact on the income statement accounts they relate to – ensure the postings have been put through correctly and any opening accruals have been properly reversed.
- Some accruals may themselves lead to additional accruals, e.g. accrued bonuses payable to directors and staff, may lead to additional employer’s social security charges.
- For all interest bearing accounts, loans, overdrafts, etc., ensure the correct accrual is made for interest payable.

**6 The audit of bank and cash**

- BANK AND CASH
- ASSERTIONS
- PROCEDURES
- EXISTENCE
- RIGHTS AND OBLIGATIONS
- VALUATION
- COMPLETENESS
- BANK LETTER
- BANK RECONCILIATION
- CASH COUNT
The bank letter (bank confirmation reports)

- Direct confirmation of bank balances gives the auditor independent, third-party evidence.
- The format of the letter is usually standard and agreed between the banking and auditing professions.
- Issues covered are:
  - the client’s name
  - the confirmation date
  - balances on all bank accounts held
  - any documents or other assets held for safekeeping
  - details of any security given
  - details of any contingent arrangements – guarantees, forward currency purchases or sales, letters of credit.
- The auditor needs the client to give the bank authorisation to disclose the necessary information. (In some jurisdictions such disclosures are illegal so bank letters cannot be used at all)
- Ensure that all banks that the client deals with are circularised.
- When items on the bank letter are dealt with, tick them off and cross-reference to the relevant working paper to make it easy to see that there are no outstanding items. The balances for each bank account should be agreed to the relevant bank reconciliation at the year end; interest charges should be agreed to the interest expense account in the general ledger; details of loans should be agreed to the disclosure in the balance sheet to ensure it is correctly classified into the current and non current elements.

Bank and cash – other evidence

- Obtain a list of all bank accounts, cash balances and bank loans and overdrafts and agree to totals to figures included in current assets and current liabilities in the financial statements
- Obtain a copy of the client's bank reconciliation, cast and agree the balances to the cash book and bank letter
- Trace all outstanding lodgements and unpresented cheques to pre-year-end cash book and post-year-end bank statements
- Ensure all accounts in the bank certificate are included in the financial statements
- Ensure bank loans and overdrafts are not offset against positive bank balances in the financial statements
- Count the petty cash in the cash tin at the end of the year and agree the total to the balance included in the financial statements
• Note. It is vital for an auditor conducting a cash count to do so in the presence of a member of the client’s staff and to obtain a signature for the amounts handed back into the client’s custody.

• Where there are multiple cash balances – a number of tills in a department store, etc. – it is important to ensure amounts cannot be moved between tills and that proper cut-off procedures are in place.

**Income statement and other account entries related to bank and cash**

• Clearly, bank loans, overdrafts and bank deposits all have interest implications.

• The bank letter may reveal details of security, borrowings and contingent liabilities which need to be disclosed in the financial statements.
7 The audit of tangible non-current assets

**Existence**

- Select a sample of assets from the **non-current asset register** and physically inspect them.

**Completeness**

- Select a sample of assets visible at the client premises and inspect the asset register to ensure they are included.
- Examine the repairs and maintenance accounts in the general ledger for large and unusual items that may be capital in nature.
Valuation

- Reperform depreciation calculations by:
  - selecting a sample of assets from the register and recalculating the charge for the year
  - recasting the list of individual asset depreciation charges
  - agreeing the total charge to the financial statement.
- Alternatively, agree this year’s charge as reasonable by taking last year’s charge and amending it for additions, disposals, revaluations, changes in method or policy, etc. Compare the predicted charge for the year with the actual charge, and seek explanations for any material differences.
- Assess depreciation policies for reasonableness by:
  - comparing methods used with prior year
  - comparing methods used with similar companies
  - analysing the recent trend of profits and losses on asset disposals.
- If any assets have been revalued during the year:
  - agree new valuation to valuer’s report
  - verify that all similar assets have also been revalued
  - reperform depreciation calculation to verify that charge is based on new carrying value.
- When physically inspecting assets, take note of their condition and usage in case of impairment.
- For a sample of assets, agree cost to purchase invoice (or other relevant documentation) ensuring all relevant costs have been included.
- If any assets have been constructed by the company, obtain analysis of costs incurred and agree to supporting documentation (timesheets, materials invoices, etc.).

