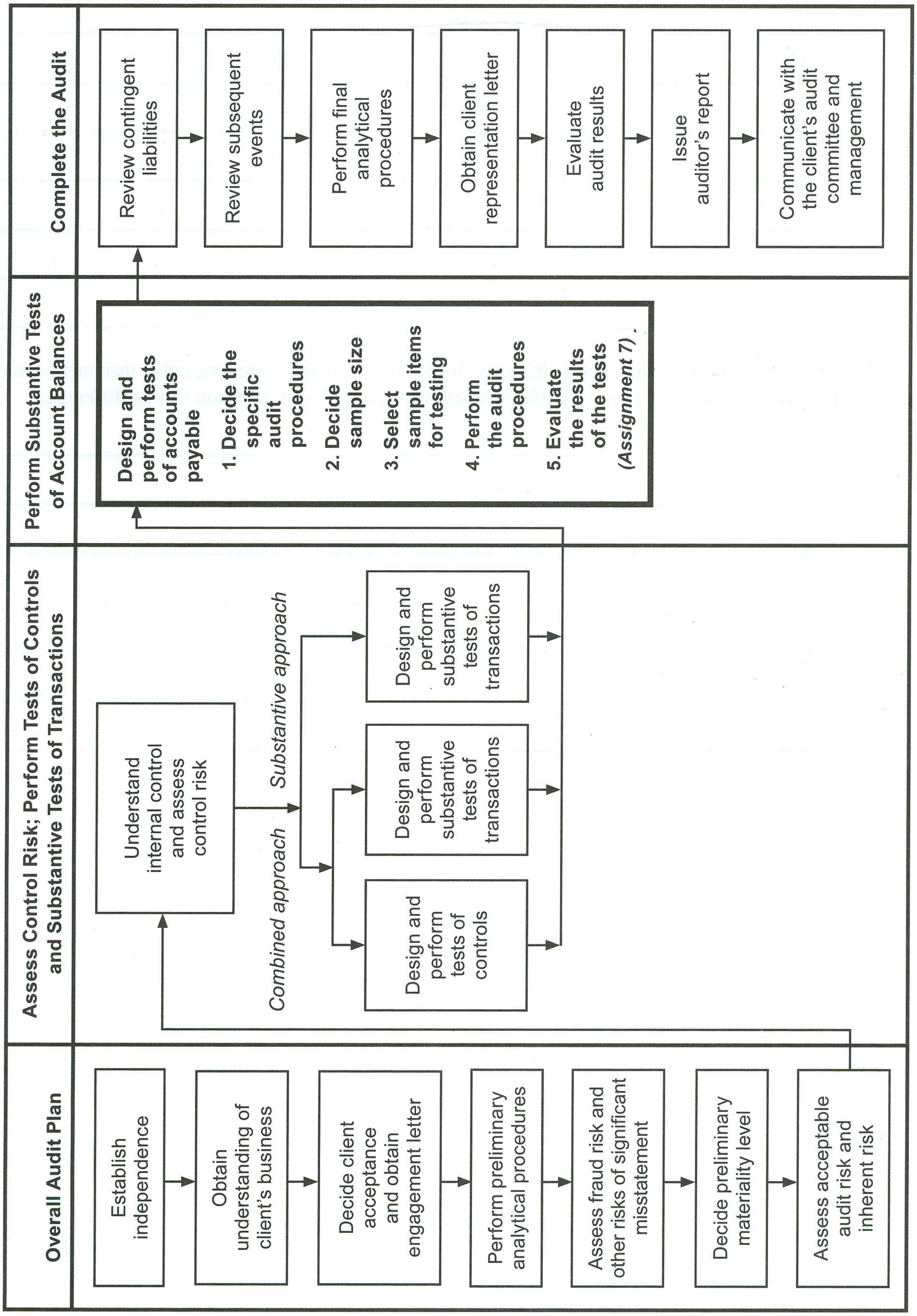
Assignment 7: Perform audit of accounts payable



ASSIGNMENT 7

Perform audit of accounts payable

Overview

In this assignment, you will audit Oceanview Marine Company's accounts payable balance.

There are five closely related steps in the audit of accounts payable:

1. Decide the specific audit procedures to be performed for each audit objective.
2. Decide the sample size for each audit procedure.
3. Select sample items for testing.
4. Perform the audit procedures for the sample items.
5. Evaluate the results of the tests and conclude whether the accounts payable balance is fairly stated.

Auditing concepts

Nature of the audit of accounts payable

The audit of the year-end accounts payable balance involves accumulating sufficient appropriate evidence to evaluate whether accounts payable is fairly stated and properly disclosed in the financial statements. Although the auditor is concerned with whether recorded accounts payable exist and are accurately recorded, the primary concerns are whether the accounts payable balance is complete and whether an accurate cutoff of accounts payable has been achieved.

The primary audit procedure performed to determine the completeness of the accounts payable balance is the search for unrecorded liabilities. This involves examining cash disbursements after year-end and unpaid invoices to determine whether they represent liabilities as of the balance sheet date. The search for unrecorded liabilities may also include tracing receiving reports issued before year-end to vendor invoices, tracing vendor statements to the accounts payable trial balance, and sending confirmations to vendors with which the client does business. Because of the availability of external documentation such as vendor invoices and statements, confirmation of accounts payable is less common than confirmation of accounts receivable.

Statistical and nonstatistical sampling

Auditors generally do not test all transactions or balances that make up a particular account. Auditing standards provide guidance to auditors when audit tests are based on a sample from a population. This guidance is applicable to both statistical and nonstatistical sampling methods, and does not explicitly endorse one method over the other. Statistical sampling is less commonly used for the audit of accounts payable than for accounts receivable. Because the focus is on omitted payables, it is difficult to define the population and determine the population size in accounts payable. In this assignment, you will use nonstatistical sampling to complete the audit of accounts payable.

Sampling for tests of details of balances

Sampling methods involve the following five general steps:

1. **Plan the sample**

   Audit procedures are designed for each audit objective (i.e., existence, completeness, accuracy, cutoff, and so on). The most important audit procedure for accounts payable is the search for unrecorded liabilities, which helps satisfy the *completeness* and *cutoff* objectives. As part of performing these procedures, the auditor also obtains evidence related to the existence and accuracy of accounts payable.

   While sampling is often appropriate for many tests in the audit of accounts payable, including the search for unrecorded liabilities, sampling is not possible when performing procedures such as footing the year-end listing of accounts payable and tracing the total to the general ledger. Thus, the auditor needs to determine whether sampling is practical for each audit procedure to be performed. Sampling will be used in this assignment for the search for unrecorded liabilities. Some auditors prefer not to use sampling in the search for unrecorded liabilities and examine all items above a dollar threshold.

