SESSION 7
AUDIT OF NON CURRENT ASSETS AND CURRENT ASSETS

Learning objectives:

- Understanding the importance of audit of assets.
- 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:
  1. inventories
  2. receivables
  3. payables
  4. bank and cash
  5. non current assets
  6. non current liabilities

Introduction:

The auditor has a duty to verify all the assets appearing on the balance sheet and also a duty to verify that there are no other assets, which ought to appear on the balance sheet.

AUDIT OBJECTIVE:

- Existence
- Ownership
- Completeness
- Valuation
- Presentation & Disclosure
AUDIT PROCEDURES:

The non-current assets schedules will show the following and suggest the associated verification procedures.

Opening balance:
- Verify by reference to previous year’s balance sheet and audit files.

Acquisition:
- Vouch the cost of acquisition with documentary evidence
- Vouch the authority for the acquisition with relevant documents (e.g. minutes etc)

Disposal:
- Vouch the authority for disposal
- Examined documentation
- Verify reasonableness of the disposal proceeds
- Verify reasonableness of scrapping of non-current assets (e.g. scrap value)
- Accounting policy notes.

Depreciation:
- Vouch authorisation of depreciation policy
- Examined adequacy and appropriateness of policy
- Investigate revaluation
- Check calculations.

Internal control:
- Purchase, disposal
- Accounting and maintenance of assets are very relevant.

Existence and ownership:
- Physical inspection of the existence of the assets and inspect the title deed and certificates of ownership.
- External verification e.g. bank letters, receivables circularisation

Presentation and value:
- Appropriate accounting policies must be adopted
- Appropriate accounting standards must be adopted
- Materiality level must be considered (e.g. in a balance sheet of a large company, it would be misleading to show an asset such as a patent in a class by itself if its total value was negligible in relation to other assets).
- The classification of assets
- The disclosure of an asset as separate items e.g. between non current and current assets.

**Other matters related to asset verification:**

- Taxation
- Insurance
- Expert advise

**Examples:**

**Audit work on Land and Building:**

- Obtain summary of all non-current assets under the categories shown in the balance sheet.
- Check casting and compare the opening balance brought forward from previous year.
- Obtain schedules of addition during the year for all classes of assets (including intangible assets)
- Test check against the supplier’s invoices or other independent vouchers to ensure revenue and capital are properly distinguished.
- Test capital expenditure for authorisation
- If the non-current assets constructed using own labour check all the labour cost is properly accounted.
- Check the accounting polices and comply with relevant accounting standard.
- Obtain schedules of disposals test check the proceeds of sales with independent evidence (Sale agreements).
- Check for an assets has been scrapped
- Verify that the original cost and accumulated depreciation have been eliminated from non-current assets accounts.
- Check calculation of profit or loss on sales and agree with profit and loss account.
- Verify the independent valuation
- Verify the depreciation policy
- Check calculations of depreciation.
- Confirm the disclosure requirements
- Physical inspection of sample of all type of assets
- Verify the adequacy of insurance cover on non-current assets
- Reconcile assets register with financial statements

**Investments:**

**Objective:**

- The proof of ownership
- Gain or loss arise from the investments
- Appropriate method of valuation
- Properly disclosed in the financial statements

**Audit work on investments:**

- Obtain list of investments check the accuracy of the analysis.
- Compare the opening balance with last year’s working papers
- Check the nominal accounts for recording for unusual entries
- Obtain third party confirmation
- Physical examination
- Review board minutes for authorisation.
- Review the profit or loss on part disposals
- Review the treatment of capital distributions, bonus and right issues.
- Verify the interest received and dividend received and accrued by reference to supporting documents and published data.
- Verify quoted price for listed investments at balance sheet
- Determine whether unlisted investments are valued on a reasonable basis.
AUDIT OF CURRENT ASSETS

The Audit of Receivables, Inventories Bank and Cash

THE AUDIT OF ACCOUNT RECEIVABLES AND PREPAYMENTS AND PROVISION FOR BAD DEBTS

Audit Objective:

- Existence
- Ownership
- Completeness
- Valuation
- Presentation & Disclosure

Account receivables are the large item among the assets of most companies and their verification is essential.

- Sales to bona fide customers only
- All such sales are to approved customers
- All such sales are recorded
- Once recorded the debts are only eliminated by receipts of cash or on the authority of a responsible person
- Debts are collected promptly
- Balances are regularly reviewed and aged, a proper system for follow up exists and if necessary, adequate provision for bad and doubtful debts is made.
- Test the effectiveness of the system.
- Obtain a schedule of account receivables
- Test balances on ledger accounts to the schedule and vice versa
- Test casts of the schedule
Examined make up of balance. They should be composed of specific items.

Ensure each account is settled from time to time.

Examine and check control accounts

Enquire into credit balance

Consider the valuation of the account receivables.