Rights and Obligations

- For a sample of recorded assets, obtain and inspect ownership documentation:
  - title deeds for properties
  - registration documents for vehicles
  - insurance documents may also help to verify ownership (and asset values).
- Where assets are leased, inspect the lease document to assess whether the lease is operating or finance (if the latter, the asset should be included on the company’s balance sheet).
Disclosure

- Agree opening balances with prior year financial statements.
- Compare depreciation rates in use with those disclosed.
- For revalued assets, ensure appropriate disclosures made (e.g. name of valuer, revaluation policy).
- Agree breakdown of assets between classes with the general ledger account totals.

8 The audit of non-current liabilities

**Assumptions**

- **Existence:**
  - Review minutes, etc.
  - Review payments to possible lenders
- **Rights and obligations:**
  - Back to back with related assets
- **Valuation:**
  - Check calculations of interest
- **Completeness:**
  - Bank letter lenders' statements

**Loan payables**

- Agree loan balance to the loan statement.
- Agree interest payments to the loan agreement and the bank statements.
- Analyse relevant disclosures of interest rates, amounts due (e.g. between current and non-current payables) to ensure complete and accurate.
- Recalculate the interest accrual to ensure arithmetical accuracy.
Provisions and contingencies

Provisions are a form of payable where the amount or timing of payment is uncertain. As such they are harder to audit.

Where the likelihood of payment is only possible, rather than probable, no amounts will be entered in the accounts. However, the matter (contingent liability) must be adequately disclosed.

- Discuss the matter giving rise to the provision with the client to verify whether an obligation exists.
- Obtain confirmation from the clients lawyers as to the possible outcome and probability of having to make a payment.
- Review subsequent events. By the time the final audit is taking place the matter may have been settled.
- Obtain a letter of representation from the client as the matter is one of judgement and uncertainty. For more on representation letters see Chaper 11.

Test your understanding 2

(1) How would you verify that all unpresented cheques are included on a client’s bank reconciliation?
(2) State two things that might be included on a bank letter besides the balances on a client’s accounts.
(3) How would you test the rights and obligations assertion for a freehold property?
(4) How would you test the completeness of a client's hire purchase and leasing liabilities?
9 Relying on the work of others

Why rely on the work of other people?

- Auditors may **need** to rely on the work of others. (The ISAs stress the need for auditors to consult with others in appropriate circumstances.)
- Auditors may **choose** to rely on the work of others because they find it effective and efficient to do so.

The need to consult others

Auditors do not need to be experts in all aspects of their clients’ business.

Where they are unable to form an opinion without expert help the auditors will need to consult. Examples are:

- property valuations
- construction work in progress
Choosing to consult others

Because of the circumstances at a particular client, it may be effective and efficient for the auditor to rely on the work of others. Examples are:

- internal audit (see below)
- confirmation from external holders of the client’s inventory
- another firm of auditors for assurance on an overseas branch or subsidiary
- service organisations (see below).

What attributes do these ‘other people’ need?

ISA 620 Using the Work of an Expert states that the auditor should obtain sufficient and appropriate evidence that the work of the expert is adequate for the purpose of the audit.

In making this assessment the external auditor must assess the expert’s:

- independence and objectivity
- competence – consider:
  - qualifications
  - experience.

For example, the auditor might inspect a valuation report to provide evidence of a revaluation of land and buildings. However, this report might be have been produced by a qualified valuer who is a close friend or relative of one of the directors.

The auditor will have to decide whether:

- the valuer is sufficiently independent
- the report provided is reliable or not.
Relying on internal audit

- Internal audit forms a part of the client’s system of internal control.
- It may well therefore reduce control risk.
- The auditor will take this into consideration when planning audit procedures and reduced levels of substantive testing may therefore be appropriate.

The auditor cannot devolve responsibility for the audit opinion onto the internal audit department.