2. **Determine sample size**

   In situations where sampling can be used, the auditor must determine an appropriate sample size. Several factors are considered when determining the sample size. These factors include:

   - *Tolerable misstatement*—inversely related to sample size (the smaller the auditor's tolerable misstatement, the larger the sample will be). Tolerable misstatement is the application of performance materiality to a particular sampling procedure.
   - *Book value of the recorded population*—directly related to sample size (the larger the population size, the larger the sample will be).
   - *Expected misstatement in the population*—directly related to sample size (the larger the expected population misstatement, the larger the sample will be).
   - *Acceptable risk of incorrect acceptance (ARIA)*—inversely related to sample size. ARIA is the risk the auditor is willing to take of concluding that the balance is fairly stated when it is actually materially misstated. ARIA is very similar to "planned detection risk" from the audit risk model. ARIA is the complement of the amount of assurance, or confidence, desired from the test (a high level of assurance is associated with a low level of risk).

   ARIA is influenced by the following five factors (note that because ARIA and required assurance are complements, higher required assurance is associated with a lower ARIA):

   1. *Control risk* (after performing tests of controls)—higher control risk increases required assurance and sample size.
   2. *Inherent risk*—higher inherent risk increases required assurance and sample size.
   3. *Acceptable audit risk*—lower acceptable audit risk increases required assurance and sample size.
   4. *Results of preliminary analytical procedures*—if the results of preliminary analytical procedures indicate a high potential for misstatements in accounts payable, required assurance and sample size would increase.

5. *Results of substantive tests of transactions*—if the results of substantive tests of transactions for acquisitions and cash disbursements indicate a high potential for misstatements in accounts payable, required assurance and sample size would increase.

There are alternative ways for auditors to assess tolerable misstatement, population size, expected misstatement, and acceptable risk of incorrect acceptance when using nonstatistical sampling. One approach is to assess each of them in terms of low, medium, or high, and then judgmentally determine whether the sample size should be small, medium, or large. Another approach is to use the formula in the AICPA Sampling Guide described in Assignment 6, Option A.

The sample size in this assignment will be determined judgmentally, giving adequate consideration to the factors described above. All items greater than tolerable misstatement will be selected for testing, plus a judgmental sample of items less than or equal to tolerable misstatement.

3. Select sample items for testing

When using nonstatistical sampling, the sample items can be selected judgmentally or randomly. In the search for unrecorded liabilities, the emphasis is on large amounts recorded in the acquisitions and cash disbursements journals during the first month after year-end.

4. Perform the audit procedures

The most time-consuming part of auditing accounts payable or any other account is performing the tests. When auditing accounts payable, these tests include examining receiving reports, other supporting documents, and journal entries to determine whether all liabilities have been recorded, whether they have been recorded in the proper period, and whether they have been recorded at the correct amounts. Goods or services received before year-end should generally be included in accounts payable at year-end, while those received after year-end should be excluded from accounts payable.

5. Evaluate the results of the tests and conclude whether the accounts payable balance is fairly stated

When the auditor evaluates the results of the tests for an account such as accounts payable, the primary objective is to decide whether the account is fairly stated or is materially misstated. The auditor must also decide whether prior assessments of control risk and inherent risk require revision based on the results of the tests of balances.

a. **Generalize to the population.** The auditor is primarily interested in an estimate of the misstatements in the account balance, not just the misstatements in the sample. The sample misstatements are used to estimate the misstatements in the account balance.

One common approach to project misstatements is to multiply the total sample misstatement (in terms of dollars) by the ratio of the population size (in terms of dollars) divided by the sample size (in terms of dollars):

$$\text{Sample Misstatement (in dollars)} \times \frac{\text{Population Size (in dollars)}}{\text{Sample Size (in dollars)}}$$

This is the approach to projection of misstatements taken in this assignment. Note that the population in the search for unrecorded liabilities is defined as the transactions after year-end, rather than the recorded account balance.

b. **Compare projected misstatement to tolerable misstatement and decide acceptability of the recorded account balance.** The auditor must compare the projected misstatement to tolerable misstatement to determine if the account balance is fairly stated. In making this comparison, the auditor must allow for sampling risk since the true (but unknown) amount of misstatement in the population is likely to be different than the projected misstatement. Sampling risk occurs whenever a sample is tested, rather than the entire population.

In practice, the allowance for sampling risk is often calculated as tolerable misstatement minus projected misstatement. This difference is the *actual allowance for sampling risk.* If the difference is large enough (and positive), then the auditor would probably accept the account as fairly stated. However, if the difference between tolerable misstatement and projected misstatement is too small (or negative), the auditor probably would not accept the account. What constitutes "large enough" and "too small" is a matter left to the auditor's professional judgment after due consideration of the acceptable risk of incorrect acceptance (ARIA) and the sample size. All other things being equal, smaller ARIAs and smaller sample sizes would require larger differences before the auditor would be willing to accept the account as fairly stated.

There are several possible actions after the auditor compares tolerable misstatement to projected misstatement:

- *Accept the population as stated.* This conclusion is likely if tolerable misstatement exceeds projected misstatement by a large amount.
- *Request the client to adjust the population.* Auditors should always inform their clients of any misstatements found in an account balance. If the account is not acceptable as stated, an adjusting journal entry to correct the misstatements (actual misstatements, not projected misstatement) may reduce projected misstatement sufficiently to make the account acceptable.
- *Expand audit tests.* If neither of the first two options applies, the auditor may expand substantive tests of balances, either by increasing the sample size or performing other tests.
- *Request that the client re-work the population.* In rare cases, the client may need to determine the account balance again. If this is necessary, the auditor will need to re-audit the population.

c. **Analyze misstatements and reassess risks.** Regardless of whether the auditor accepts or rejects the recorded account balance, the auditor should determine the nature and cause of every misstatement found in the sample. Normally, if tolerable misstatement is significantly greater than projected misstatement, it is unnecessary to expand the audit tests beyond those originally planned. The auditor may decide that the original assessment of control risk or inherent risk may require revision, given the findings of the substantive tests.

Requirements

a. In preparation for this assignment, obtain the following workpapers from the *Current Workpapers*: 30-1, 30-2, 30-4, 30-5, 30-21, 30-22, 30-23, and 30-24.

These workpapers will be completed in this assignment and turned in to your instructor for grading. Remember to **sign off** on each workpaper as you complete it. Use 2/25/2016 as the completion date for each workpaper you complete in this assignment.

