ACCOUNTS PAYABLE

Highlights Of Technical Clinic

BY
KOH SOO HOON

PHOTO GETTY IMAGES

Audit of accounts payable (AP) remains an area where common and repeated findings are highlighted at the Practice Monitoring Programme (PMP). What are the areas to look out for in the audit of AP? Wong Sook Yee, an experienced consultant, facilitated this topic at a technical clinic for a group of practitioners on September 20. Here are the highlights of the discussion.

Q1 WHAT ARE THE COMMON PRACTICAL CHALLENGES FACED BY THE AUDITOR IN THE AUDIT OF AP FOR SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs)?

Lack of proper accounting records maintained by SMEs is a common issue encountered by the auditor. Take an example of a car accessories trading company which does not keep proper accounting records. It may exhibit one or more of the following symptoms: (1) Payment vouchers are not sequentially filed; (2) Unpaid supplier invoices are not filed; (3) Delay in recording of transactions. The lack of proper accounting records heightens the risk of a potential misstatement for AP, especially where completeness of liabilities is the key concern for this account balance. Accordingly, the auditor needs to vary the nature, timing and extent of the audit procedures to obtain more assurance on the balance.

In such circumstances, the auditor

The lack of proper accounting records heightens the risk of a potential misstatement for AP, especially where completeness of liabilities is the key concern for this account balance. Accordingly, the auditor needs to vary the nature, timing and extent of the audit procedures to obtain more assurance on the balance.

could vary the nature, timing and extent of procedures in carrying out a thorough search for unrecorded liabilities as follows:

- **Nature** In addition to the usual procedures, the auditor should consider checking to the following:
  - Supplier's statements subsequent to financial year-end;
  - Bank statements (to look out for all payments, including electronic disbursements), instead of only the payment vouchers to ascertain completeness of liabilities.
- **Timing and extent** Depending on the period covered by the auditor, the length of period coverage should be *longer* (for example at least two payment cycles).

Ascertaining the obligations of liabilities is another tricky task in the audit of SMEs. As most SMEs are likely to be family-owned businesses where shareholders are also directors, there is a tendency for the company to take in liabilities relating to a director's personal expenses, such as private loan, entertainment, travel, accommodation, and children's school fees. Remarks such as "These are left-pocket, right-pocket expenses" or "It doesn't matter, the director is also the shareholder" are usually made.

Are such liabilities indeed the obligations of the entity? This depends on whether such expenses are the director's entitlement, in accordance with the contractual terms between the entity and director. One of the audit procedures is to review the employment contracts of all the directors and key management personnel. If there is no

contractual agreement, the auditor should request each director to provide a declaration of all the remuneration and benefits. The auditor should also perform additional procedure to check to the IR8A of each director.

In addition, SMEs may provide guarantee on director's personal loan. If the entity has indeed provided such guarantee, the auditor should check that appropriate disclosure is made about the guarantee and/or a liability is accounted for in accordance with FRS 37 and FRS 39, as applicable.

Q2 AFTER DETERMINING A SAMPLE SIZE OF SAY, 20, FOR CIRCULARISATION, HOW DO YOU SELECT THE 20 SAMPLES? WOULD IT BE BASED ON THE LARGEST 20 BALANCES IN THE AP LISTING?

The auditor can select the 20 samples in a number of ways. One common practice is selection focusing on major and active suppliers. Selection of major suppliers stems from the higher risk that omission of large purchases may be material. The selection of such major and active suppliers should be done after gaining an understanding of the entity's operations. SSA 315 requires the auditor to identify and assess the risks of material misstatement through understanding the entity and its environment, that is, who the entity's suppliers are, the process of raising purchase orders, receiving and paying for goods and services etc. Without such understanding of the entity and relevant business processes, perfunctorily selecting the suppliers with the largest balances from the AP listing may not address the risks that AP balance is materially misstated.

In obtaining an understanding of the typical business process (of expenditure cycle), the auditor follows a transaction through the process, from the very first initiation of a transaction (raising of purchase order) to the very last step (payment of transaction). Such procedures solidify the auditor's understanding of the entity's expenditure system, and not merely rely on management representation. Once walkthrough is performed, it should be documented in the audit working papers, which may be in the form of a flow chart or a list of narrative chronological steps.

