Liabilities, capital and expenses

CHAPTER CONTENTS

Table 16.1: Audit testing - purchases and payables

Assertions about classes of transactions	– All purchase transactions recorded have occurred and relate to the entity **(occurrence)** – All purchase transactions that should have been recorded have been recorded **(completeness)** – Amounts relating to transactions have been recorded appropriately **(accuracy)** – Purchase transactions have been recorded in the correct period **(cut-off)** – Purchase transactions are recorded properly in the accounts **(classification)**
Assertions about period-end account balances	– Trade payables and accrued expenses are valid liabilities (**existence)** – Trade payables and accrued expenses are the obligations of the entity **(rights and obligations)** – All liabilities have been recorded **(completeness)** – All liabilities are included in the accounts at appropriate amounts **(valuation and allocation)**
Assertions about presentation and disclosure	– All disclosed events and transactions relating to liabilities have occurred and relate to the entity **(occurrence and rights and obligations)** – All disclosures required have been included **(completeness)** – Financial information is appropriately presented and described and disclosures clearly expressed **(classification and understandability)** – Financial information is disclosed fairly and at appropriate amounts **(accuracy and valuation)**

Internal control considerations for payables

The audit of payables is closely linked to the procurement to pay system (or purchases system). We looked at controls over this system in Section 2 of Chapter 6, where we saw that they were based around ensuring purchases were authorised, the segregation of duties, matching GRNs with invoices, and prompt recording to minimise cut-off issues.

A specific control often operated by clients over the completeness of trade payables balances is the reconciliation of month-end balances to supplier statements. If the client has carried out this reconciliation at the year-end for all suppliers, the auditor can review these reconciliations.

However, if the client has not carried out these reconciliations, the auditor will need to compare supplier statements with year-end payables balances and investigate differences, so this becomes a substantive procedure that the auditor must undertake.

Procedures for trade payables and accruals

The largest figure in **current liabilities** will normally be **trade accounts payable** which are generally audited by comparison of **suppliers' statements** with **purchase ledger accounts.**

Audit procedures

As with accounts receivable, accounts payable are likely to be a material figure in the statement of financial position of most enterprises. The tests of controls on the **procurement-to-pay cycle** will have provided the auditors with some assurance as to the completeness of liabilities.

Table 16.2: Audit procedures - payables and accruals

AUDIT PROCEDURES: ACCOUNTS PAYABLES AND ACCRUALS	
Completeness	• Obtain a listing of trade accounts payables and **agree** the total to the general ledger by casting and cross-casting. • Test for unrecorded liabilities by **enquiries of management** on how unrecorded liabilities and accruals are identified and examining post-year-end transactions. • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts (see Section 2.3 for details of suppliers' statements). • Examine files of unmatched purchase orders and supplier invoices for any **unrecorded liabilities**. • Perform a **confirmation of accounts payables** for a sample (see Section 2.2 for details of the accounts payables' confirmation) • Complete the **disclosure checklist** to ensure that all the disclosures relevant to liabilities have been made. • **Compare** the current year balances for trade accounts payables and accruals to the previous year. • **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year.

	• **Compare** the payables' turnover and payables' days to the previous year and industry data. • **Re-perform casts** of **payroll records** to confirm completeness and accuracy. • **Confirm** payment of net pay per payroll records to cheque or bank transfer summary. • **Agree** net pay per cashbook to payroll. • **Inspect** payroll for **unusual items** and **investigate** them further by **discussion** with management. • Perform **proof-in-total (analytical procedures)** on payroll and compare to figure in draft financial statements to assess reasonableness.
Existence	• **Vouch** selected amounts from the trade accounts payables listing and accruals listing to supporting documentation such as purchase orders and suppliers' invoices. • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. • Perform a **confirmation of accounts payables** for a sample. • Perform **analytical procedures** comparing current year balances to the previous year to confirm reasonableness, and also calculating payables' turnover and comparing to the previous year.
Rights and obligations	• **Vouch** a sample of balances to supporting documentation, such as purchase orders and suppliers' invoices, to obtain audit evidence regarding rights and obligations.
Valuation and allocation	• **Trace** selected samples from the trade accounts payables listing and accruals listing to the supporting documentation (purchase orders, minutes authorising expenditure, suppliers' invoices etc). • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. • For a sample of **accruals, recalculate** the amount of the accrual to ensure the amount accrued is correct. • **Compare** the current year balances for trade accounts payables and accruals to the previous year. • **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year. • **Compare** the payables' turnover and payables' days to the previous year and industry data.