> **Electronic workpaper option:** In this assignment, you will complete and print workpapers 30-21 through 30-24 using *Excel*. You may disregard the copies of workpapers 30-21 through 30-24 included in the *Current Workpapers*.

Plan the sample

b. Specific audit procedures for accounts payable have been designed by your firm and form the audit program on workpapers 30-3 to 30-5. Before continuing, carefully read through the audit program to be sure that you understand the purpose of each audit procedure, including those procedures already completed by Bill Cullen.

c. Review the Planned Tests of Balances Matrix for accounts payable (workpaper 30-6) completed by Bill.

> **Note:** The matrix summarizes the factors that influence the extent of tests of balances for accounts payable.
>
> The first factor, acceptable audit risk, is *inversely* related to the extent of testing; i.e., as acceptable audit risk increases, the extent of testing decreases.
>
> Each of the other factors is *directly* related to the extent of testing; e.g., as inherent risk or control risk increases, the extent of testing increases.
>
> Notice that each factor is evaluated separately for each audit objective.

Also study the work completed by Bill on workpapers 30-7 to 30-19.

Decide sample size for search for unrecorded liabilities

d. Your primary responsibility in this assignment is to complete steps 4(b) through 4(e) on workpaper 30-4. Bill has already determined the sample size for the tests of subsequent cash disbursements [step 4(a)].

Study workpaper 30-20 to learn how Bill determined the sample size to be used.

> **Note:** Notice that Bill used his judgment in determining the sample size, incorporating information about performance materiality and related tolerable misstatement, expected misstatements, acceptable audit risk, inherent risk, control risk, and results of analytical procedures.

> **Note:** The search for unrecorded liabilities involves testing of subsequent cash disbursements, as well as testing purchases recorded in the acquisitions journal after year-end, and invoices which have not yet been recorded in the acquisitions journal. The purpose of examining each type of transaction is to determine whether any liabilities have been omitted from the year-end list of accounts payable. Because the objective of each test is the same, testing is limited to January cash disbursements in this practice case. Because many disbursements after year-end will represent payments against valid accounts payable included in the year-end accounts payable listing, the accuracy of amounts in the year-end list of accounts payable can be tested simultaneously with the test for omitted liabilities.

Select sample items for testing

e. As determined in step (d), the computed sample size consists of the following:

- All 20 disbursements greater than tolerable misstatement.
- A random sample of 15 of the remaining 134 disbursements.

Use the top half of workpaper 30-21 to determine the sampling interval for the sample of 15 disbursements that are less than or equal to tolerable misstatement.

> **Electronic workpaper option:** Workpaper 30-21 is included in the file named "ASSIGN 7 EXCEL_6ED.XLSX."
>
> Complete and print workpaper 30-21 using *Excel.*

Indicate the 2nd, 3rd, and 4th cash disbursements selected for testing in each stratum on workpaper 30-21.

> **Tips:** Select your sample from the list of cash disbursements (check register) beginning on workpaper 30-11.
>
> For the first set of items, you should select only disbursements that exceed tolerable misstatement.
>
> For the second part of the sample, your selection process will involve counting by the length of the sampling interval, making sure to exclude the disbursements greater than tolerable misstatement that have already been selected.
>
> Since the sample is being drawn from subsequent cash disbursements, your sample should be drawn from the disbursements (check totals), rather than the individual voucher amounts that make up each disbursement.

Perform the audit procedures

f. Assume that Bill has examined the supporting documents for 29 of the 35 subsequent cash disbursements selected for testing and found no misstatements.

To complete the tests for omitted liabilities, you are to examine the supporting documents for the remaining six cash disbursements and trace each disbursement representing a liability at year-end to the year-end Accounts Payable List (workpapers 30-7 to 30-10).

Write appropriate tickmarks on the year-end Accounts Payable List (workpapers 30-7 to 30-10) and on the Check Register (workpapers 30-11 to 30-18) to indicate the work you performed and the results. (Use the tickmarks created by Bill; see tickmarks d and e on workpaper 30-19 and tickmark d on workpaper 30-10. You will need to create additional tickmarks if you discover any misstatements.)

Document any misstatements you find by completing the "Summary of Misstatements" sections on workpaper 30-22.

Electronic workpaper option: Use *Excel* workpapers 30-22, 30-23, and 30-24 to complete steps (f) and (g).

Tips: The six disbursements you will test are the same as the 2nd, 3rd, and 4th cash disbursements selected in each part of the sample on workpaper 30-21.

You are testing the six cash disbursements to determine (1) that those disbursements that represent accounts payable at December 31 were properly included in the year-end list of accounts payable and (2) that those disbursements that did *not* represent liabilities at December 31 were properly excluded from the year-end list of accounts payable.

You will use the following documents as you trace each of the six disbursements to the year-end accounts payable list: receiving reports for Tradewind Marine, Great Outdoor Boats, Lift King, and Anderson Marine (two), and the invoice for Salt, Sand & Sea Advertising. All receiving reports are for inventory, except the receiving report from Lift King which is for a fixed asset. For Anderson Marine, receiving report #5895 relates to check #6281, and receiving report #5901 relates to check #6298. These documents are included in the *Client Documents* booklet.

For each payment for a purchase of goods, you need to examine the date on the related receiving report to determine whether the purchase created a liability as of December 31. Assume all shipments from vendors are shipped FOB destination (title passes, and the liability is created, when the goods are received by Oceanview). For each payment for a service, you need to examine the related invoice to determine the date the service was received by Oceanview.

When calculating the net misstatement on workpaper 30-22, overstatements should be treated as positive numbers and understatements as negative numbers.

Evaluate the results of the tests and conclude whether accounts payable is fairly stated

g. Workpaper 30-22 is used to summarize the client misstatements detected, and workpapers 30-23 and 30-24 are used to project those misstatements to the population and to decide the acceptability of the account balance using your professional judgment.

Note: In order to ensure adequate coverage of accounts payable testing, Bill chose to select all items greater than tolerable misstatement, and a sample of the remaining amounts (see workpaper 30-20). When a sample is selected, misstatements should be projected to the population being sampled.

Complete workpapers 30-23 and 30-24 using the following steps:

1. Calculate the projected misstatement using the formula provided on workpaper 30-23.

> **Tip:** When calculating projected misstatement for the sample of items less than tolerable misstatement, the population size (in dollars) is the amount of January disbursements less than tolerable misstatement indicated on workpaper 30-20, since the test is for omitted liabilities.

2. Given a tolerable misstatement of $30,000 for both over- and understatements, use the bottom of workpaper 30-23 to calculate the allowance for sampling risk. Write "none" if the allowance is zero or negative.