In determining who the major and active suppliers are, the auditor should peruse the purchases listing, to corroborate his understanding after discussion with the appropriate entity personnel. This is because there could be many purchases from active suppliers throughout the year with small or zero AP balance at period-end. Such commercial arrangement may arise due to bargaining power between the entity and certain key suppliers (big players in the market) who insist on prompt payment.

★

Being third-party documents, suppliers' statements are often used to verify the selected AP balances. This is because such documents are independent evidence generated by external parties. In the event such documents are not available, circularisation is performed.

In addition to the selection of major and active suppliers, there could be many other smaller suppliers. The manner in which the samples are selected for those numerous small suppliers includes random, systematic and haphazard methods. For further details on such methods, please refer to SSA 530 *Audit Sampling*.

Q3 WHERE SUPPLIER'S STATEMENT IS AVAILABLE, IS THERE A NEED TO SEND CIRCULARISATION?

Being third-party documents, suppliers' statements are often used to verify the selected AP balances. This is because such documents are independent evidence generated by external parties. In the event such documents are not available, circularisation is performed.

However, the auditor should be alert to the risk in circumstances where such suppliers' statements may not be relied upon as the only persuasive evidence regarding the completeness of AP balances. An example is where an entity has numerous and large transactions with a major supplier. Due to the frequency and magnitude of each transaction, there is a risk of material misstatement of AP if one or two transactions are omitted. In such an instance, the auditor may still consider obtaining, from this major supplier, direct confirmation of the outstanding

PHOTO SHUTTERSTOCK

balance as at year-end. Another situation where the auditor may not use a supplier's statement as the only evidence is where the supplier closes its books, say five to seven days prior to month-end, to facilitate finalisation of financial results reporting. Therefore, the supplier's statement may not reflect all transactions up to month-end date. In such an instance, the auditor may still consider requesting direct confirmation from the supplier and performing a more rigorous search for unrecorded liabilities (Questions 4 and 5).

Q4 WHAT IS THE LENGTH OF PERIOD COVERED FOR THE SEARCH FOR UNRECORDED LIABILITIES – FOR EXAMPLE, THREE MONTHS AFTER YEAR-END OR UP TO THE DATE OF AUDIT REPORT?

Search for unrecorded liabilities involves reviewing payment vouchers issued after year-end and unpaid supplier invoices as at the date of audit to check that all material liabilities relating to the financial year have been recorded as at year-end.

In determining the length of period, the auditor needs to consider the following: (1) Entity's internal control in place for the payment cycle; (2) Relevant risks assessed, and (3) Length of payment cycle. If the entity has strong internal control procedures for the payment process, the auditor may consider a shorter search period. Conversely, if the risk assessed for completeness of AP balance is high, the length of period should be longer (Question 1). Generally, the length of period covered should be at least one payment cycle instead of an arbitrary estimate of three months or even all the way up to the date of audit report. Therefore, if the entity usually takes two months to pay its suppliers, the period for search for unrecorded liabilities should be at least two months for low-risk clients. If risk of material misstatement has been assessed to be other than "low risk", the engagement team is required to extend the audit procedures and period of coverage. Needless to say, such basis of length of period covered should be documented in the audit working papers.

Q5 WHAT SHOULD THE AUDITOR DOCUMENT IN THE AUDIT WORKING PAPERS WITH RESPECT TO THE AUDIT PROCEDURES PERFORMED AND THE RESULTS OF THE SEARCH FOR UNRECORDED LIABILITIES?

SSA 230 paragraph 8 requires the auditor to prepare sufficient audit documentation to enable an experienced auditor to understand the nature, timing and extent of audit procedures, results performed and audit evidence obtained as well as significant matters arising and conclusions reached.

Generally, the documentation should include:

a) Characteristics of the items tested, for example, payment voucher numbers for payments made after financial year-end, invoice numbers for unpaid suppliers' invoices;
b) Basis of length of period covered;
c) Review of audit evidence gathered, including any exception noted;
d) Outcome of the test, that is, whether the expenses or liabilities have been recorded in the appropriate accounting period, and any resulting audit adjustment. ISCA

Koh Soo Hoon is Manager, Professional Development, at ISCA.