



AUDIT STAFF TRAINING WORKSHOP

SUBJECT : AUDIT OF THE STATEMENT OF FINANCIAL POSITION PRACTICAL APPLICATION

**THURSDAY 17TH TO FRIDAY 18TH NOVEMBER, 2016
NAIROBI SAFARI CLUB, NAIROBI**

**Presenter
FCPA Erastus K. Omolo
Horwath Erastus & Co., Certified Public Accountants
E-mail : horwatherastus@crowehorwath.co.ke**

AUDIT OF THE STATEMENT OF FINANCIAL POSITION – PRACTICAL APPLICATION

Coverage

A. Assets

B. Liabilities

C. Equity

CAUTION

- 1) Not possible to be 100% exhaustive**
- 2) Audit verification approaches : Assets, Liabilities and Equity – use the same rigor with any other item not specifically discussed**
- 3) Knowledge and working experience of the auditor is critical in introducing / extending audit tests.**

CAUTION

- 4) The general rule in the audit of statement of financial position is that “the statement” (balance sheet) presents a TRUE and FAIR VIEW, so :**
- **Must not be misleading (TRUE)**
 - **Must not contain material errors (FAIR)**
- 5) Consider the THREE Case Studies outlined (Enron, WorldCom & Parmalat) and consider the consequences on the concerned auditors, shareholders and auditees.**

CASE STUDIES

- **Enron**
- **WorldCom**
- **Parmalat**

CASE STUDY 1 – ENRON SCANDAL (2001) (Energy and Service Corporation - USA) - Quoted

What Happened?

**Dubious accounting schemes caused
shareholders to lose \$74 Billion**

How did it happen?

- **Reduction of Enron's tax payments;**
- **Inflation of Enron's income and profits;**
- **Inflation of Enron's stock price and credit rating;**

CASE STUDY 1 – ENRON SCANDAL (2001) (Energy and Service Corporation)

How did it happen?

- **Hidden losses in off-balance-sheet subsidiaries;**
- **Engineered off-balance-sheet schemes to funnel money to CEOs themselves, friends, and family;**
- **Arthur Andersen (USA) the auditors could not verify the stock of gas accurately and instead inflated the stock revenue and stockholders equity in the balance sheet**

CASE STUDY 1 – ENRON SCANDAL (2001)

Key Players

Chief Financial Officer Jeff Skilling and Chief Executive Officer Kenneth Lay

How was it discovered?

Internal whistle blowing by the Vice President Sherron Watkins after suspicion over high stock prices

Sanctions

- 1. Chief Accounting Officer, Richard Causey sentenced to five years and six months in prison on one count of securities fraud.**

CASE STUDY 1 – ENRON SCANDAL (2001)

- 2. Jeffrey Skilling, Chief Financial Officer convicted and sentenced to 24 years and four months in prison. The sentence was later reduced by ten years.**
- 3. Kenneth Lay, Chief Executive Officer convicted of conspiracy and fraud. He died before appeal and his conviction was erased.**
- 4. The auditors, Arthur Andersen (USA) indicted and found guilty of obstruction of justice. Decision later overturned by Supreme Court.**
- 5. Andrew Fastow, Chief Financial Officer pleaded guilty to two counts of wire fraud and securities fraud and served a four year sentence.**

CASE STUDY 2– WORLDCOM SCANDAL (2002) (Telecommunications Company - UK) - Quoted

What happened?

Assets inflated by over \$11 Billion leading to \$180 losses in Billions to investors.

How did it happen?

- **Fake accounting entries**
- **Accounting department underreported line costs by capitalizing and not expensing**
- **Inflated revenues**

Person involved

Chief Executive Officer, Bernie Ebbers

CASE STUDY 2 – WORLDCOM SCANDAL (2002) (Telecommunications Company - UK) - Quoted

How was it discovered?

Whistle blowing - WorldCom's Internal Auditor discovered inappropriate accounting.