3. Using your professional judgment, decide whether to:

   - accept the population as fairly stated,
   - request the client adjust the account,
   - expand your audit tests of accounts payable, or
   - request the client re-work the account.

   Re-read step 5(b) of the nonstatistical sampling steps earlier in this assignment for clarification of this process.

   Use workpaper 30-24 to document and justify your decision.

4. In the middle section of workpaper 30-24, write your conclusions regarding whether accounts payable is fairly stated or whether further testing will be necessary based on the results of your tests.

h. Use workpaper 30-2 to propose an adjusting journal entry(ies) to correct the actual misstatement(s) found in your tests.

i. Assume the client has agreed to record your proposed adjusting journal entry(ies). Write the net effect of your entry(ies) in the "Net Adjustments" column on the accounts payable leadsheet (workpaper 30-1) and on the leadsheet(s) (if included as part of this practice case) of the other account(s) affected by your adjusting journal entry(ies). Write the new account balance in the "2015 Adjusted Balance" column on the leadsheet(s). The entry(ies) will be posted to the trial balance in Assignment 10.

   Cross-reference the Adjusting Journal Entries workpaper (30-2) to the adjustment(s) shown on the accounts payable leadsheet (30-1) and the other leadsheets affected.

j. Complete the bottom section of workpaper 30-24 by deducting, from projected misstatement, the net effect on accounts payable of the adjusting journal entry shown of workpaper 30-2.

   Carry forward any remaining unadjusted projected misstatement to the *Summary of Possible Misstatements* (workpaper 90-1).

   At the end of the audit, workpaper 90-1 will be reviewed and compared to materiality to determine if further adjusting entries are required to reduce the misstatements to an acceptable level.

Tip: Since the client has already agreed to your proposed adjusting entry to correct the actual misstatements found in your tests, you will enter "0" in the "Identified Misstatement" column on workpaper 90-1. Your remaining *unadjusted projected misstatement* on workpaper 30-24 should be entered in the "Likely Aggregate Misstatement," "Current Liabilities," and "Income Before Taxes" columns on workpaper 90-1.

Note: Unadjusted actual and projected misstatements are carried forward to the *Summary of Possible Misstatements* (workpaper 90-1). If your adjusting journal entries had not been recorded at this time, then the actual and projected misstatements you discovered in your tests of accounts payable would have been carried forward to the *Summary of Possible Misstatements*. The net amount of the actual misstatements would have been entered in the "Identified Misstatement" column, and the net projected misstatement would have been entered in the "Likely Aggregate Misstatement," "Current Liabilities," and "Income Before Taxes" columns.

k. Complete the conclusion section, step 9, on workpaper 30-5.

Completing the assignment

Make sure you **signed off** on the following workpapers completed in this assignment, using 2/25/2016 as the date: 30-1, 30-2, 30-4, 30-5, 30-21, 30-22, 30-23, and 30-24.

Also make sure you **signed off** on step 4, sub-steps (b) through (e), on workpaper 30-4 by writing your initials in the "INIT" column, added a reference to workpapers 30-21 to 30-24 in the "W/P" column, and added "*Sample per 30-21*" in the "COMMENTS" column next to step (b).

Staple the following items together in the order listed and submit them to your instructor for grading:

- Cover page with your printed name, your signature, and the assignment number.
- Workpapers 30-1, 30-2, 30-4, 30-5, 30-21, 30-22, 30-23 and 30-24.
- Answers to discussion questions 1 through 4 (see next two pages) if required by your instructor.

Discussion questions

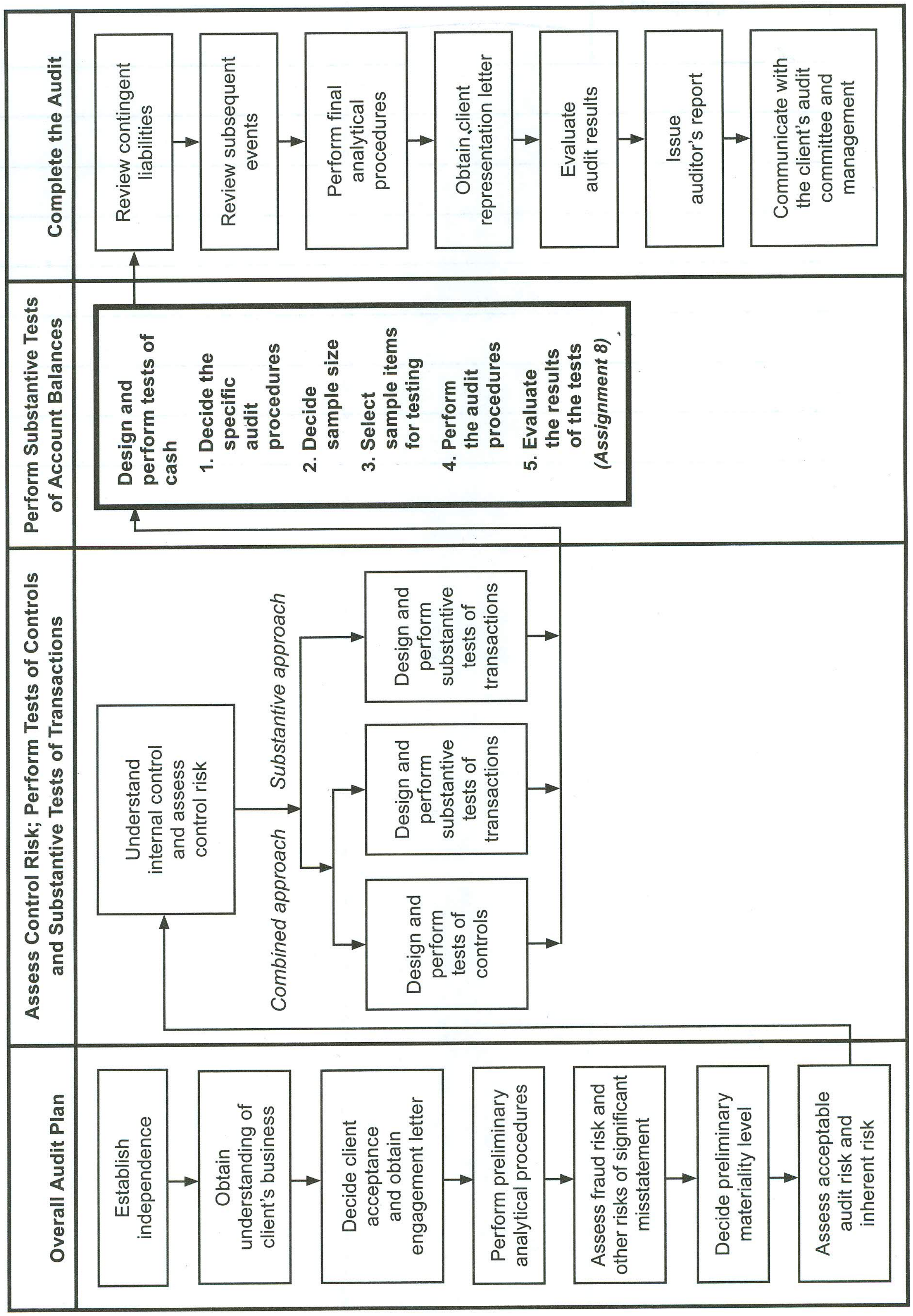
1. In Assignment 5, you performed tests of controls and substantive tests of transactions for acquisitions. How do the results of these tests affect the extent of testing in the audit of accounts payable?

