**Chapter-Seven**

**Audit of Revenues and Expenses, & Completion of Audit Engagements.**

**7.1: Audit of revenues and expenses**

The doctrine of conservatism is a powerful force influencing decisions on revenues and expenses. The concept remains important in large part due to the subjectivity involved with many accounting estimates (as for expected future credit losses on receivables, lives of assets, and the warranty liability for products sold). Conservatism in the valuation of assets means that when two (or more) reasonable alternatives values are indicated, the accountant will choose the lower amount. For valuation of liabilities, the higher amount is chosen. Therefore, when applied to the income statement, the conservatism concept results in a low or “conservative” income figure.

Most auditors have a considerable respect for the doctrine of conservatism. In part, this attitude springs from the concept of legal liability to third parties. Financial statements that understate financial positions and operating results almost never lead to legal actions against the auditors involved. Nevertheless, auditors must recognize that overemphasis on conservatism in financial reporting is a narrow and shortsighted approach to meeting the needs of our society. To be of great value, financial statements should present fairly, rather than understate, financial position and operating results.

Auditors obtain evidence about many income statement accounts concurrently with related balance sheet accounts. Depreciation expenses, for example, are most conveniently verified along with the plant and equipment accounts. Once the existence and cost of depreciable assets are established, the verification of depreciation expenses is merely an additional step. On the other hand, to verify depreciation expenses without first establishing the nature and amount of assets owned and subject to depreciation would obliviously be a cart-before-the horse approach. The same line of reasoning suggests that the auditors’ work on inventories, especially in determining that inventory transactions were accurately cut off at the end of the period, especially, is a major step toward the verification of the income statement figures for sales and cost of goods sold.

The auditors’ examination of operations should, however, be much more than an incidentally by-product of the examination of assets and liabilities. They use a combination of cross-referencing, analytical procedures, and analysis of specific transactions to bring to light errors, omissions, and inconsistencies not disclosed in the audit of balance sheet accounts.

**Specifically, the auditors’ objectives for the audit of revenues and expenses are to:**

1. Consider internal control over revenues and expenses
2. Determine the occurrence of recorded revenue and expense tractions
3. Establish the completeness of recorded revenue and expense tractions
4. Establish the clerical accuracy of schedules and revenue and expenses
5. Determine that the valuation of revenue and expenses and transactions in accordance with generally accepted accounting principles
6. Determine that the presentation and disclosure of revenue and expenses accounting are appropriate

**7.1.1: Revenue**- In this section **(1)** the relationship of revenue to various balances sheet accounts and **(2)** the miscellaneous revenue account.

**Relationship of revenue to balance sheet accounts-**As pointed out previously, most revenue accounts are verified by the auditors in conjunction with the audit of a related assets or liabilities. The following list summarizes the revenue verified in this manner.

**Balance sheet Item Revenue**

Accounts receivables Sales

Note receivables Interest

Securities and other investments Interest, dividends, gains on sale,

 Shares of invitee’s income

Property, plant and equipments Rent, gains on sale

Intangible assets Royalties

**Miscellaneous Revenue**- Miscellaneous revenues, by its very nature, is a mixture of minor items, some nonrecurring and others likely to be received at irregular intervals. If the client’s personnel receive a cash payment and are not sure of the source, it is likely that it will be recorded as miscellaneous revenue. Because of the nature of items recorded in the miscellaneous revenue account, the auditors will obtain an analysis of the account. Among the items the auditors might find importantly included as miscellaneous revenue are the following:

* Collections on previously written-of accounts or notes receivables
* Write-offs of old outstanding checks or unclaimed wages-in many states, unclaimed properties revert to the state after statutory period; in such circumstances, these write-offs should be credited to a liability accounts rather to miscellaneous revenues.
* Proceeds from sales of scrap- should be generally be applied to reduce cost of goods sold, under by-product cost accounting principles.
* Rebates or refunds of insurance premiums-these refunds should be offset against the related expenses or unexpired insurance.
* Proceeds from sale of plant assets –should be accounted for in the determination of the gain or loss on the assets sold.

The auditor should propose adjusting journal entries to classify correctly any material items of the types described above that have been included in miscellaneous revenues by the client. Before conducting the audit work on revenue, the auditor should perform analytical procedures and investigate unusual fluctuation. Material amounts of unrecorded revenue, as well as significant misclassifications affecting revenue accounts, may be discovered by these procedures.