Sanctions

- Arthur Andersen LLP, (UK) the auditors breached professional duty to evaluate the internal controls of the organization and to design tests to detect material errors which can result in misstatement of financial statements.**
- Kenneth M. Avery and Melvin Dick were the primary auditors representing their firm. Dick was barred from practicing accounting for 4 years and Avery was barred for 3 years.**

CASE STUDY 2 – WORLDCOM SCANDAL (2002)

Sanctions Cont...

- ❑ Bernie Ebbers - Chief Executive Officer sentenced to 25 years for fraud, conspiracy and filing false documents.**
- ❑ Scott Sullivan – Chief Financial Officer received 5 years in prison for improper accounting.**
- ❑ David Myers – Controller and Senior Vice President sentenced to 1 year and 1 day in prison for improper accounting**
- ❑ Buford Yates – Director of Accounting sentenced to 1 year and 1 day in prison for participating in the scandal.**

CASE STUDY 3– PARMALAT SCANDAL (2003) **(Dairy Food company - Italy) - Quoted**

What happened?

Parmalat was unable to pay a debt of over \$185Million

How did it happen?

- **Financial misreporting and manipulation of balance sheet**
- **Inflated revenues**
- **Bank confirmations were fake. Scanned copies “received”**
- **Auditors (Grant Thornton and Deloitte) “allowed” Parmalat to follow wrong / false accounting practices and helped them to cover fraud.**

CASE STUDY 3 – PARMALAT SCANDAL (2003) **(Dairy Food company)**

Person involved

Chief Executive Officer Calisto Tanzi

How was it discovered?

Whistle blowing by Internal Auditors after scrutinizing Parmalat accounts

Sanctions

- i. Calisto Tanzi - Chief Executive Officer sentenced to 18 years imprisonment.**
- ii. Fausto Tonna - Chief Financial Officer sentenced to 30 months for faking accounts.**

References

All viewed on 14th November, 2016

- http://www.larouchepub.com/other/2004/3102parmalat_invest.htm
|
- <https://www.ft.com/content/d41a0184-538f-11d9-b6e4-00000e2511c8>
- https://en.wikipedia.org/wiki/Enron_scandal
- <http://www.investopedia.com/updates/enron-scandal-summary/>
- https://en.wikipedia.org/wiki/MCI_Inc
- <https://www.theguardian.com/business/2002/aug/09/corporatefraud.worldcom2>
- <http://www.worldfinance.com/special-reports/the-parmalat-scandal>
- <https://en.wikipedia.org/wiki/Parmalat>

ASSETS

1). Audit of Fixed Assets

a). Property, Plant & Equipment (PPE)

Identify key controls, risks (including fraud risks) identified and the approach to assessed risk.

- i. Prepare a lead schedule setting out the movement in the period on each category of PPE.**
- i. Confirm that the accounting policies applied to PPE comply with IFRS, particularly IAS 16.**

ASSETS

iii. Test the key controls identified and conclude on the effectiveness of their design.

- ☐ **Beneficial use**
- ☐ **Full and proper title**
- ☐ **Assets register**
- ☐ **Physical verification**

ASSETS

a). Property, Plant & Equipment (PPE)

iv. Tailor the substantive audit tests below to provide sufficient assurance to conclude on validity of each assertion:-

- ✓ **compare PPE as stated in the GL with assets register – obtain explanations on differences**
- ✓ **Verify PPE by:- physical inspection and comparison with records**

ASSETS

- ✓ **Verify titles to assets by:- inspection of deeds, purchase invoices, vehicle registration documents, confirmation from solicitors, bankers and other third party sources.**
- ❖ **Depreciation – review reasonableness of rates used.**

ASSETS

a). Property, Plant & Equipment (PPE)

- ❖ **Impairment – consider need for provision due to changes in life, external information, obsolescence, damage in accordance with IAS 36.**
- ❖ **Additions – Verify additions, check if purchases have been recorded in the PPE register, consider whether PPE purchased are capital or revenue items, identify additions that are not eligible for tax allowances**
 - **Danger of capitalizing instead of expensing !
(Relevant Case Study - “WorldCom”)**

ASSETS

a). Property, Plant & Equipment (PPE)