2. What is the primary objective in the audit of accounts payable? How might this affect the sampling method used and how the sample is evaluated?

3. The client received and recorded a large shipment of inventory on January 3rd that was shipped FOB shipping point on December 29th. How should the auditor account for this in the search for unrecorded liabilities?

4. Confirmations were emphasized in tests of accounts receivable, but are rarely used in tests of accounts payable. What factors account for this difference? When would confirmation of accounts payable be appropriate?

Assignment 8: Perform audit of cash



Perform audit of cash

Overview

In this assignment you will audit Oceanview Marine Company's general bank account.

Auditing concepts

Audit of cash balances

The audit of year-end cash balances involves accumulating sufficient appropriate evidence to evaluate whether cash balances are fairly stated and properly disclosed on the financial statements. To determine the extent of testing of cash, the auditor must evaluate internal controls over cash. Examples of these controls include but are not limited to:

- proper segregation of duties
- the signing of checks by an authorized person
- the use of prenumbered checks
- the use of a prelisting of cash receipts
- a monthly reconciliation of all bank accounts by someone independent of the handling or recording of cash receipts and cash disbursements.

If the auditor determines that the internal controls over cash are inadequate, he or she will most likely extend the year-end audit procedures to include one or more of the following items: extended tests of bank reconciliations, a proof of cash, and other procedures that may detect possible fraud. The audit procedures discussed in the following sections apply when the auditor has identified no significant deficiencies in the internal controls over cash.

General and impress payroll cash accounts

To begin the audit of cash accounts, the auditor obtains from the client a year-end bank reconciliation for each bank account. Most audit procedures are limited to obtaining assurance that the information on the bank reconciliation is correct. Typical audit procedures include:

- Test the clerical accuracy of the client's bank reconciliation, including outstanding checks, deposits in transit, and other reconciling items.
- Confirm the cash balance directly with the client's bank and reconcile the balance given by the bank with the bank balance shown on the bank reconciliation. The confirmation may be sent by mail or electronically through a third-party intermediary.
- Trace the book balance from the bank reconciliation to the general ledger.
- Request that a cutoff bank statement, along with copies of canceled checks, be sent directly from the bank to the auditor for a 7- to 10-day period after the client's balance sheet date. Some auditors use online electronic access to the client's bank account activity in place of a cutoff bank statement.
- Trace checks received with the cutoff bank statement dated on or before the balance sheet date to the list of outstanding checks on the bank reconciliation.
- Investigate any significant checks listed on the bank reconciliation that did not clear the bank as of the cutoff statement date.

- Vouch deposits in transit on the bank reconciliation to the cutoff bank statement and verify other reconciling items.
- Test the client's schedule of intercompany and interbank transfers for a few days before and after the balance sheet date and determine that each transfer was recorded in the proper period for both accounts.

When analyzing a schedule of intercompany and interbank transfers, you should also verify that each partially completed transfer at year-end is properly reflected in the bank reconciliation(s).

For example, assume the balance sheet date is 12/31/2015. If, for one of the transfers shown on the schedule of interbank transfers, the date per books and the date per bank for the disbursing account were 12/27/2015 and 1/5/2016, respectively, then the transfer is an outstanding item (check or wire transfer) at year-end. You would vouch the transfer as part of the tests of the year-end bank reconciliation for the disbursing account to verify that the transfer properly appears in the list of outstanding items. The transfer should then be cross-referenced from the schedule of transfers to the outstanding item on the bank reconciliation.

Similarly, if the dates per books and bank for the receiving account were 12/27/2015 and 1/5/2016, respectively, then the transfer is a deposit-in-transit at year-end. You would vouch and cross-reference the transfer to the year-end bank reconciliation for the receiving account to verify that the deposit-in-transit appears on the reconciliation.

If the dates per books and bank for the disbursing account were 1/5/2016 and 12/27/2015, respectively, then the transfer is an unrecorded disbursement at year-end. You would vouch and cross-reference the transfer to the year-end bank reconciliation for the disbursing account to verify that the reconciliation contains an adjustment to the balance per books to reflect the unrecorded disbursement.

Similarly, if the dates per books and bank for the receiving account were 1/5/2016 and 12/27/2015, respectively, then the transfer is an unrecorded deposit at year-end. You would vouch and cross-reference the transfer to the year-end bank reconciliation for the receiving account to verify that the reconciliation contains an adjustment to the balance per books to reflect the unrecorded deposit.

Background information

Oceanview's cash balance includes the following accounts: petty cash, payroll bank account, and general bank account. Bill Cullen performed all of the cash audit program procedures except steps 9, 10, 11, 12, 13, and 16 on workpapers 20-2 and 20-3. He completed these steps for the payroll bank account but did not perform them for the general bank account. Bill also did not complete step 19 on workpaper 20-4.

Requirements

a. In preparation for this assignment, obtain the following workpapers from the *Current Workpapers*: 20-1, 20-2, 20-3, 20-4, 20-6, 20-7, and 20-8.

These workpapers will be completed in this assignment and turned in to your instructor for grading. Remember to **sign off** on each workpaper as you complete it. Use 2/25/2016 as the completion date for each workpaper you complete in this assignment.

> **Note:** On workpaper 20-1, notice that Bill has agreed the figures for petty cash, the payroll bank account, and the general bank account to the general ledger, and has also agreed all three amounts for 2014 to the prior year's workpapers file. Bill also cross-referenced the unadjusted balance per books on workpaper 20-5 to workpaper 20-1.

b. Bill Cullen has completed the audit of Oceanview's payroll bank account.

Study workpapers 20-2 to 20-5 to familiarize yourself with the work already performed by Bill.