Cut-off	• For a sample of vouchers, **compare the dates** with the dates they were recorded in the ledger for application of correct cut-off. • **Test transactions** around the year-end to determine whether amounts have been recognised in the correct financial period. • **Perform analytical procedures** on purchase returns, comparing the purchase returns as a % of sales or cost of sales to the previous year.
Accuracy	• **Recalculate** the mathematical accuracy of a sample of suppliers' invoices to confirm the amounts are correct. • **Recast** calculation of **remuneration.** • **Re-perform** calculation of **statutory deductions** to confirm whether correct. • Confirm validity of **other deductions** by **agreeing** to supporting documentation. • **Recast** calculation of **other deductions**.
Occurrence	• For a sample of vouchers, **inspect** supporting documentation such as authorised purchase orders. • **Agree individual remuneration** per payroll to personnel records, records of hours worked, salary agreements etc. • Confirm **existence** of employees on payroll by meeting them, attending wages payout, inspecting personnel and tax records, and confirmation from managers. • **Agree benefits** on payroll to supporting correspondence.
Classification and understand-ability	• **Review** the trade accounts payables listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately. • **Read** the disclosure notes relevant to liabilities in the draft financial statements and review for understandability.
Accuracy and valuation	• **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

Reconciliations of accounts payables with suppliers' statements

Many suppliers provide **monthly statements** to their customers. These may therefore be available in the entity for examination. Because they are a source of documentary evidence originating outside of the entity, they are a **reliable** source of evidence to support suppliers' balances and provide evidence as to the **existence, completeness** and **valuation** of balances.

Having said this, auditors do still need to be **cautious** when using them as they may have been **tampered** with by the entity. The auditor should not rely on **photocopies or faxed statements**. If there is any doubt, the auditor should request a copy **directly** from the supplier or confirm the balance with the supplier

Auditing deferred taxation liabilities

LKAS 12

Audit issues and procedures

As part of the **planning process**, if the client receives tax services from the firm, the auditor should consult the tax department as to the company's future tax plans, to ascertain whether they expect a deferred tax liability to arise. This will assist any analytical procedures they carry out on the deferred tax provision.

Remember that **manipulating the deferred tax figure will not affect the actual tax position**. However, a **deferred tax charge** (the other part of the double entry for the statement of financial position provision) **is recognised in profit or loss before dividends**, even if it is not actually paid to the taxation authorities.

The following procedures will be relevant:

- Obtain a copy of the deferred tax workings and the corporation tax computation
- Check the arithmetical **accuracy** of the deferred tax working
- Agree the **figures used** to calculate timing differences to those on the **tax computation** and the **financial statements**
- Consider the assumptions made in the light of your knowledge of the business and any other evidence gathered during the course of the audit to ensure reasonableness
- Agree the opening position on the deferred tax account to the prior-year financial statements
- Review the basis of the provision to ensure:
  - It is in line with accounting practice under LKAS 12
  - It is suitably comparable to practice in previous years
  - Any changes in accounting policy have been disclosed

Auditing, purchases and expenses

The following are procedures specifically related to the audit of purchases and other expenses:
(a) Inspect a sample of purchase invoices to ensure they agree to the amount posted to the general ledger.
(b) Compare expenses making up administrative expenses to the prior-year charge and to expectations on a line-by-line basis. Where differences from expectations are discovered, they should be investigated.
(c) Enquire of management whether there are any unsettled claims or obligations arising before the year-end and ensure these are provided for (to give evidence over the completeness of the charge in the related expense category in the statement of profit or loss)
(d) Recalculate accruals and prepayments to gain evidence that other expenses are not over or understated.
(e) Compare gross profit margin with the previous year, the gross margin per the budget and expectations. Investigate any unexpected fluctuations.