ISA 610 Considering the Work of Internal Audit states that before relying on the work of internal audit, the external auditor must first assess the internal audit function with regard to:

- the objectivity and technical competence of the internal audit staff
- whether the internal audit function is carried out with due professional care
- the effect of any constraints or restrictions placed on the internal function by management or those charged with governance.

If the function is assessed and is found not to be sufficiently independent of the management structure or the staff are not suitably qualified and trained, there is no point in the external auditor going to the trouble of assessing the work that has been performed by the function during the year as it will not be considered reliable enough for external audit purposes.

However, if the internal audit function has been assessed as reliable, the specific work should be evaluated to ascertain its adequacy. The external auditor must consider whether:

- the work is properly supervised, reviewed and documented
- the persons performing the work have relevant experience and training
- sufficient and appropriate evidence has been obtained
- the conclusions drawn are valid given the results of the work performed
- recommendations made have been acted on by management.

If the auditor assesses both the function and the specific work to be reliable and adequate, the work will be relied on and reduced levels of testing will be performed.
Service organisations

The client may outsource certain functions to another company – a service organisation, e.g.

- payroll
- receivables collection
- the entire finance function
- internal audit.

Advantages from the auditor's point of view

- The independence of the service organisation may give increased reliability to the evidence obtained.
- Less detailed work may therefore be required.

Other considerations

- The auditor will need to be confident of the reliability and the independence of the service organisation.
- If the audit firm provides some of these services itself – e.g. bookkeeping or payroll services – it will need to ensure that it can maintain its own independence and objectivity as auditor.

Reference to the work of others in the audit report

It is the auditors' responsibility to obtain sufficient and appropriate audit evidence in order to arrive at the correct audit opinion.

Therefore, no reference should be made in the audit report to the use of others during the audit.

If the auditors cannot satisfy themselves that the work of others is sufficiently reliable then the auditor must find another means of obtaining the required level of comfort.

They cannot pass the blame onto another party.
Accounting estimates are of particular concern to the auditor as by their nature there may not be any physical evidence to support them. They are subjective and judgemental and therefore prone to management bias. If the directors wish to manipulate the accounts in any way, accounting estimates are the easy way for them to do this. The auditor must take care when auditing estimates to ensure this has not been the case.

Procedures used by the auditor in respect of estimates are:

- Discuss with management their process for calculating the estimate and assess whether this appears reasonable.
- For estimates such as provisions it may be possible to obtain an independent expert opinion for example correspondence from lawyers regarding a legal provision or a surveyor’s report for evidence of an environmental provision.
• Review subsequent events, for example if there is a pending legal case with a legal provision at the balance sheet date, the case may have been settled by the time of the audit and therefore will provide evidence as to whether the provision was reasonably stated. An accrual can be compared with the actual invoice if the invoice has been received by the client by the time of the audit.

11 Computer assisted audit techniques (CAATs)

The use of a computer to either perform, be tested or to assist the auditors in carrying out their audit procedures.

With so many accounting systems now held on computer, the assurance provider may wish to make use of CAAT’s. There are two types of CAAT’s

(1) Audit software
(2) Test data
**Auditing around the computer?**

This term means that the 'internal' software of the computer is not documented or audited by the auditor, but the inputs to the computer are agreed to the expected outputs to the computer.

**Audit outcome**

**Increase the AUDIT RISK Why?**

- The actual computer files and programs are NOT TESTED.
- Therefore no DIRECT evidence that the programs are working as documented
- Where errors are found it maybe difficult or even impossible to determine why those errors have occurred.
- If amendments cannot be made, there is an increased likelihood of audit qualifications.
- Since controls are being tested, all discrepancies between predicted and actual results must be fully resolved and documented, irrespective of financial amounts involved.

**Audit software**

**Description**

This is software specifically designed for audit purposes, there are a number of off-the-shelf packages available, or the auditor could have a tailor-made system. It is used to process the client’s data in order to check that the figures themselves are correct. It can therefore carry out a whole range of substantive procedure, across all sorts of different data.

