The balance sheet approach

In this approach, substantive procedures are focused on statement of financial position accounts, with only very limited procedures being carried out on income statement/profit and loss account items. The justification for this approach is the notion that if all statement of financial position accounts are tested and verified, then the profit/loss figure reported for the accounting period will not be materially misstated.

Audit of Non Current Assets

Fixed assets are inherently risky and deserve close attention for a number of reasons:

- Depreciation charges can be manipulated by choosing unrealistic expected life spans and scrap values.
- Cost can be capitalized as assets to boost up profits.
- Intangible assets can be introduced on the balance sheet to reduce gearing.
- Internal controls over fixed assets may be weak.

Audit objectives

- Are the assets valued correctly?- Valuation
- Do the assets exist?- Existence
- Are the assets owned by the company?- Rights and Obligations
- Are the assets properly disclosed in the financial statements?- Presentation and disclosures
- Have recurrent items been capitalized?- Completeness

Audit Programme

Mnemonic: CAVEBOP (completeness, accuracy, valuation, existence, beneficial ownership, presentation and disclosures)

Completeness

- Visible assets to fixed assets register(FAR)- select a sample of assets visible at client premises and inspect to FAR to ensure they are included.
- Mispostings recurrent v/s capital: examine the repairs&maintenance accounts in the general ledger for large and unusual items that may be capital in nature.
- Examine payment vouchers to GL: to identify large payments in respect of non current assets to ensure they are included in GL.
- Last year brought forward: ensure last year’s closing balance have been brought forward this year.
- Reconciliation FAR/GL: ensure FAR reconciles to general ledger.
**Accuracy/Measurement**

- Cast the fixed assets schedule and agree to figures in FS.
- Test additions for the year- from a sample of FA additions chosen from entries in the nominal ledger, the auditor will:
  - Agree details of the additions to an invoice.
  - Ensure goods have been received by checking to the GRN.
  - Agree details to user’s specification.
  - Trace to FAR.
- Check whether closing balance in the nominal ledger agree to the total in the FAR.
- If any assets have been constructed by the company, obtain analysis of costs incurred and agree to supporting documentation.
- Check the profit/loss on disposal.

**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 FS.
- **Analytical review of depreciation charge for the year:** agreement this year’s charge as [reasonable](#) by taking last year’s charge (amendment for additions, disposals and revaluations) and seek explanation for any material differences.
- Assess depn policies for reasonableness.
- **Review profits/losses on disposals:** large profits indicate high depn rate whilst large losses is an indication of low depn rate being used.
- **Impairments:** review assets and establish the need for any write down for impairments in value.
- **Revaluation:** 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.
  - Ensure that depn charge is based on new carrying value.
  - Check qualifications and independence of valuer.
  - Review valuation report.
  - Perform site visit
- **Condition of asset during inspection:** when physically inspecting assets, take note of their condition and usage in case of impairment.
- **Entries in FAR and FA schedule traced to source documentation:** check a sample of entries in the fixed assets register and fixed asset schedule and trace back to source documentation to ensure properly stated cost.
Existence

- Select a sample of assets from FAR and physically inspect them.

Beneficial ownership

- For a sample of recorded assets, obtain and inspect ownership documentation:
  - Title deeds for properties.
  - Registration documents for vehicles.
  - Insurance documents.
- For leased assets, inspect the lease documents to assess whether the lease is operating or finance.

Presentation & Disclosure

- Agree opening balances with prior year financial statements.
- Compare depn rates in use with those disclosed made e.g name of valuer, revaluation policy.
- Ensure that disclosure is made of charges on FA to secure a loan.
- Schedule of FAR disclosed by way of a note to the account.

Audit of receivables and prepayments

Audit objectives

- Debtors balance represents amounts owed by customers at the balance sheet date.- Rights And Obligations
- Debtors include claims sent to customers at the balance sheet date.- Cut off error
- Debtors at the balance sheet date represent legal claims of the entity on the customers for payment.- Existence
- The provision for bad debts represents a reasonable estimate of the difference between gross debtors and their NRV.- Valuation
- Debtors are properly identified and classified in the balance sheet.- presentation and disclosures.

Audit programme - CAVEBOP

Completeness

- Tally sub ledger to FS schedule: check the balances from sales ledger to the schedule.
- Last year brought forward: check whether last year’s closing balances have been properly brought forward.
• Cut off for cash receipts from debtors and credit sales: perform cash receipts cut off test. Perform credit sales cut off test.
• Tally control account in GL to sub ledger.
• Perform analytical procedures- calculate the trade receivables collection period and compare to last year to assess reasonableness.