Employee expenses and management remuneration

Employee expenses

One expense that may make up a significant proportion of expenses is the wages cost included in the statement of profit or loss.

Audit procedures

(a) Reconcile the gross costs on the payroll to the wages cost in the financial statements.
(b) Re-perform casts of payroll records to confirm completeness and accuracy of costs used as a basis for the journals to the financial statements
(c) Confirm payment of net pay per payroll records to cheque or bank transfer summary.
(d) Inspect payroll for unusual items and investigate them further by discussion with management.
(e) Perform proof-in-total (analytical procedures) on payroll by multiplying estimated average wage (using last year's figures plus expected increases)
by average number of employees (therefore incorporating starters and leavers) and compare to figure in draft financial statements to assess reasonableness.
(f) Re-perform calculations of statutory deductions to establish whether valid deductions have been included in the payroll expense.

Pension schemes

Expenses and related liabilities for employee pension schemes need special auditor consideration. There are two types or categories of post-employment benefit plan: **defined contribution plans** and **defined benefit plans**.

You should have covered the accounting treatment for each of these during your accounting studies, but a brief recap follows.

LKAS 19 *Employee benefits*

LKAS 19 *Employee benefits* deals with the benefits awarded to employees as part of their remuneration package. These benefits may include short-term benefits such as sick pay, long-term benefits such as disability benefit, postemployment benefits such as pensions and termination benefits.

Employee benefits

Employee benefits are all forms of consideration given by an entity in exchange for services performed by employees.

LKAS 19 Employee benefits recognises four categories of employee benefits. These four categories are as follows.

1. Short-term benefits, eg salaries, sick leave, maternity leave and annual leave
2. Post-employment benefits, eg pensions and post-employment medical care and post-employment insurance
3. Other long-term benefits, eg sabbatical leave and disability benefits
4. Termination benefits, eg early retirement payments and redundancy payments

Benefits may be paid to the employees themselves, to their dependants (spouses and children etc) or to third parties.

Definitions
LKAS 19 formally defines these categories of employee benefit as follows.

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

Other long-term employee benefits are all employee benefits other than short term employee benefits, post-employment benefits and termination benefits.

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either of the following:
(1) A company decision to terminate an employee's employment before the normal retirement date
(2) An employee's decision to accept an offer of benefits in exchange for termination

Short-term employee benefits

Recognition and measurement

Short-term employee benefit costs are recognised as employee costs in the employer's financial statements in the period in which employee service is given (unless these costs can be capitalised, for example as part of a non-current asset).
Unpaid short-term employee benefits at the end of an accounting period are recognised as an accrued expense.
Any short-term benefits paid in advance are recognised as a prepayment (to the extent that it will lead to, for example, a reduction in future payments or a cash refund).

QUESTION

Abekoon Traders (Pvt) Ltd gives its employees an annual entitlement to paid holiday leave. If there is any unused leave at the end of the year, employees are entitled to carry forward the unused leave for up to 12 months. At 31 December 20X3, the company's employees carried forward in total 35 days of unused holiday leave. Employees are paid Rs. 400 per day. Abekoon Traders expects all employees to use their carried forward holiday entitlement before the end of
20X4.

Required

Record the amounts recognised in the financial statements of Abekoon Traders for the year ended 31 December 20X3 in respect of the unused leave.

Answer

Statement of profit or loss Rs
Staff costs (400 × 35) 14,000
Statement of financial position
Accrued leave 14,000

Post-employment benefits

The most common type of post-employment benefit is a pension. There are two types of post-employment benefit plan:

- Defined contribution plans
- Defined benefit plans

Post-employment benefit schemes are often referred to as **plans**. The plan receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in assets, such as stocks and shares and other investments.