- ❖ **Disposals – Verify disposals with sales and purchase invoices, if items disposed have been deleted from the PPE register in correct accounting year.**
- ❖ **Charges and Commitments – Discuss with Directors / staff if there are any encumbrances, commitments, charges or liens which may need disclosure.**

ASSETS

b). Intangible Assets – IAS 38

- ✓ **Compare intangible assets as stated in the GL with Trial Balance and Financial Statements and obtain explanations on differences.**
- ✓ **Verify items in GL by:- Comparison with records of income produced e.g. royalty income, licenses etc**
- ✓ **Legal agreements covering use of :**
 - **Patents, Licenses, Brands etc**

ASSETS

b). Intangible Assets – IAS 38

❖ Amortization

- ✓ **Determine whether estimates of useful lives of the assets are reasonable and reflect the expected usage and pattern in which future economic benefits will accrue.**
- ✓ **Determine the reasonableness of amortization rates for intangible assets with finite useful lives,**

ASSETS

considering:

- **Expectations of useful life;**
- **Previous gains or losses**
- **Consistency with previous years.**

b). Intangible Assets – IAS 38

❖ **Impairment**

- ✓ **Consider whether any provisions are needed and check whether circumstances continue to support the initial assumptions.**

ASSETS

2). Audit of Current Assets

a). Trade & Other Receivables – IAS 32 & IAS 39

Trade Receivables

- ✓ **Check whether debtors ledger control a/c reconciles with list of debtors listing**
- ✓ **Compare list of balances with individual debtors sub-ledger accounts**
- ✓ **Check subsequent receipt of payment posted to the correct year and in the correct amount.**

ASSETS

2). Audit of Current Assets

a). Trade & Other Receivables – IAS 32 & IAS 39

Debtor Circularization

- ✓ Obtain confirmation of debtors' ledger balances
- ✓ Supervise the making up of the contents of letter, client's statement, pre-addressed postage envelopes
- ✓ Select sample trade receivables using:-
overdue dates, accounts written off, large receivable balances

ASSETS

- ✓ **Review replies and summarize them as:-
balance agreed, balance disagreed,
confirmation refused, no reply**
- **Balance disagreed – ascertain & verify
explanations**
- **Refused – check if debtor is willing to
confirm specific invoices**

ASSETS

2). Audit of Current Assets

b). Cash and Cash Balances – IAS 7 & IAS 39

Bank Reconciliations

- ✓ **For each bank a/c check balance to:- Cash Book, General Ledger, Bank Statements & Bank Confirmations**
- ✓ **Trace uncleared items to bank statements and confirm uncleared bankings to paying-in records**

ASSETS

✓ **Consider adjustments for:-**

☐ **Cheques dishonoured after year-end**

☐ **Long outstanding cheques**

(Relevant Case Study – “Parmalat”)

ASSETS

2). Audit of Current Assets

a). Cash and Cash Balances – IAS 7 & IAS 39

Bank Mandates & Special Instructions

- ✓ **Check if any accounts are secured on the assets**
- ✓ **Review minutes and documentation for evidence of restrictions availability and use of bank balances**

Bank Confirmations

- ✓ **Ensure confirmations (originals) are independently received and questions are fully answered**

ASSETS

Foreign Bank Accounts

- ✓ **Confirm correct rate of exchange has been used**
- ✓ **Check on any restrictions on movement of funds**

(Relevant Case Study – “Parmalat”)

ASSETS

2). Audit of Current Assets

a). Cash and Cash Balances – IAS 7 & IAS 39

Bank Receipts

- ✓ **Check if cash received agrees to:- Cash book, Paying-in records, Sales / general ledger.**
- ✓ **List all cheques received, not yet banked and confirm - if date is current, all crossed and payable to the entity.**

ASSETS

Bank Payments

- ✓ **Select items in cash book and agree – to Purchase / General Ledger, Supplier invoices / statements**
- ✓ **Check sequence of cheque numbers. Missing numbers checked to confirm if subsequently used. Tag for follow-up action**