**7.1.2: Expenses –** The auditors’ work relating to purchase and cost of goods sold was covered in previous chapters. Hence, the concern of this section will be audit procedures for other types of expenses.

**Relationship of Expenses to Balance Sheet Accounts**- The following relationships between the balance sheet accounts and expenses accounts should be considered by auditors in the audit of expenses.

**Balance sheet Item Expenses( and costs)**

Accounts and notes receivables Uncollectible accounts and notes expense

Inventories Purchases, cost of goods sold, and payroll

Property, plant and equipment Depreciation, repair and maintenance, and

 depletion

Prepaid expenses and differed Various related expenses, such as rent,

Charges property, taxes, advertising, postages, and and others

Intangible assets Amortization

Accrued liabilities Commissions, fees, bonuses, product

 Warranty expenses, and others

Interest-bearing debt Interest

**Substantive Testing Procedures for Selling, General, and Administrative Expenses**- for other expenses not verified in the audit of balance sheet accounts, the following substantive tests are appropriate.

1. Perform analytical procedures related to the accounts
	1. Develop an expectation of the accounts balances- auditors develop an expectation of the accounts balance by considering factors such as budgeted levels, the prior-year audited balances, industry averages, relationships among financial data, and relevant nonfinancial data.
	2. Determine the amounts of difference from the expectation that can be accepted without investigation-the auditors uses their estimate materiality to arrive at which differences are to be investigated and which might be expected to occur by chance. However, the extent of procedures for analytical procedures must also be considered.
	3. Compare the company’s accounts balances with the expected accounts balance-Comparison of the revenue and expense accounts with expected amounts may reveal significant differences that warrant investigations.
	4. Investigate significant deviations from the expected accounts balances-the starting point for investigating significant variations in expenses generally is inquiry of management. The auditors substantiate management’s expiations for significant variations by various means, including analyses of accounts.
2. Obtain or prepare analysis of selected expenses accounts- the auditor may analyze selected expense accounts such as advertising, research and development, legal exposes and other professional fees, maintenance and repairs, and rents and royalties.
3. Obtain or prepare analyses of critical expenses in income tax returns- income tax return generally require schedules for officers’ salaries, directors’ fee, taxes, travel and entertainment, contributions, and causality losses. In addition to these, officers’ expenses account allowances are presented in the analysis of officer’s salaries. Accordingly, the auditors should obtain or prepare analyses of any of these expenses that were not analyzed when performing other audit steps.

**7.2: Completing the audit engagements**

The auditors’ opinion on the financial statements is based on all evidences gathered by the auditors upon the last day of fieldwork, and any other information that comes to their attention between that date and the issuance of the financial statements. To be effective, certain audit procedures described in previous chapters can not be completed before the end of the audit. Auditor, therefore, may apply audit procedures after the balances sheet date in relation to many items such as the following.

1. Search for unrecorded liabilities
2. Review the minutes of meetings
3. Perform final analytical procedures
4. Perform procedures to identify loss contingencies
5. Perform the review for subsequent events
6. Obtain the representation letter.

**7.2.1: Search for unrecorded liabilities-**Throughout the audit, the auditors must be alert for any unrecorded payables. The search for unrecorded liabilities includes procedures performed through the last day of field work such as reconciliation, confirmation examining subsequent cash disbursements and analytical procedures which are perhaps used to disclose unrecorded. These procedures are designed to detect liabilities that existed at year-end but were omitted from the liabilities recoded in the client’s financial statements. In addition to normal trade payables, that may be unrecorded, other examples include unrecorded liabilities related to customer’s deposits recorded as credits to accounts receivables, obligations for securities purchased but not settled at the balance sheet date, and unbilled contractor or architect fees for a building under construction at the audit date and unpaid attorney or insurance broker fees.

In addition to the prior audit steps, when searching for unrecorded accounts payable, the auditors will examine transactions that were recorded following year-end. A comparison of cash payments occurring after balance sheet date with the accounts payables trial balances is generally the most affective means of disclosing unrecorded accounts payable. All liabilities must eventually be paid and will, therefore, be reflected in the account at least by the time they are paid. Regular monthly expenses, such as rent and utilities are often posted to the ledger accounts directly from the cash disbursements journal without any accounts payable or other liability having been set up. Therefore, thee auditors will often examine all cash disbursements, over specific dollar amounts that are made by the client during the subsequent periods.

The auditors should also consider sources of potential unrecorded payables such as the following.