> **Note:** The cutoff bank statements for the payroll account and the general bank account are located at the end of the *Client Documents* booklet. (Assume that Bill Cullen received the cutoff bank statements directly from the bank, and that they will be given to the client when the auditors are finished with them. Accordingly, when using the cutoff statements in the following steps, you should not write any tickmarks on them.)

c. Make sure the unadjusted balance per books on workpaper 20-6 agrees with the 2015 balance shown on workpaper 20-1, and then cross-reference the balance from workpaper 20-6 to workpaper 20-1 (the cash leadsheet).

Complete steps 9, 10, 11, 12, and 13 on workpapers 20-2 and 20-3 for the general cash account.

> **Tip:** Use workpapers 20-6 and 20-7 to document your work. Use workpaper 20-5 as a guide. Create additional tickmarks as needed.
>
> As you perform step 9, write the tickmark *"F"* below each column of numbers on the reconciliation (workpaper 20-6) after you verify the numbers have been added (or subtracted) correctly.
>
> When performing step 11, keep in mind that the last check written in 2015 was #6269.
>
> When performing step 12, assume that you reviewed the January 2016 monthly bank statement to investigate checks that had not cleared the bank by the cutoff statement date (January 8, 2016). Also assume that all such checks cleared by January 31, 2016 and appeared on the January 2016 bank statement.

d. Complete steps 16(a), 16(b), and 16(d) on workpaper 20-3.

> **Tip:** Bill has already verified that the dates, amounts, and payee and payor information on the transfer schedule are correct.
>
> You should analyze the pattern of dates for each transfer to determine whether kiting has occurred (see workpaper 20-8).
>
> In addition, you should determine whether each transfer has been handled properly on the bank reconciliation for each account. For guidance, review the notes on "General and imprest payroll cash accounts" in the Auditing Concepts section earlier in this assignment.
>
> Document your performance of step 16(a) by writing your initials in the "INIT" column on workpaper 20-3. Briefly summarize the results of your procedure in the "COMMENTS" column.
>
> As you perform step 16(b), write the appropriate workpaper reference(s) below the amount(s) on the transfer schedule (workpaper 20-8).
>
> As you perform step 16(d), document your procedure by creating a new tickmark. In the tickmark legend on the bottom of workpaper 20-8, write an explanation for the tickmark you create.

e. Complete the conclusion, step 19, on workpaper 20-4.

f. Write the net effect of any adjustments you believe should be made to the year-end cash balances in the "Net Adjustments" column on the cash leadsheet (workpaper 20-1), and complete the "2015 Adjusted Balance" column. (If no adjustments are needed, write "0" in the "Net Adjustments" column.)

Completing the assignment

Make sure you **signed off** on the following workpapers completed in this assignment, using 2/25/2016 as the date: 20-1 to 20-4 and 20-6 to 20-8.

Also make sure you **signed off** on workpapers 20-2 and 20-3, steps 9, 10, 11, 12, 13, and 16 by writing your initials in the "INIT" column, added references to appropriate workpapers in the "W/P" column, and added any appropriate comments in the "COMMENTS" column.

Staple the following items together in the order listed and submit them to your instructor for grading:

- Cover page with your printed name, your signature, and the assignment number.
- Workpapers 20-1, 20-2, 20-3, 20-4, 20-6, 20-7, and 20-8.
- Answers to discussion questions 1 through 5 (see next three pages) if required by your instructor.

Discussion questions

1. What is the primary purpose of a bank confirmation? Why does the auditor confirm the bank balance in addition to agreeing the year-end bank balance to the bank statement? What additional information is included with a standard bank confirmation?

2. Suppose there were several large outstanding checks on the year-end bank reconciliation that did not clear the bank by the cutoff date. Discuss the possible cause(s) of this, and discuss the nature of the potential misstatement(s) that could result.

3. Suppose there was a deposit-in-transit on the year-end bank reconciliation that was not received by the bank by the cutoff date. Discuss the possible cause(s) of this, and discuss the nature of the potential misstatement(s) that could result.

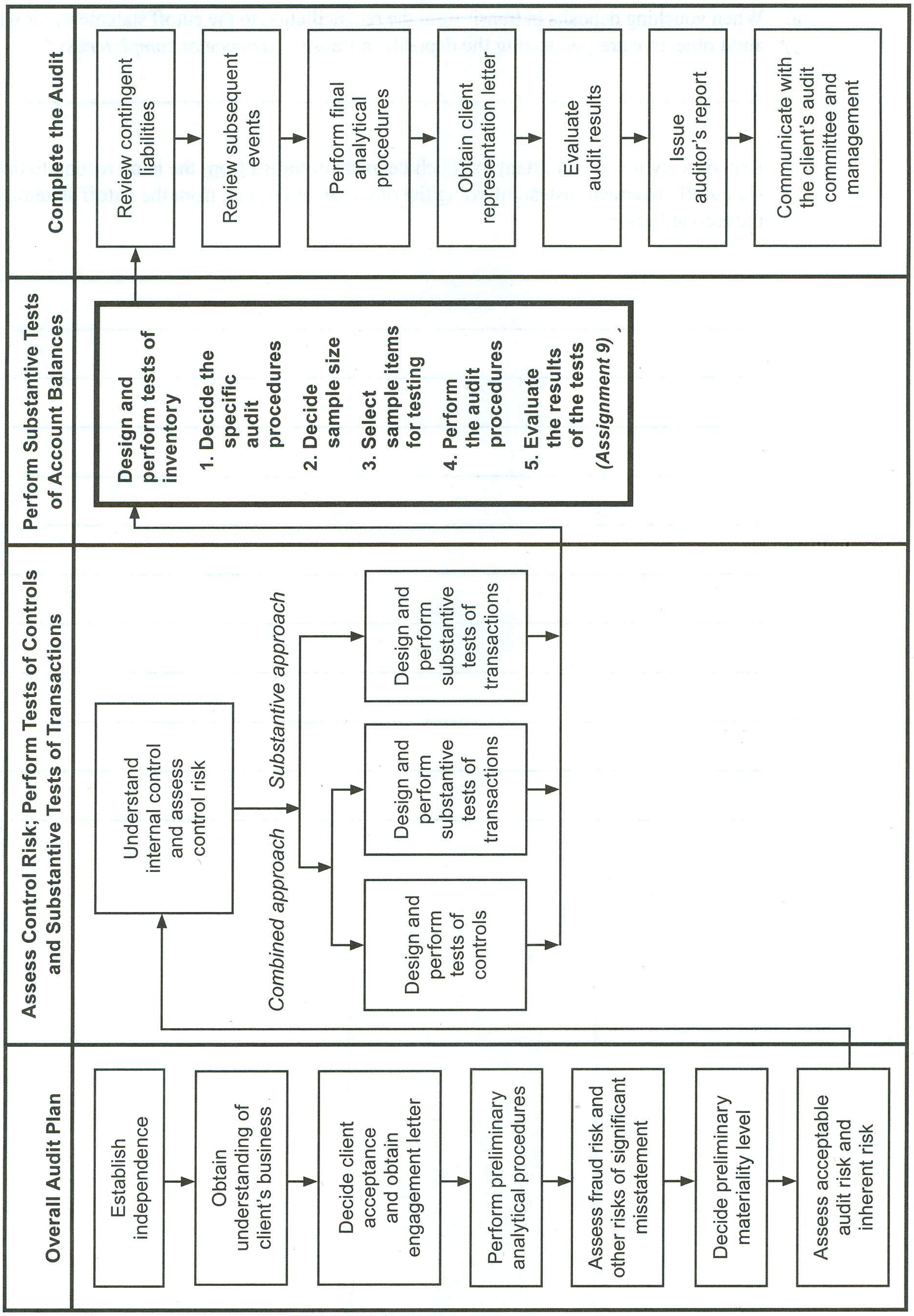
4. Refer to workpaper 20-8. Suppose there was a third transfer on the interbank transfer schedule for $16,500. Assume that the funds were transferred from the general cash account to the payroll cash account. Also assume that the transfer was recorded in the client's cash disbursements journal on 1/4/2016, and the check cleared the disbursing bank on 1/4/2016. In addition, assume that the transfer was recorded in the client's cash receipts journal on 12/26/2015 and was received by the receiving bank on 12/26/2015. Discuss the concerns you would have about this transfer.