The post-employment benefits are paid out of the income from the plan assets (dividends and interest) or from money from the sale of some plan assets. Benefits may take the form of pensions, post-employment life assurance or medical care.

Defined contribution and defined benefit plans

LKAS 19 sets out the following definitions relating to classification of plans.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or onstructive

obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in
the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Defined contribution plans.
In the case of a defined contribution plan, the employer (and possibly current employees) pays fixed amounts into the plan each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the investments of the plan perform.

Fixed contributions → PENSION PLAN → Variable benefits

Recognition and measurement
Statement of profit or loss
Contributions to a defined contribution plan are recognised as an expense in the period in which they are payable (unless labour costs are included in the cost of assets such as property under construction).

Statement of financial position
Any unpaid contributions that are due at the end of a period are recognised as an accrued expense (liability).
Any excess contributions are recognised as a prepaid expense (asset) to the extent that the prepayment will result in a reduction in future payments or a refund.

QUESTION
Pacific Plants Ltd contributes 5% of employees' salaries into a post-employment plan each period. Salaries amounted to Rs. 8m in the year ended 31 March 20X4 and the company had paid Rs. 350,000 into the plan by the reporting date.

Required
Prepare the journal entry made by Pacific Plants Ltd in the year ended 31 March 20X4 to recognise pension costs.

ANSWER

DEBIT	Staff costs (SPL) (5% × 8m)	400,000	
CREDIT	Cash		350,000
CREDIT	Pension cost accrual		50,000

Defined benefit plans.
In the case of a defined benefit plan, the size of the post-employment benefits is fixed and the employer (and possibly current employees) pays contributions into the plan, which are

invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits.

If the assets in the fund are insufficient, the employer will be required to make additional contributions into the plan to make up the expected shortfall; if the fund assets appear to be larger than they need to be, and in excess of what is required to pay the post- employment benefits, the employer may be allowed to take a **contribution holiday** (ie stop paying in contributions for a while).

Variable contributions → PENSION PLAN → Fixed benefits

LKAS 19 requires that a net defined benefit plan asset or liability is recognised in the statement of financial position at each reporting date and movements in this net amount from year to year are recognised in the statement of profit or loss and other comprehensive income.
The net defined benefit asset or liability is calculated as

	Rs
Present value of defined benefit obligation (obligation to pay future benefits to employees)	X
Fair value of plan assets	(X)
Net defined benefit liability/(asset)	X/(X)

Where a net defined benefit liability results, this is sometimes referred to as a deficit; where there is a net defined benefit asset, this is a surplus.

LKAS 19 makes it very clear that the defined benefit obligation refers not only to the legal obligation under the formal terms of a defined benefit plan that an entity must account for, but also for any **constructive obligation** that it may have. A constructive obligation, which will arise from the entity's informal practices, exist when the entity has no realistic alternative but to pay employee benefits; for example, if any change in the informal practices would cause unacceptable damage to employee relationships.

Accounting steps

LKAS 19 prescribes a 4-step approach to accounting for a defined benefit plan, as outlined below. Each step will be explained in more detail later.

Step 1 **Measure the deficit or surplus**:
(a) An actuarial technique is used to make a reliable estimate of the cost to the entity of providing the post-employment benefit earned by employees in the current and prior periods.
(b) The benefit is discounted to arrive at the present value of the defined benefit obligation.

(c) The fair value of any plan assets is deducted from the present value of the defined benefit obligation.

Step 2 **Determine the amount of the net defined benefit liability or asset**
The surplus or deficit measured in Step 1 may have to be adjusted if a net benefit asset has to be restricted by the asset ceiling.