1. Un matched invoice and unbilled receiving report
2. Vouchers payables entered in the vouchers register subsequent to the balances sheet date.
3. Invoices received by the client after the balances sheet date
4. Consignments in which the client acts as a consignee in which case the consignee assumes liabilities for consigned merchandise when those goods have been sold to third party.

When unrecorded liabilities are discovered by auditors, the next question is whether the omissions are sufficiently material to warrant postings and adjusting.

**7.2.2 Review the minutes of meetings-**the auditor’s review the minutes of meeting of stockholders and directors, including important subcommittees of directors such as the audit committee and the investment committee.

The corporate minute’s book is an official record of the actions taken at meetings of directors and stockholders. Typical of actions taken at meetings of stockholders is the extension of authority to management to acquire or dispose of subsidiaries and to adopt or modify pension or profit sharing plans for officers and employees. The stockholders also customarily approve the selection of a firm of independent auditors. Representative of the auditing firm attend the stockholders’ meetings for the purpose of assuring questions that may arise concerning internal control and the financial operation of the business.

Minutes of directors’ meetings usually contain authorization fro important transactions and contractual arrangements, such as the establishment of bank accounts, settings of officers’ salaries, declaration of dividends, and formation of long-term agreements with venders, customers, and lesser. In addition, the minutes may document discussions by the board of pending litigation, investigation by regulatory agencies, or other loss contingencies. Therefore, the auditors should read the minutes of meetings held through the last day of field work. The review of the minutes of meetings includes meetings held through the last day of field work. In completing the audit, the auditors must determine that they have considered all minutes, including those for meetings subsequent to year-end. They will also obtain representation from management that all minutes have been made available.

**7.2.3: Perform final Analytical procedures-** Analytical procedures must be performed in planning as well as for overall review purpose at the completion of the audit. Analytical procedures involve evaluation of financial statements information by a study of relation ships between among financial and non-financial data (SAS-56), “Analytical procedures,” provide guidance and examples of applications of these procedures.

Essentially, the process of performing analytical procedures consists of steps:

1. Develop an expectation of an account balances
2. Determine the amount of differences from the expectations that can be accepted without investigations
3. Compare the company’s account balances with the expected account balances
4. Investigate significant deviations from the expected account balances.

Techniques used in performing analytical procedures range in sophistication from straight forward comparisons and ratios to complex models involving many relationships and data from many previous years. Examples of analytical procedures includes comparisons of revenues and expenses amounts for the current year to those of prior periods, to industry averages, to budget levels, and to relevant non financial data, such as units produced or hours of direct labor.

 A more sophisticated analytical procedure might involve the development of an multiple regression model to estimate the amount of sales for the year using economic and industry.

In addition analytical procedures may involve computations of percentage relationships of various items in the financial statements such as gross profit percentages. When the relation ships turn out as expected, auditors are provided with evidence that the data being reviewed are free from material error. On the data hand, unusual fluctuations in these relationships may indicate serious problems in the financial statements and should be investigated fully by the auditors.

Analytical procedures performed as a part of the overall review assist the auditors in assessing the validity of the conclusions reached including the opinion to be issued. This final review may identify areas that need to be examined further as well as provide a consideration of the adequacy of data gathered in response to unusual or unexpected relationships identified during the audit.

**Illustrative case**

In performing analytical procedures for a marine supply store, the auditors noticed that uncollected accounts expense, which normally had been running about 1 percent of net sales for several years, had increased in the current year to 4 percent of net sales. This significant variations caused the auditors to make a careful investigation of all accounts written-off during the year and those presently past due-mostly of the uncollectible accounts examined were found to be fictitious and thee cashier-bookkeeper then admitted that he had created and the cashier-bookkeeper then admitted that he had created those accounts to cover up his abstraction of cash receptions.

**7.2.4: Perform procedures to identify loss contingencies-**a loss contingency may be defined as a possible loss, stemming from events that will be resolved as to existence and amounts by some future events. Central to the concept of a contingent loss is the idea of uncertainty both as to the amount of loss and whether, in fact, any loss has been incurred i.e. its existence. This uncertainty is resolved when some future event occurs or fails to occur.

Most loss contingencies may also appropriately be called contingent liabilities. Loss contingencies, however, is broader term, encompassing the possible existence of liabilities.

The audit problem with respect to loss contingencies is twofold. **First**, the auditors must determine the existence of the loss contingencies. Because of the uncertainty factor, most loss contingencies do not appear in the accounting records, and a systematic search is required if the auditors are to have reasonable assurance that no important loss contingencies have been over looked.