Examples of what audit software can do include:

- Extract a sample according to specified criteria
  - Random
  - Over a certain amount
  - Below a certain amount
  - At certain dates
- Calculate ratios and select those outside the criteria
Audit procedures

- Check calculations (for example additions)
- Prepare reports (budget v actual)
- Produce letters to send out to customers suppliers
- Follow items through a computerised system

Package programmes are generally designed to:

- read computer files
- select information
- perform calculations
- create data files, and
- print reports in a format specified by the auditor

**Test data**

The assurance provider supervises the process of running data through the clients system. To do this the auditor would have to

- Note controls in the clients system
- Decide upon the test data

It maybe processed during a normal production run (‘live’ test data) or during a special run at a point in time outside the normal cycle (‘dead’ test data), either with real data or dummy data.

- Run the test data
- Compare results with those expected
- Conclude on whether controls are operating properly

Through test data, this is data generated by the auditor in order to test the systems, processing logic, calculations and controls, to ensure that the controls within the system are operating properly.

An auditor would take a transaction through a system, testing the systems limits. So you would have ‘normal’ transactions and invalid transactions to test that the system work. If the results are positive that means the auditor can rely on the system and have more confidence that the output is accurate.
## What are the benefits of CAAT’s?

<table>
<thead>
<tr>
<th>Benefits / Advantages</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAAT’s force the auditor to rely on programmed controls during the audit. Sometimes it may be the only way to test controls within a computer system, therefore enables the auditor to test program controls</td>
<td>Credit limits within a system can only be changed by the accountant. A computer assisted check will test that this is the case.</td>
</tr>
<tr>
<td>Using CAAT’s enables the auditors to comply with ISA of obtaining appropriate audit evidence increasing the overall confidence for the audit opinion</td>
<td>Checking the depreciation charged on each asset would be quicker with a computer assisted program than manually</td>
</tr>
<tr>
<td>Large number of items can be tested quickly and accurately</td>
<td>Actual wages will be tested instead of paper copies.</td>
</tr>
<tr>
<td>CAAT’s test original documentation instead of print outs, therefore the authenticity of the document is more valid this way.</td>
<td>Examples of use or audit tests</td>
</tr>
<tr>
<td></td>
<td>(1) Calculation checks</td>
</tr>
<tr>
<td></td>
<td>(2) Reviewing lists of old or outstanding items and investing those specifically</td>
</tr>
<tr>
<td></td>
<td>(3) Detecting for unreasonable items</td>
</tr>
<tr>
<td></td>
<td>(4) Detecting violation of the system rules</td>
</tr>
<tr>
<td></td>
<td>(5) New analysis</td>
</tr>
<tr>
<td></td>
<td>(6) Completeness checks</td>
</tr>
<tr>
<td></td>
<td>(7) Selects samples</td>
</tr>
<tr>
<td></td>
<td>(8) Identifying exception reporting facilities</td>
</tr>
<tr>
<td>After initial set up costs, using CAAT’s are likely to be cost effective, as the same audit software can be used each year as long as the system doesn’t changed</td>
<td>Allow the results from using using CAATs to be compared with ‘traditional’ testing, If the two sources of evidence agree then this too will increase the overall audit confidence</td>
</tr>
</tbody>
</table>
**What are the weaknesses, or problems with CAAT’s, and how can they be resolved?**