Step 3 **Determine the amounts to be recognised in profit or loss**
These may include:
(a) Current service cost
(b) Any past service cost and gain or loss on settlement
(c) Net interest on the net defined benefit liability (asset)

Step 4 **Determine remeasurements to be recognised in other comprehensive income (items that will not be reclassified to profit or loss)**
These may include:
(a) Actuarial gains and losses
(b) Return on plan assets (excluding amounts included in net interest on the net defined benefit liability (asset))
(c) Any change in the effect of the asset ceiling (excluding amounts included in net interest on the net defined benefit liability (asset))

Example: accounting for a defined benefit plan

At 1 January 20X2 the fair value of the assets of a defined benefit plan were measured at Rs. 1,100,000, and the present value of the defined benefit obligation was Rs. 1,250,000. On 31 December 20X2, the plan received contributions from the employer of Rs. 490,000 and paid out benefits of Rs. 190,000.

The current service cost for the year was Rs. 360,000, and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at 31 December 20X2 was Rs. 1.5m. The present value of the defined benefit obligation was Rs. 1,553,600.

Required

Calculate the gains or losses on remeasurement through OCI and the return on plan assets, and **demonstrate** how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X2.

Solution

It is always useful to set up a working reconciling the assets and obligation:

	Assets	*Obligation*
	Rs	Rs
Fair value/present value at 1/1/X2	1,100,000	1,250,000
Interest (1,100,000 × 6%)/(1,250,000 × 6%)	66,000	75,000
Current service cost		360,000
Contributions received	490,000	
Benefits paid	(190,000)	(190,000)
Return on plan assets excluding amounts in net interest (balancing figure) (OCI)	34,000	-
Loss on remeasurement (balancing figure) (OCI)	-	58,600
	1,500,000	1,553,600

The following accounting treatment is required.

(a) In the **statement of profit or loss and other comprehensive income**, the following amounts will be recognised

In **profit or loss**:

	Rs
Current service cost	360,000
Net interest on net defined benefit liability (75,000 – 66,000)	9,000
In **other comprehensive income** (34,000 – 58,600)	24,600

(b) In the **statement of financial position**, the net defined benefit liability of Rs. 53,600 (1,553,600 – 1,500,000) will be recognised.

Table 16.4: Audit evidence

Area	Procedures
Scheme assets (including quoted and unquoted securities, debt instruments, properties)	• Ask directors to reconcile the scheme assets valuation at the scheme year-end date with the assets' valuation at the reporting entity's date being used for LKAS 19 purposes • Obtain direct confirmation of the scheme assets from the investment custodian • Consider requiring scheme auditors to perform procedures
Scheme liabilities	• Auditors must follow the principles of SLAuS 620 *Using the work of an auditor's expert* to assess whether it is appropriate to rely on the actuary's work • Specific matters would include – The source data used – The assumptions and methods used – The results of actuaries' work in the light of auditors' knowledge of the business and results of other audit procedures

	Actuarial source data likely to include: • Scheme member data (for example, classes of member and contribution details) • Scheme asset information (for example, values and income and expenditure items)
Actuarial assumptions (for example, mortality rates, termination rates, retirement age and changes in salary and benefit levels)	Auditors will not have the same expertise as actuaries and are unlikely to be able to challenge the appropriateness and reasonableness of

Area	Procedures
	the assumptions. Auditors can, however, through discussion with directors and actuaries: • Obtain a general understanding of the assumptions and review the process used to develop them • Compare the assumptions with those which directors have used in prior years • Consider whether, based on their knowledge of the reporting entity and the scheme, and on the results of other audit procedures, the assumptions appear to be reasonable and compatible with those used elsewhere in the preparation of the entity's financial statements • Obtain written representations from directors confirming that the assumptions are consistent with their knowledge of the business
Items charged to operating profit (current service cost, past service cost, gains and losses on settlements and curtailments, interest)	• Discuss with directors and actuaries the factors affecting current service cost (for example, a scheme closed to new entrants may see an increase year-on-year as a percentage of pay, with the average age of the workforce increasing)