**ISA 505 External Confirmations:**

**Circularisation of account receivables:**

It is very common in the verification of account receivables is to circularise the account receivables or some of them for direct confirmation.

**Advantages:**

- Direct external evidence
- It provides confirmation of the effectiveness of the system of internal control.
- It assists in the auditor’s evaluation of cut-off procedures
- It provides evidence of items in dispute

**There are two methods:**

**Negative:**

- The customers are asked to communicate only if he does not agree the balance. This method is mostly where internal control is very strong.

**Appropriate when:**

- Internal control systems is strong
- Large number of small accounts
- Errors not expected

**Positive:**

- The customer is asked to reply whether he agrees the balance or not or is asked to supply the balance himself. This approach is used when there is weakness in internal control or suspicious of irregularities or numerous bookkeeping errors is found.

**Appropriate when:**

- Weak internal control systems
- Suspicion of theft and fraud
- Numerous book keeping errors

**Procedures:**

- Select samples from positive, negative balances and all customers can be circularised stating the balance in circularisation letter.

- Letter sent on client’s note paper requesting reply to auditors and including stamped addressed envelope to auditors’ address.

- The circularisation should be carried out auditors without client’s interventions.

- The auditors should follow up any legal disputes between the client and it is customers.

**Examples: Provision for bad and doubtful debts:**

The valuation of account receivables is really a consideration of the adequacy of the provision for bad and doubtful debts. The auditor should consider the following matters:

- The adequacy of the system of internal control relating to the approval of credit and following up of poor payers.

- The period of credit allowed and taken.

- Whether balances have been settled by the date of the audit.

- Whether an account is made up of specific items or not

- Whether an account is withbon the maximum credit limit.

- The state of legal proceedings and the legal status of the account receivables e.g. in liquidation or bankruptcy

- Comparison of account receivables to sales with comparison of the ratios with those of previous periods and those achieved by other companies.

- Evidence of any debt in dispute e.g. for non-delivery, breakage, poor quality.

**Example: Prepayments:**

- Obtain list of prepayments

- Verify the prepayments for the expenses

- Review the income accounts for the details of prepayments

- Review the disclosure in the Balance sheet “as current assets”.
THE AUDIT OF CASH AND BANK BALANCE

Audit Objective:

- Existence
- Ownership
- Completeness
- Valuation
- Presentation and disclosure

The composition of cash:

- Cash in hand include petty cash and receipt from customers not deposited.
- Cash at bank include cash held in saving, current accounts (assets) and cash overdrawn on current accounts (a liability)

Audit test:

- Check the opening and comparative figures brought forwards and review the previous year working papers.
- Review activity in the nominal ledger for any unusual transaction requiring investigation.
- Obtain client summaries, check arithmetic and agree with nominal ledger.
- Perform analytical procedures
- Test the cut-off
- Count un-deposited cash on hand and reconcile with imprest systems
- Confirm bank balance by sending a confirmation request to all banks used by the client.
- Verify bank and cash reconciliation
- Follow up and obtain reasons for any un-cleared items appearing in the year-end reconciliation in the month following the year-end.
- Check that cash and bank is properly classified in the balance sheet
  
  Cash at Bank = Current assets
  
  Bank overdraft = Current liability
- Check disclosure of any charges on cash balances.
Bank Reports for Audit Purposes:

- It is audit evidence
- Existence and amount of liabilities
- Existence amount, ownership and custody of assets.

Inventories and Work in Progress

Audit procedures:

- Adequate inventories records
- Categories of inventories
- Systematic and organised
- Location of store

Auditor’s duties

- The auditor must satisfy himself as to the validity of the amount attributed to inventories and work in progress in the balance sheet.

Physical inventory counts: 2 type of inventory counts

1. Periodical counts
2. Perpetual counts or continuous counts

- Periodical counts usually undertaken at the end of the financial year of the enterprises.
- Perpetual counts is continuous count of inventories held in storage to ensure the inventories are physically inspected to identify any slow moving items and damaged items.

- The key advantages of continuous counts as follows:
  - To ensure adequate records are kept on items in storage
  - Less disruptions to daily business of the enterprises
  - To ensure adequate internal control systems exist to avoid any theft and misappropriation.

Before the counting

- Review previous year’s working paper and discuss with management any significant changes from previous year.
- Discuss counting arrangement with management
- Nature and volume of inventories
- Location of store
- Consider cut off point
- Internal audit
- Confirmation from 3rd parties
- Expert advise
- Evaluate the client inventories counting procedures
- Review the client’s internal control procedures
- Brief audit staff and audit planning issues

**During the counting:**

- Observe the counting procedures to ascertain that the client’s employees are carrying out the instructions.
- Check the count of a selected number of lines and crossed reference to the inventory records.
- Observe and identify the obsolete, damaged and slow moving inventories.
- Verify the inventories sequences held in store
- Test the cut-off procedures
- Identify any high value item
- To obtain copies the client’s inventories records for working paper file

**After the counting:**

- Check the cut-off with details of the last numbers of inventories movement forms and goods inward and goods outward notes during the year after the year end.
- Test the final inventories records have been properly prepared from the count records.
- Final check on pricing, casting, summaries
- Inform the management of any problems encountered during the counts for action in subsequent count.