**Second,** the auditors must appraise the probability that a loss has been incurred and its amount. This is mode difficult both by the uncertainty factor and also by the tendency of the client management to maintain at least an out word appearance of optimisms.

In FASB statement No. 5, “ Accounting for contingencies”, the financial Accounting standard board set forth the criteria for accounting for loss contingencies such losses should be reflected in the accounting records when both of the following conditions are met:

**(1).** Information available prior to the issuance of the financial stalemates indicates that it is probable that a loss had been sustained before the balances sheet date, and

**(2)** The amounts of the loss can be reasonably estimated.

Recognition of the loss may involve either recognition of a liability or reduction of assets. When a loss contingency has been accrued in the accounts, it is usually desirable to explain the nature of the contingency in a desirable to explain the nature of the contingency in a note to the financial statements and to disclose any exposure to loss in excess of the amount accrued.

Loss contingencies that don not meet both of the above criteria should still be disclosed in a not to the financial statements when there is at least a reasonable possibilities that a loss has been incurred. This disclosure should describe the nature of the contingency and, if possible, provide an estimate loss. If the amount of loss cannot be reasonably estimated, the disclosure should include either a range of loss or a statement that an estimate cannot be made.

The procedures undertaken by the auditors to ascertain the existence of loss contingencies and to assess the probability of loss vary with the nature of the contingent item. Regardless of the procedures performed, it is important that they be extended to near the last day of fieldwork, so that the auditors have the latest available information to evaluate the financial statements presentation and disclosure of loss contingencies. Some of the more frequent types of contingencies warranting financial statements disclosure includes litigation, income tax disputes between client co. and tax authority, with respect to the amount of income to be paid, accommodation endorsements and other guarantees of indebtedness, accounts receivable sold or assigned with recourse, commitments to purchase, sale and to undertake certain transaction for specified price, and so on.

**The auditors procedures for loss contingencies-**A summary of the auditors procedures to detect and evaluate loss contingencies is described below**.**

1. Review the minutes of directors meetings to the date of completion of fieldwork. Important contracts, lawsuits, and dealings with subsidiaries are typical of matters discussed in board meetings that may involve contingencies.
2. Send a letter of inquiry to the client’s lawyers requirements
	1. A depreciation ( or evaluation of management’s description) of the nature of pending and threatened litigation and of tax disputes.
	2. An evaluation of the likelihood of an unfavorable outcome in the matters described
	3. An estimate of the probable loss or range, or a statement that an estimate can not be made
	4. An evaluation of management’s description of any unasserted claims that, if asserted, have a reasonable possibility of an adverse outcome.
	5. A statement of the amount of any legal fees.
3. Send confirmation letters to financial institutions to request information on contingent liabilities of the company.
4. Review correspondence with financial institutions for evidence of accommodation endorsements, guarantees of indebtedness, or sales or assignments of accounts receivables.
5. Review reports and correspondence from regulatory agencies to identify potential assessments or fines.
6. Obtain a representation letter from the client including that all liabilities known to officers are recorded or disclosed.

**7.2.5: Perform review of subsequent events-**evidence not available at the close of the period under audit often becomes available before the auditors finish their field work and write their audit report. The auditors’ opinion on the fairness of the financial statements may be changed considerably by these subsequent events. The term subsequent event refers to an event or transaction that occurs after the date of the balance sheet but prior to the completion of the audit and issuance of the audit report. Subsequent events may be classified into two broad categories.

1. Those providing additional evidence about facts existing on or before the balance sheet date, and
2. Those involving facts coming into existence after the balances sheet date.

**Type-1 subsequent events** are event that provide additional evidence as to conditions that existed at the balance sheet date and affects the estimates inherent in the process of preparing financial statements. These types of subsequent events require that the financial statements amounts be adjusted to reflect the changes in estimates resulting from the additional evidences.

As an example, let us assume that a client’s accounts receivable at December-31 includes one large account and numerous small ones. The large amounts due from the major customer was regarded as a fully collectable at the year end, but during the course of the audit engagement the customer entered bankruptcy. As a result of this information, the auditors found it necessary to recommend an increase in the December-31 allowance for uncollectible accounts. The bankruptcy of the customer shortly after the balance sheet date indicates that the financial strength of the customer had probably deteriorated before December-31, and the client was simply in error in believing the receivables to be fully collectable at that date. Evidence becoming available after the balance sheet date through the date of issuance of the auditors’ report should be used in making judgments about the valuation of receivables.