5. One of the audit procedures you performed when testing Oceanview's general cash account was "Vouch all deposits-in-transit from bank reconciliation to cutoff statement(s)."

   a. When vouching deposits in transit from the reconciliation to the cutoff statement, for which audit objective are you testing the deposits in transit: *existence* or *completeness?*

   b. Explain why it was important to vouch deposits in transit <u>from</u> the bank reconciliation <u>to</u> the cutoff statement instead of going the other direction; i.e., from the cutoff statement to the reconciliation.

Assignment 9: Perform audit of inventory



Perform audit of inventory

Overview

In this assignment you will audit Oceanview Marine Company's inventory account.

Auditing concepts

Nature of the audit of inventory

The audit of the year-end inventory balances involves accumulating sufficient appropriate evidence to evaluate whether inventory balances are fairly stated and properly disclosed in the financial statements. To plan the appropriate extent of testing, the auditor must evaluate internal controls over inventory. Examples of these controls include but are not limited to:

- authorization of purchase orders by an appropriate person
- the maintenance of inventory records by someone independent of the custody of inventory
- periodic inventory counts
- documents authorizing the movement of inventory

If the auditor determines that internal controls over inventory are inadequate, he or she will most likely extend the year-end audit procedures to include more emphasis on the observation of the inventory count, including cutoff procedures and the valuation of the inventory.

Checking cutoff accuracy involves examining receiving reports prior to and after the count date to ensure all major items are correctly included in the inventory count if received prior to the count or excluded, if after. The receiving reports should also be checked to purchases and payables accounting records for an accurate cutoff in the general ledger. The last few shipping documents prepared prior to the count should be checked to ensure these goods are excluded from inventory, and that goods shipped after year-end are included in year-end inventory.

Even if the internal controls over inventory appear to be adequate, it is often more cost efficient not to perform tests of controls but to rely on extended substantive procedures and the year-end inventory count. This assignment assumes that relying on extended substantive procedures is the approach that will be taken for the audit of inventory.

Background information

Oceanview's inventory includes new boats, used boats, repair parts, and marine supplies. Bill Cullen performed all of the inventory audit program procedures except steps 32, 33, and 38 on workpapers 22-6 and 22-7.

Bill Cullen tested the repair parts and marine supplies inventory. Due to the bulkiness of the final listings, they have been filed in a separate file. No misstatements were found. You are to audit only the boat inventory listed on workpapers 22-8 to 22-10.

Requirements

a. In preparation for this assignment, obtain the following workpapers from the *Current Workpapers*: 22-1, 22-6, 22-7, 22-15, 22-18, and 22-19.

These workpapers will be completed in this assignment and turned in to your instructor for grading. Remember to **sign off** on each workpaper as you complete it. Use 2/25/2016 as the completion date for each workpaper you complete in this assignment.

> **Electronic workpaper option:** In this assignment, you will complete and print workpaper 22-18 using the computer. You may disregard the copy of workpaper 22-18 in the *Current Workpapers*.

b. Study workpapers 22-3 to 22-7 to gain a better understanding of the audit procedures required to audit the inventory account.

> **Note:** Bill Cullen attended the physical inventory count performed at year-end, completed the *physical inventory count* section of the audit program (workpapers 22-3 and 22-4) and found no discrepancies except for the provision for obsolete items.
>
> As shown on workpaper 22-11, Bill noted $10,900.00 of repair parts and supplies that were obsolete. Although these items were all very old, Don Phillips did not believe that an adjustment was required as he felt that "these things will come in handy someday."
>
> Since Bill and Don could not agree on this issue, Bill decided to carry this amount forward to the *Summary of Possible Misstatements* (workpaper 90-1).

c. Perform audit program procedure 32 on workpaper 22-6 by following steps one and two described on the next page.

> **Tip:** You are to gain assurance that all the boats counted by the client as listed on their Inventory Count Sheet (workpapers 22-12 to 22-14) appear on the Final Inventory Listing (workpapers 22-8 to 22-10) (testing the completeness assertion), and that all boats which appear on the final inventory listing are in the possession of the client (testing the existence assertion).
>
> This is done by selecting a sample of boats and comparing *from* the count sheet *to* the final inventory listing, and vice versa, as described on the next page.

> **Note:** The two-way test count tracing described earlier is often performed when a detailed inventory listing is not available at the time of the physical observation. Assume that a listing was not available at the time of Oceanview's physical inventory observation. Detailed perpetual records would often be available for large, specific identification inventory such as boats.
>
> Note that the auditors counted 100% of the boat inventory, rather than only a sample, because of the significant dollar value of individual boats.

1. Begin by selecting every tenth item from the Inventory Count Sheet (workpapers 22-12 to 22-14), using the top half of workpaper 22-15 to record the boat numbers selected. (Your first stock number should be 8111; your last number should be 8679.)