 Accuracy of measurement

• Tally FS schedule to GL: check a sample of balances from the schedule to the ledger e.g total trade debtors to debtors control a/c in GL.
• Tally control a/c in GL to sub ledger: check the total of the debtors list to the debtors control account.
• Trace debtors transactions to source documentation: vouch a sample of recorded debtors transactions to supporting documents( e.g. sales invoice, receipt, credit notes etc)
• Debtors balances are specific invoices/transactions: checking that the balances are made up of specific invoices relating to recent transactions and enquiring into any balances which appear to be in dispute or old.
• Review major customers accounts for irregularity: review the individual accounts of major customers and those that appear irregular either by nature, composition or size of the balances or the transactions therein.
• Irregular credit notes at start of next FY: auditor should check if there has been the issue of a substantial volume of credit notes after the year end to cancel false sales made before the year end.
• Good on sale or return should not be included in sales or receivables: until the right to return the goods expire. Instead they form part of the inventories.
• Analytical procedures
  ➢ A comparison of receivable days with budgets or prior years.
  ➢ A high or increasing incidence of old debts may indicate either poor or deteriorating economic conditions or credit control. In such instances, year end bad debt provisions are critical.
  ➢ A comparison of the proportion of the debts in different age bands to prior year.

 Valuation- provn for doubtful debts

• Discuss the assumptions: underlying the general provision with management to ensure reasonableness.
• Recalculate: the provn based on management’s assumptions.
• Tally: agree the provn computed to the figure in FS.
• Compare the prior year provn to the amounts actually written off as bad: in the year to test how accurate management usually are in estimating possible bad debts.
• **Ageing and recoverability**: obtain a list of ageing of receivables and investigate the recoverability of debts.

• **Unpaid receivables to be traced to provns**: where overdue receivables have not been paid, trace the balances to the provn for doubtful debts.

• **Re-asses recoverability of long overdue debts**: if long outstanding balances are not included in the provn, discuss with management the basis on which they believe the debtor to be recoverable.

**Existence**

• Carry out debtors circularization.
• Check whether opening balances exist as at last year.
• Vouch debts to supporting sales invoices, dispatch notes, and sales orders.

**Beneficial ownership**

• Check documentation- invoices, sales orders.
• Reply from debtors circularization confirming their indebtedness to the company.

**Occurrence**

• Select a sample of transactions from debtors ledger and trace to invoices, delivery notes and store ledger to confirm sales.
• For bad debts written off, trace to authority.

**Presentation & disclosure**

• Check that figures disclosed in the FS agree to the audited accounts.
• Credit balances disclosed under Current Liabilities.
• Proper disclosure of related party transactions.

**Prepayments**

**Prepayments** are for expenditure that has been paid for in the current period, but relates to the next period.

Evidence will include:

• **Proper accounting at time of payment**: considering the client’s own system (if any) for accounting for prepayments.

• **Obtaining a schedule of prepayments**: ensuring that it is cast correctly and comparing it with prior year prepayments and performing other analytical procedures.

• **Test checking a sample of prepayments for correct calculation**: referring to supporting documentation.
**Debtors circularization (Confirmation of accounts receivable)**

One of the most effective methods for confirming receivable balances is by the auditor communicating directly (thru letter) with the customers of the client to seek direct confirmation of the amounts outstanding. This is a standard procedure as per 505-External confirmations.

ISA 505 covers external confirmations in general, including

- Confirmations from bankers of bank balances, debtors, creditors, loan balances, entity inventory held by third party (goods on consignment)
- Confirmations from lawyers of property title deeds held as security.

External confirmations of debtors: it is a direct party confirmation of debtors and provide:

- Strong evidence whether receivables are overstated.
- Weaker evidence whether receivables are understated.
- Indirect evidence of the sales figures.
- Evidence of the functioning of internal controls.
- Evidence of the efficiency of the cut off procedures if carried out at the year end.
- Evidence of accuracy of balances.
- Evidence of rights.
- Evidence of existence of debtors.

**POINT TO NOTE:**

- The auditor should obtain direct confirmation (from clients debtors) of material accounts receivable balances.
- External confirmations of debtors does not provide evidence as to the collectability of balances or the existence of unrecorded balances.
- External confirmations does not provide evidence of unrecorded balances.

**Timing of confirmation**

There are two types of request:

- **Positive**- customers are asked to confirm to the auditor directly in all cases, whether they agree or disagree with the balance. Positive confirmations provide more reliable evidence than negative confirmations. The choice depends on the auditor’s assessment of risk. The positive form is preferred when control risk is assessed as high.
- **Negative**- customers are only asked to respond if they disagree. This method may be appropriate where there are a large number of small balances, where the system is well controlled.
Procedures for confirmation of balances

- Select a sample of receivables to be circularized. The sample should include:
  - Material as well as small balances.
  - Old unpaid balance.
  - Accounts with credit balances.
  - Accounts with nil balance.
  - Accounts written off.
- Inform client of intended list of those to be circularized, management must sign.
- Consider implications if client objects to any accounts selected being circularized.
- Dispatch by auditor and replies should be direct to auditor.
- Record replies received and consider implications of any accounts not agreed.
- For non replies perform alternative procedures.

Problems

- Some customers will disagree. All such disagreements must be followed up until the auditor is satisfied, and the results noted on the working papers.
- Some customers will fail to respond, even after a reminder.
- Some customers do not maintain purchase ledgers but use a system where invoices are held in a file until paid. In such cases it may be possible to confirm on an individual invoice basis.

Procedure where it is expected that customers will not or do not respond to confirmation letter:

Perform alternatives procedures such as:

- Reminder
- Phone call
- Review of cash received after balance sheet date.
- Or examination of sales invoice and signed dispatch documentation.