ASSETS

2). Audit of Current Assets

c). Inventory – IAS 2

Tests at the Inventory Count

- ✓ **Observe and test count inventory and compare with records**
- ✓ **Confirm basis of valuation**
- ✓ **Prepare inventory count report for each location**
- ✓ **(Relevant Case Study – “Enron”)**

ASSETS

2). Audit of Current Assets

c). Inventory – IAS 2

Cut Off Tests

- ✓ **Select items from goods inwards and outwards each side of the year end date and trace to inventory records**
- ✓ **Select items from inventory and trace to relevant goods inwards and outwards**
- ✓ **Check last dispatches if included in sales**
- ✓ **Check goods-in-transit and internal movements of inventory**
- ✓ **Check if sales resulted in cash or debtor and if debtor became cash or bad thereafter**

ASSETS

2). Audit of Current Assets

c). Inventory – IAS 2

After the Inventory Count

- ✓ **Verify final count sheets**
- ✓ **Trace items test counted to final inventory sheets**
- ✓ **Check additions of inventory sheets and summary**
- ✓ **Verify if inventory records have been adjusted to amounts physically counted**
- ✓ **Check receipts of goods-in-transit at year end**
- ✓ **Scrutinize inventory sheets for unusual items**

ASSETS

2). Audit of Current Assets

c). Inventory – IAS 2

Valuation

- ✓ **Ensure valuation policies have been applied**
- ✓ **Verify material prices / standard costs with invoices and price lists**
- ✓ **Check if the following costs have been treated correctly:-**
 - ☐ **Transport costs, duties**
 - ☐ **Trade discounts are excluded**
 - ☐ **Selling & distribution overheads are excluded**
 - ☐ **Inter-company profit been excluded**

ASSETS

2). Audit of Current Assets

c). Inventory – IAS 2

Valuation

- ✓ **Consider if standard costs have been used – compare actual and standard costs, investigate variances**
- ✓ **Verify if inventory is stated at lower of cost and net realizable value by:-**
 - ❑ **Confirming current selling price**
 - ❑ **Check adequacy of provision for anticipated losses**
 - ❑ **Confirm adequacy of provision against obsolete items**
 - ❑ **Review other indicators that inventory holding might be excessive**

ASSETS

SPECIAL PROBLEMS WITH INVENTORIES

- **Some may be invisible e.g. Gas or Minerals**
- **Complex in chemical make-up or underground storage**
- **Specialized in nature**
- **An increase in value or decrease has same effect on operating results / comprehensive income.**

B.) LIABILITIES

1. Trade & Other Payables – IAS 39

Creditors' Statement Reconciliations

- ✓ **Select sample creditor balances and obtain reconciliations and agree to:-**
 - ☐ **Supplier's statement**
 - ☐ **Creditors ledger**
- ✓ **Test reconciling items as follows:-**
 - ☐ **Invoices on creditors' statements but not in client's books**
 - ☐ **Payments made not reflected on creditors' statements**

LIABILITIES

2. Trade & Other Payables – IAS 39

✓ **Test reconciling items as follows (Cont...):-**

☐ **Invoices appearing in books and not in creditors' statements**

☐ **Payments in creditors statement and not in books**

Creditor Circularization

✓ **Consider circularization where:-**

☐ **Suppliers' statements are unavailable**

☐ **Weaknesses in control system exists**

☐ **Small number of major suppliers**

LIABILITIES

3. Trade & Other Payables – IAS 39

- ☐ **Unusual creditors – material unusual loans**
- ☐ **Suppliers with large balances at year end**
- ☐ **Suppliers with large balances at other times**
- ☐ **Unusual balances**
- ✓ **Review replies and categorize:-**
 - ☐ **Balances agreed**
 - ☐ **Balances disagreed – ascertain and verify explanations, acknowledge reply.**
 - ☐ **Confirmation refused**
 - ☐ **No reply**

LIABILITIES

4. Trade & Other Payables – IAS 39

Employee Taxes

- ✓ **Check whether accruals are correct**
- ✓ **Verify liability with underlying records**
- ✓ **Verify reconciliation of employee tax control accounts**