**Work in Progress:**

- Examine the costing systems
- Examine the reliability of the costing systems
Examine systems of inspection for scarp and ratification work

Valuation basis on IAS 2(Inventories)

Determine the progress payments and profit on each contracts.

**The audit objective:**

- Existence
- Completeness
- Ownership
- Valuation
- Presentation and disclosure

**Audit test:**

- Reconciliation of changes in inventories (e.g. Purchases and Sales)
- Compare the quantities of each kind of inventories held with purchase and sales
- Consider the movement in gross profit ratios
- Consider the inventory turnover ratios
- Review the variance report on inventories and work in progress

**The auditor’s duty:**

- Accounting policies adopted for valuing inventories
- Consider the acceptability of the accounting polices
- Test the inventory records with relevant documents such as Purchase invoice
- Check and test the treatment of overhead (WIP)
- Check the arithmetic and accuracy of all calculation
- Check the consistency with which the amount have been computed
- Check the disclosure requirements

**VERIFICATION OF QUANTITIES**

The procedures in relation to this subject are covered in an extant auditing guideline “Attendance at counting” which is summarised in the following notes.

- An entity may ascertained quantities of inventories at it is year-end either by:
Performing a full physical count or Extracting balance from its inventories records

- The latter is acceptable to the auditor if inventories has been physical counted during the year and the results compared with the record—any discrepancies being investigated and adjusted—thus giving confidence in the accuracy of those records.

- It is therefore essential in any audit where inventories are material to attend and observe the client’s counting procedures.

**VERIFICATION OF VALUE**

IAS 2 requires inventories should be valued at the lower of cost and net realisable value.

**Cost:**

- All costs incurred in getting inventory to its present location and condition.

**The cost therefore comprises:**

**Cost of purchase:**

- In getting the inventory to its present location, the following costs will be incurred:
  - The invoice cost
  - Carriage inward
  - Import duties and other taxes
  - Transport and handling charges

- From an audit point of view, establishing these costs presents little problem reference will be made to purchase and expense invoices.

- However where items of inventory cannot be directly related to specific invoices (eg identical items bought at different prices and stored together) it is necessary to make assumptions or to adopt a policy in relation to cost.

**Cost of conversion:**

- IAS 2 states that this should be based on normal levels of activity in normal operating condition, taking one year with another.

- Conversion cost includes both direct and indirect cost incurred in converting the raw material into finished product. These costs are allocated systematically into product cost or unit cost.

- In determining what is “normal” the following should be taken into account:
  - Production capacity
  - Budgeted production level
  - Actual production level
Net realisable value:

- NRV= What can be realised for inventory at their present condition at the balance sheet date in the case of raw material, finished goods and WIP.

Valuation method:

- The IAS 2 requires the inventory valuation should be determined using the FIFO and Weighted average method and The LIFO method is commonly used in USA but not in the UK.

Procedure to identity items likely to be valued at lower than cost:

- Examine inventory records for items marked damages, slow moving or obsolete.
- Determine items returned by customers for faulty or damaged goods
- Extract from inventory records, items held longer than their normal turnover period (slow moving)
- Consider the effects of technological developments and possibility of obsolescence.
- Check with competitors’ prices
- Discuss with management any intended sales, special offer or discounts offer to existing customers.
- Determine actual selling prices realised from post balance sheet receipts.

Procedures to check NRV has been properly calculated:

- Check post balance sheet sales for actual gross proceeds
- Check budgets/forecast for estimated gross proceeds
- Check the post balance sheet cashbook or nominal ledger expense accounts for actual selling and distribution costs.
- Check for estimated selling and distribution etc costs and for further costs to completion.
- Check repairs costs to put damaged inventories into a saleable condition.

Presentation:

- The inventories should be disclosed in Balance sheet as “Current Assets”.

Disclosures:

- By way of note to the accounts, the following disclosures should be made i.e. proper accounting policy adopted.
The categorisation of inventories into:

- Raw material and components 
- Goods held for resale
- Work in progress
- Finished goods

Total stock

Risk associated with holding inventories:

- High level inventories held in storage resulting poor cash flow management and financial loss for the enterprises.
- The enterprises may have inadequate inventory records resulting in meeting customers demands.
- There is lack of internal control in storage area resulting in theft and misappropriation of inventory.
- High level damages or deterioration due poor storage facilities.
- Lack of information on inventory held by the enterprise resulting in poor decision and inability to meet the demands and objective of the business.
- Holding inappropriate or inadequate inventory in storage may lead to lack of demand from customers and from production unit.