<table>
<thead>
<tr>
<th>Weaknesses / problems</th>
<th>Recommendations / resolve</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limitations</strong></td>
<td>Ensure you understand the system to assess whether audit software will be relevant for the company.</td>
</tr>
<tr>
<td>CAAT’s will be limited depending on how well the computer system is integrated. The more integrated the better the use of CAAT’s. For example the invoices should be computer generated and then processed through the accounts system to feed in to the financial statements.</td>
<td>Need to assess whether there is a need for the audit software.</td>
</tr>
<tr>
<td>The existing system made do some of the functions of the CAAT, for example highlight old balances or obsolete inventory</td>
<td>Assess the reliability, document and then make a decision whether it’s relevant to use audit software as part of the evidence collected.</td>
</tr>
<tr>
<td><strong>Reliability</strong></td>
<td>A cost benefit analysis from the audit point of view should be carried out prior to deciding to use the audit software.</td>
</tr>
<tr>
<td>CAAT’s are only useful methods of testing if you can rely on the system, so the auditor would have to assess the reliability first, before use.</td>
<td>Shouldn’t use audit software until these have been identified. Hold until this point.</td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td>A cost benefit analysis from the audit point of view should be carried out prior to deciding to use the audit software.</td>
</tr>
<tr>
<td>It takes time to design CAAT’s tests therefore may not be cost effective if the auditor is dealing with a bespoke system, as there maybe a lot of set up costs. The reason for this is it takes time to write specific test data or to program the audit software to the needs of the client.</td>
<td>Or if you know there to be a change in the near future hold the audit software until that year.</td>
</tr>
<tr>
<td><strong>Lack of software documentation</strong></td>
<td>Shouldn’t use audit software until these have been identified. Hold until this point.</td>
</tr>
<tr>
<td>If the company you are auditing can not confirm all system documentation is available, then the auditors will be unable to do the tests effectively due to lack of understanding</td>
<td></td>
</tr>
<tr>
<td><strong>Change to clients systems</strong></td>
<td>A cost benefit analysis from the audit point of view should be carried out prior to deciding to use the audit software</td>
</tr>
<tr>
<td>If there is a change in the accounting year or from the previous year then the audit software will have to be reset and designed, therefore may be costly.</td>
<td>Or if you know there to be a change in the near future hold the audit software until that year.</td>
</tr>
</tbody>
</table>
**Lack of direction and useless results**
Audit tests may be done just because the auditors have the facility to do them, therefore the output of results will either be inconclusive or not required. Therefore having an inefficient and costly audit.

The audit manager needs to be clear exactly what audit assertions are being tested, and what the expected outputs are.

**Use of copy files**
Clients tend to provide the auditors with copies of the system notes and any other relevant information. The problem here is do we know if those are the actual files?

To ensure the files are genuine either the auditor should supervise the copying or use the originals in the first place.

**Test data - problems**

**Damage of computer system**
Because we are testing the limits of the system the dummy process may damage the computer system.

Ensure as auditors we understand the system and have support if need be from software experts.

**Need to reverse or remove dummy transactions**
Ideally test data should be run ‘live’ if not possible then the ‘dead’ test data needs to be used under identical systems for it to be valid, and enough computer time should be provided. The transactions may be incorrectly or incompletely removed, leaving dummy data in a live system.

Ensure there is a process for ensuring all dummy transactions are cleared and the auditor has discussed when they can use the computer and for what test specifically.

### Examples of Test Data

<table>
<thead>
<tr>
<th>Tests</th>
<th>Reason for the Test</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td><strong>Reason for the Test</strong></td>
</tr>
<tr>
<td>Input an order into the clients system that would cause a customer to exceed their credit limit.</td>
<td>The order should not be accepted, or should raise a query whether you are sure you wish to proceed. If this happens then the auditors will have confidence the system is working properly.</td>
</tr>
<tr>
<td>Input a negative number of items on an order</td>
<td>Ensures only positive quantities are accepted.</td>
</tr>
<tr>
<td>Input incomplete customer details</td>
<td>The system should not process the order unless all information is completed</td>
</tr>
<tr>
<td>Input an excessive amount</td>
<td>There are reasonable checks in the system to identify possible input errors. A warning should appear on the screen confirming the number</td>
</tr>
<tr>
<td><strong>Input and invalid inventory code</strong></td>
<td>Ensures that the computer detects the invalid code and presents an error message rather than taking the nearest code and accepting it</td>
</tr>
<tr>
<td><strong>Input of invalid details</strong></td>
<td>Ensures that no errors are made for sipping and payment</td>
</tr>
</tbody>
</table>

**Purchases**

| **Raise an order from a supplier not on the preferred supplier list** | A query should be raised as to whether you want to proceed with this transaction |
| **Process an order with an unauthorised staff ID** | The system should reject the process altogether or send the request through to an appropriate person for authorisation |
| **Try and make changes to the supplier standing data using the ID of someone who is not authorised to do so** | The system should reject the process altogether or send the request through to an appropriate person for authorisation |