Others examples of this first type of subsequent events include the following.

* Customers’ check included in the cash receipts of the last day of the year prove to be uncollectible and are charged back to the client’s account by the bank. If the checks were material in amounts, an adjustment of the December-31 cash balance may be necessary to exclude the checks now known to be uncollectible.
* A new three year union contract signed two weeks after the balance sheet date provides evidences that the clients has materially underestimated the total cost to revenues is recognized by the percentage of completion method. The amount of income (or loss) to be recognized using revised cost estimates.
* Litigation pending against the clients in settled shortly after the balance sheet date, and the amount owned by the client is material. This litigation was to be disclosed in notes to the financial statements, but no liability had been accrued because at year end no reasonable estimate could be made of the amount of the client’s loss. Now the competent evidence exists as to the dollar amount of the loss, this loss contingency meets the criteria for accrual in the financial statements, rather than mere note disclosures.

**Type-2 Subsequent events** are events that involve conditions coming into existence after the balance sheet date. These events do not require adjustments to dollar amounts shown in the financial statements, but they should be disclosed if the financial statements other wise would be misleading. To illustrate assume that shortly after the balance sheet date, a client sustain an uninsured fire loss destroying most of its plant assets. The carrying value of plant assets should not be reduced in the balances sheet because these assets were infact at year end. However, any one analyzing the financial statements would be misled if they were not advised that most of the plant assets are no longer in a useable condition.

It is generally agreed that the subsequent events involve business combination, substantial causality losses, early retirements of bond payables, and other significant changes in a company’s financial position or financial structures should be disclosed in notes. Otherwise, the financial statements might be misleading rather than informative.

**NB**. In distinguishing between the two types of subsequent events and in deciding whether particular subsequent events should result in adjustments to the financial statements or notes disclosure, the auditors should carefully consider when the underlying condition came into existence. E.g. Bankruptcy of client customer resulted from a steady deterioration in financial position where the receivables were uncollectible at year end and the allowance for doubtful accounts should be increased. On the other hand, if the customer’s bankruptcy stemmed from casualty ( such as fire) according after year end the conditions making the receivables uncollectible came into existence after the balance sheet date and this subsequent event should be disclosed in a not to financial statements.

**Audit procedures related to subsequent events-** The period of time between the balance sheet date and the last day of field work is called the subsequent period. During this period, the auditors should determine that proper cut offs of cash receipts, and disbursements and sales and purchase have been made, and should examine data to aid the evaluation of assets and liabilities as of the balances sheet date. In addition, the auditors should:

1. Review the latest available interim financial statements and minutes of directors, stockholders, and appropriate committee meetings.
2. Inquire about matters dealt with at meetings for which minutes are not available.
3. Inquire of appropriate clients’ officials as to loss contingencies, changes in capital stock, debt, or working capital, changes in the current status of items estimated in the financial statements under audit, or any unusual adjustments made subsequent to the balance sheet date.
4. Obtain a letter from the client’s lawyers describing as of the last day of field work any pending litigation, unasserted claims, or other loss contingencies.
5. Include in the representation letter a representation from the client concerning subsequent events.

Generally, the auditors’ responsibility for performing procedures to gather evidences as to subsequent events extends only through the last day of field work. However, even after completing normal audit procedures, the auditors have the responsibilities to evaluate subsequent events that come to their attention. E.g. subsequent events that become evident between the final field work day and audit report day.

**7.2.6: Obtain Representation letters-** At the conclusion of the letters summarizing the most important oral representations made during the engagement. Many specific items are included in this representation letter. For example, management usually represents that all liabilities known to exist are reflected in the financial statements most of the representation fall into the following broad categories.

**1.** All accounting records, financial data, and minutes of directors meetings have been made available to the auditors of directors

**2.** The financial statements are complete and prepared in confirmation with generally accepted accounting principles.

**3.** All items requiring disclosure (such as loss contingencies, illegal acts, and related party transactions) have been properly disclosed.

**SAS-19** “clients Representation” requires auditors to obtain a representation letter on every engagements and provides suggestions as to its form and content. These letters are dated as of the last day of field work and usually are signed by both client’s chief executive official and chief financial officers.

**NB.** A client representation letter is a low grade of audit evidence and should never be used as a substituted for performing other audit procedures. The financial statement already constitutes written representations by the client; hence a representation letter does little more than asset that the original representations were correct.