   Next, trace each of these boat numbers to the Final Inventory Listing (workpapers 22-8 to 22-10) to verify that the boats are listed on the Final Inventory Listing. As you do this, verify that the stock number, manufacturer name, and model number are the same on the count sheet and the inventory listing.

2. Select every tenth item from the Final Inventory Listing (workpapers 22-8 to 22-10), using the bottom half of workpaper 22-15 to record the boat numbers selected. (Your first stock number should be 8009; your last number should be 8778.)

   Next, vouch the boat numbers to the Inventory Count Sheet (workpapers 22-12 to 22-14) to verify that the boats were in the client's possession at year-end (i.e., included in the year-end physical inventory count). As you do this, verify that the stock number, manufacturer name, and model number are the same on the inventory listing and the count sheet.

> **Note:** Your testing will be documented on workpaper 22-15. Therefore, it is unnecessary to also document your testing on either the Final Inventory Listing or Inventory Count Sheet.

d. Perform audit program procedure 33 on workpaper 22-6.

To help you perform this step, Bill Cullen has chosen a systematic sample of 30 items on workpapers 22-16 and 22-17.

Assume that, for each of the 30 items selected for testing on workpaper 22-17, Bill compared the price listed on the client's Final Inventory Listing with recent vendors' invoices. Bill found no differences with the exception of three inventory items. Information on the nature of the differences is explained in tickmarks *a*, *b*, and *c* on workpaper 22-10. The invoices for these three items are the last three items in the *Client Documents* booklet.

After reviewing the invoices and reading Bill's notes on workpaper 22-10, complete the six columns in the top section of workpaper 22-18 for the exceptions noted.

> **Electronic workpaper option:** Workpaper 22-18 is included in the file named "ASSIGN 9 EXCEL_6ED.XLS" in your downloaded files.
> Complete the six columns in the top section of workpaper 22-18 using *Excel*.

> **Tip:** When calculating the "Net misstatement in sample" on workpaper 22-18, overstatements should be treated as positive numbers and understatements as negative numbers.

e. Complete workpapers 22-18 and 22-19 using the following steps:

> **Electronic workpaper option:** Complete and print workpaper 22-18 using *Excel.* Follow these steps.
>
> 1. Study the numbers and formulas used by Bill on workpaper 22-18 to determine the projected misstatement and the allowance for sampling risk. Make any necessary corrections.
>
> Go to step 3 below.

1. Calculate the projected misstatement using the formula provided on workpaper 22-18. "Population size (in $)" is the *boat* inventory total from workpaper 22-10. "Sample size (in $)" is the sample total from workpaper 22-17. Round projected misstatement to the nearest dollar.

2. Assuming the tolerable misstatement is $50,000 for both over- and understatements, use the bottom of workpaper 22-18 to calculate the allowance for sampling risk.

3. Using your professional judgment, decide whether to:

   - accept the population as fairly stated,
   - request the client to adjust the account,
   - expand your audit tests of inventory, or
   - request the client re-work the account.

Re-read step 5(b) of the sampling steps in Assignment 7 for clarification of this process.

Use workpaper 22-19 to document and justify your decision.

f. On workpaper 22-19, write your conclusion regarding whether inventory is fairly stated or whether further testing will be necessary based on the results of your tests.

g. Carry forward to workpaper 90-1 your actual and projected misstatement amounts from workpaper 22-18.

> **Tip:** Write the net total actual misstatement in the "Identified Misstatement" column and the projected misstatement in the "Likely Aggregate Misstatement," "Current Assets," and "Income Before Taxes" columns on workpaper 90-1.

Cross-reference the two workpapers by writing *22-18* in the "W/P ref." column on workpaper 90-1, and *90-1* below or to the right of the net sample misstatement and the projected misstatement on workpaper 22-18.

Note: In step (g), the assumption is made that the client has, for now, chosen *not* to record an adjusting journal entry to correct the actual misstatements found in your tests. Thus, workpaper 22-2 will be left blank. The "Net adjustments" column on workpaper 22-1 will also be left blank, unless you identified adjustments affecting inventory in other assignments.

If the client had chosen to correct the misstatements, you would document the adjusting journal entry on workpaper 22-2 and write the net effect of the entry in the "Net adjustments" column on workpaper 22-1. In addition, you would enter "0" in the "Identified Misstatement" column on workpaper 90-1. Your remaining unadjusted projected misstatement would be entered in the "Likely Aggregate Misstatement," "Current Assets," and "Income Before Taxes" columns on workpaper 90-1.

Unadjusted actual and projected misstatements are carried forward to the *Summary of Possible Misstatements* (workpaper 90-1). Since the client is not correcting the misstatements at this time, then the actual and projected misstatements you discovered in your tests of inventory are carried forward to the *Summary of Possible Misstatements*. The net amount of the actual misstatements is entered in the "Identified Misstatement" column, and the net projected misstatement is entered in the "Likely Aggregate Misstatement," "Current Assets," and "Income Before Taxes" columns.

h. Complete step 38 on workpaper 22-7.

i. On workpaper 22-1, complete the "Net Adjustments" and "2015 Adjusted Balance" columns for each inventory category.

Completing the Assignment

Make sure you **signed off** on the following workpapers completed in this assignment, using 2/25/2016 as the date: 22-1, 22-6, 22-7, 22-15, 22-18, and 22-19.

Also make sure you **signed off** on steps 32 and 33 on workpaper 22-6 by writing your initials in the "INIT" column, added references to appropriate workpapers in the "W/P" column, and added any appropriate comments in the "COMMENTS" column.

Staple the following items together in the order listed and submit them to your instructor for grading:

- Cover page with your printed name, your signature, and the assignment number.
- Workpapers 22-1, 22-6, 22-7, 22-15, 22-18, and 22-19.
- Answers to discussion questions 1 through 4 (see following two pages) if required by your instructor.

Discussion questions

1. Oceanview's inventory consists primarily of boats and involves a comparatively small number of inventory items. How would inventory observation and test count tracing tests differ if the client has a large number of inventory items and the client did not have a detailed list of inventory on hand at the time of the inventory observation?

2. Because of the nature of Oceanview's inventory, pricing is done using the specific identification method. How would the pricing tests differ if the inventory consisted of a large number of items for each product?

3. Oceanview identified some potentially obsolete inventory items. What tests should the auditor perform to identify inventory that is obsolete or inventory that should be reduced from historical cost to net realizable value?

4. The client received a large shipment of inventory on December 31st during the inventory observation. What procedures should the auditor perform to verify that the acquisition of inventory is properly accounted for?