**Payroll**

| **Try and set up a new employee up on the payroll system using an unauthorised ID** | The system should reject the process altogether or send the request through to an appropriate person for authorisation |
| **Try and make employee changes of detail using an unauthorised ID** | The system should reject the process altogether or send the request through to an appropriate person for authorisation |
| **Make an excess change for example increase someone’s salary by $1,000,000 by someone authorised** | The system should have parameters in place to question this amount, and maybe reject it due to it being outside the normal range |

**Receivables**

<p>| <strong>Cast the receivables ledger to ensure it agrees with the total on the receivables control account</strong> | To ensure the completeness and accuracy of the items on the receivables control account |
| <strong>Compare the balances to the credit limits to ensure they haven’t been exceeded</strong> | To check or violation of the system rules |
| <strong>Review the balances to ensure they don’t exceed the total sales to that customer</strong> | To check for unreasonable items in the ledger |
| <strong>To review the receivable days on a monthly basis and compare to year</strong> | To obtain new / relevant statistical information |</p>
<table>
<thead>
<tr>
<th>Purpose</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>To form receivable balances to show all material items and select appropriate sampling for testing.</td>
<td>To select specific items for the audit test.</td>
</tr>
<tr>
<td>To produce an aged receivables analysis to assist with identification of irrecoverable receivables.</td>
<td>To assist in the receivables valuation testing.</td>
</tr>
</tbody>
</table>

**Test your understanding 3**

Give examples of test using CAATs when dealing with orders received, goods despatched, and invoices raised?
12 Chapter summary

- Working Papers
- Receivables
- Analytical Procedures
- Inventories
- CAATs
- Payables
- The Work of Others
- Bank and Cash
- Non-Current Assets
- Non-Current Liabilities
- Accounting Estimates
### Test your understanding answers

#### Test your understanding 1

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
</table>
| 1. State three things the auditor should consider when reviewing a client’s instructions for the stock count. | Are they flawed in any way?  
The impact on the logistics for the audit team attending the count.  
How to ensure that the most material/risky stock lines are included in the auditors’ tests. |
| 2. How would you test stocks for existence?                                                                                           | Select items from the client’s final stock listing and compare with the results of the auditor’s test counts |
| 3. How would you test stocks for completeness?                                                                                       | Trace the items counted by the auditor into the client’s final stock listing.               |
| 4. Saxophone Ltd runs a petrol filling station. How would you test the quantities of petrol in stock?                                 | If the tank has a gauge – read the results.  
The accuracy of the gauge can be tested by noting the reading just before and after a new delivery of fuel is made and comparing with the quantity delivered.  
If there is no gauge, it will be necessary to ‘dip the tank’ using a measuring stick. |
| 5. Flute Ltd makes large machines out of very heavy lumps of steel. How would you assess its stock of sheet and bar steel?           | Test count bars sheets of steel.  
Assess average weights of bars and sheets from delivery/ weighbridge records              |
| 6. Piccolo Ltd has a sheep farming business. How would you verify the number of animals it owns at the year end?                  | Count them at dipping time or when they are herded together for some purpose.  
Or (preferably) use the report of a relevant expert.                                  |
1. How would you verify that all unpresented cheques are included on a client’s bank reconciliation?

Review post-year-end bank statements to test that all cheques drawn before year end but clearing after the balance sheet date are included on the reconciliation.

2. State 2 things which might be included on a bank letter besides the balances on a client’s accounts.

Deeds and other documents or assets held.
Guarantees.
Forward currency contracts
Bills of exchange and letters of credit.

3. How would you test the rights and obligations assertion for a freehold property?

Check title deeds and register of charges.

4. How would you test the completeness of a client’s hire purchase and leasing liabilities?

For all assets acquired in the year review correspondence to ensure there are no hire purchase or leasing liabilities in relation to the asset.

Test your understanding 3

Solution

Orders
Place orders on the website using test data.

Goods dispatched
Programme audit software to select a sample of customer orders, obtain the GDN number from each order, and verify that each GDN number exists in the GDN file.

Invoice
Programme audit software to select a sample of GDNs, obtain the invoice numbers from each order and verify that each invoice number exists in the invoice file.

(GDN – goods despatch note)