VAT

- ✓ **Compare VAT returns with VAT Control a/c**
- ✓ **Trace payments to / repayments from Tax Authority, General ledger or cash book to VAT returns**
- ✓ **Check subsequent payment of amount shown as payable at year end**

LIABILITIES

5. Trade & Other Payables – IAS 39

Accruals

- ✓ **Confirm accruals with supporting documents**
- ✓ **Review if provision for outstanding amounts were made**
- ✓ **Ensure estimated accruals are reasonable**
- ✓ **Examine post year-end payments and invoices to see if further amount should be accrued**

Deferred Income

- ✓ **Consider if any income recognized this year should be deferred in accordance with IAS 18.**

LIABILITIES

6. Trade & Other Payables – IAS 39

Current Tax – IAS 12

- ✓ **Check tax computation and consider:-**
 - ☐ **Items treated differently for tax and accounts**
 - ☐ **Items disallowed for tax**
 - ☐ **Tax allowances have been claimed on eligible assets**
 - ☐ **Available tax losses have been utilized**
 - ☐ **Non-trading income treated correctly**
 - ☐ **Correct tax rate used**

LIABILITIES

7. Trade & Other Payables – IAS 39

Deferred Tax – IAS 12

- ✓ **Consider whether all circumstances leading to temporary differences have been taken into account, e.g:-**
 - ☐ **Tax allowances on capital assets**
 - ☐ **Unrealized exchange gain / loss**
 - ☐ **General provision for impairment**
 - ☐ **Revaluations of PPE**
 - ☐ **Losses carried forward**

C.) EQUITY

8. Share Capital – IAS 1

✓ **Check and verify if there are changes in share capital to:-**

☐ **Prospectus**

☐ **Return of allotment**

☐ **Minutes**

☐ **Receipts**

☐ **Obtain a file search report from the Registrar of Companies**

☐ **Agree authorized share capital to the company's Memorandum & Articles or / and Special Resolution**

EQUITY

9. Long-Term Debt

- ✓ **Ensure the balances agree to the accounting records**
- ✓ **Vouch significant additions to loan agreements, amendments or other supporting documentation**
- ✓ **Assess if the loan amortization period is appropriate and consistent with prior periods**
- ✓ **Assess the reasonableness of the interest rate based on market rates for loans with similar risk and maturities**

EQUITY

10. Short-Term Debt

- ✓ **Ensure the balances agree to the accounting records**
- ✓ **Vouch significant additions to loan agreements, amendments or other supporting documentation**
- ✓ **Assess if the loan amortization period is appropriate and consistent with prior periods.**
- ✓ **Assess the reasonableness of the interest rate based on market rates for loans with similar risk and maturities.**

EQUITY

11. Borrowings – IAS 23 & IAS 39

- ✓ **Inspect minutes, loan agreements & other evidence**
- ✓ **Verify advances and repayments with Cash Book, Minutes and Agreements**
- ✓ **Request confirmation from :-**
 - ☐ **All lenders**
 - ☐ **Accrued interest**
 - ☐ **Particulars of any security for loan**
 - ☐ **Terms of repayment**
 - ☐ **Compliance with covenants**

DANGER AHEAD !!

AVOID FEE TRAPS. REMEMBER WHAT BEFELL THE AUDITORS & AUDITEES IN THE THREE CASES

- **BE SAFE & OBSERVE ETHICAL BOUNDARIES**
- **SOME AUDIT JOBS ARE POISONED BATES !**
- **IS THE BOAT SINKING ?!**

**** SINS DO FIND US OUT SOMEDAY ****
(Numbers 32 : 23)

AUDIT OF THE STATEMENT OF FINANCIAL POSITION PRACTICAL APPLICATION

STATEMENT OF FINANCIAL POSITION

IS IT TRUE AND IS IT FAIR ?

(Proverbs 11: 1 : dishonest scales are an abomination to the lord but a just weight is His delight)



**THANK YOU FOR SUPPORTING OUR
INSTITUTE**

 ***Questions / Comments ?***

**Horwath Erastus & Co., Certified Public
Accountants**

www.crowehorwath.net/ke