Substantive testing of Account Receivables

Objective	Assertion
All receivables on the balance sheet are real claims of the entity	Existence (E)
All real claims of the entity for amounts receivable are included on the balance sheet.	Completeness (C)
Receivables are carried at their net realisable (collectable) value (i.e. the gross receivables are properly stated with appropriate allowances provided for uncollectable accounts, discounts, returns, warranties and similar items).	Valuation and allocation (V&A)
The entity owns, or has legal right to, all the receivables on the balance sheet at year-end. All receivables are free from liens, pledges or other security interests or, if not, such liens, pledges or other security interests are identified.	Rights and obligations (R&O)
Receivables are properly classified, described and disclosed in the financial report, including the notes, in conformity with prescribed accounting principles (IFRSs).	Classification (Cl), classification and understandability (C&U)

Existence	• Usually addressed by **debtors' confirmation** (ASA 505; ISA 505). - Positive confirmation - the auditor requires a response to the confirmation request from the customer before concluding that the customer (trade receivable) exists. - Negative confirmation -auditor requests reply only if debtor disagrees with balance shown. Weak evidence → What if the confirmation never reaches the AR debtor, or the AR debtor does not exist, or in case they owe us more than what we said they owed us, they will not reply the correct amount they actually owe. • A positive confirmation only provides audit evidence as to the **existence** of the debt. That is, the receivable is real and goods or services were provided to the customer to the value recorded in the trade receivables transaction file. It does not provide any assurance as to whether the client will recover all of the balance → Not provide evidence for Valuation - E.g. a customer may confirm that a balance is due and payable, but the auditor is unable to determine whether or not the customer has the ability to pay the amount. • If debtors do not reply to our confirmation, we can check **subsequent cash receipt** (invoice paid after the confirmation date). The auditor searches the cash receipts journal for evidence that the customer has paid the amount outstanding, which provides evidence that they existed at the confirmation date. - When the customer has not paid the amount outstanding at the date of confirmation, the auditor searches for evidence that the sale occurred. E.g. the auditor agrees the amount to **shipping reports** signed by external carriers which indicates that the item was shipped prior to the confirmation date. - If no shipping reports available, we can **vouch against sales invoices** but this is not favourable because sales invoices are internally generated and therefore more easily manipulated. • Focus on debtors with large balance outstanding → Non-statistical sampling (rank debtors based on their balance outstanding and select top 10 largest debtors as the audit sample). As well as overseas debtors → stratify the population into local and overseas debtor and select a sample of debtors from each stratum → ensure overseas debtors are tested.
Completeness	• The audit procedures to verify that trade receivables are complete are relatively simple and consist of performing **cut-off procedures** as at year-end. • Inspecting the sales transaction file, billings, shipping documents and other supporting documents **immediately before and after the cut-off date** and determine that the transactions were recorded in the proper period.

Rights and obligations	• The client may have restrictions on trade terms as part of its conditions of sale. For example, some clients sell stock that is on consignment from a third party and therefore the stock is not recorded as owned by the client. • Or if the company already sells the AR to somebody else so they will not collect the money outstanding themselves. • **Review minutes, loan agreements and other documents** for evidence of liens, pledges or other security interests in receivables; determine that necessary disclosures are made.

Valuation and allocation	• **Subsequent receipts**: a sample of trade receivables outstanding at year-end is vouched to the subsequent receipt of cash from the customer. Even if they don't pay the full amount outstanding, evidence of payment shows that they have the ABILITY to pay and not likely to default.
	• Or **enquiry management** about their estimation and test their assumptions about Allowance for Doubtful Debts.
	• **Additional analytical procedures** can also be performed to corroborate the results of the valuation testing. E.g.
	  ○ Compare the ageing of trade receivables to the prior period
	  ○ Calculate the number of days it takes to convert trade receivables to cash for the current and prior period. Consider the reasonableness of the current period's amounts in relation to current economic conditions, credit policies and collectability.
	  ○ Compare the current period's accounts written off and the allowance for doubtful debts as percentages of accounts receivable and sales with the prior period's percentages. Evaluate the trends in light of current economic conditions and what you know about the client and the industry they operate in.
	  ○ Compare the ageing with the client's and with the industry's collection practices.
	• Very important when the client has **overseas debtors** since more likely to default. May need to acquire expert opinions regarding the economy and industry those overseas debtors operate in. Also focus on customers with **large outstanding balance**.

Classification	• Can be important because of disclosures, such as related parties and financial instruments. • For example, **enquire mgmt. if there are any related parties involved** in AR and request a representation letter from mgmt.

- There are **three important types of transactions that affect AR balance: sales, sales returns and allowances (credit memos) and cash receipts**. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or has determined that it is more efficient to test the balance substantively.

Substantive testing of Inventory

Objective	**Assertion**
All inventory on the inventory listing is included in the financial report	Existence (E)
All inventory is owned by the entity at year-end are included on the balance sheet.	Completeness (C)
Inventory is carried at the lower of cost or market value. The costs and market determinations are appropriate, including adequate provisions for excess, slow-moving, obsolete and damaged goods, and for losses on purchase and sale commitments.	Valuation and allocation (V&A)
The entity owns, or has legal right to, all the inventory on the balance sheet. All inventory is free of liens, pledges and other security interests or, if not, such liens, pledges or other security interests are identified.	Rights and obligations (R&O)

Inventory is properly classified, described and disclosed in the financial report, including the notes, in conformity with prescribed accounting principles (IFRSs).	Classification (Cl), classification and understandability (C&U)

Existence	• Usually addressed by **testing or physically sighting client's annual or cyclical stock take**.
	  ○ Stock count is MANAGEMENT job!!! Auditor just test the stock count that has been done by management. Auditor does NOT do stock count!
	• Before the client performs their inventory count, the auditor typically **reviews the client's proposed policies/procedures pertaining to the inventory count**. The auditor also **selects, in advance, a sample of items to test on the day of the count**.
	  ○ Perform tests both tracing from floor to recorded counts (sample selected from inventory listing - completeness) and vouching from recorded counts to floor (sample selected from inventory accounting records - existence) → Random (statistical) sampling.
	• The better a company controls its stock, the easier it is to implement cycle counting (to test the perpetual stock records to the physical records) on a regular basis throughout the year. If the controls are not strong, or if it is physically difficult to count the stock, often only an annual stocktake is held (usually close to or on the final day of the reporting period).
	• **If the physical inventory is taken at an interim date or on a staggered basis during the year, review the rollforward of activity** from the date of the physical inventory to year-end and investigate unusual items; consider counting (at year-end) significant new items and those items with significant increases or decreases between the physical inventory date and year-end.

Completeness	• Not usually a major issue • **Risk of understatement can be issue where goods sold on consignment**. For example, for clients selling to retail outlets, the retailer often does not take ownership or title of the goods held in-store until the goods are actually sold. It is not until the sale has occurred that the supplier (our client) is able to recognise the sale. It is highly dependent on the customer's ability to sell the goods, not on anything the client can necessarily do.
Rights and obligations	• Relevant for some clients due to **consignment sales, complex purchasing contracts**. • For example, if stock is owned by the client as soon as it is shipped from the manufacturer, the inventory needs to be recognised as stock before it is actually received into the client's warehouse. • **Review minutes, contracts and other documents** for evidence of liens, pledges or other security interests in inventory; determine that the necessary disclosures are made.