

APPENDIX 10.1: SUBSTANTIVE AUDIT PROGRAMME FOR PRODUCTION WAGES: TROSTON PLC

The detailed audit programme production wages of Troston plc set out on pages 390 and 391 but you may note the following general points:

General point

This programme incorporates tests of detail, but we draw your attention to the following paragraph A7 of ISA 520 – *Analytical procedures*:

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Directional tests that should be incorporated into the audit programme are principally as follows:

- Tests to ensure there is no overstatement of gross wages.
- Tests to ensure there is no understatement of deductions from wages.

The auditor checks both calculations of gross wages and deductions to confirm that the gross wage cost (including any employer's share of National Insurance contributions) has been properly calculated and distributed to wage earners, tax authorities, Social Security Offices and so on.

In drawing up appropriate audit programmes for production wages for Troston plc, we will make assumptions about the size of sample and the

basis of selection in carrying out substantive tests. We shall discuss sample size and basis of selection in Chapter 11.

Programme objectives should be clearly stated.

Suitable objectives for a production wages programme would be to determine:

- That the financial accounting and costing records contain an accurate, complete and valid record of production wages, including proper allocation within the costing system to revenue expense, non-current assets and inventories.
- That the money paid out by the company for production wages and related costs and described as such in the financial accounting and costing records reached the persons for whom it was intended.
- That the wages paid have been made for services performed for the benefit of the company.

The detailed programme for production wages of Troston plc is set out in Figure 10.4. Read carefully through the audit programme and the explanatory notes, noting that they are designed to meet the objectives we set out above and are tailor-made to the company.

The programme shown in Figure 10.4 is designed to give you a flavour of the kind of work carried out and is not necessarily complete.

You should note in particular the following matters:

- (a) The programme includes programme objectives, as it is important for auditors to be constantly aware of what they wish to achieve. Having set objectives, prepared the audit programme and carried out tests of details in accordance with the programme, the auditor should be able to form conclusions about the accuracy, completeness and reliability of the accounting records (stage 12 of the audit process shown in Figure 6.3 on page 230).
- (b) The auditor's approach is dependent on the sophistication of the computer system in place.

FIGURE 10.4 Audit programme for substantive tests of production wages (Troston plc)

Troston plc Year ended 31 December 2010	
Objectives are to determine: <ul style="list-style-type: none"> • That the money paid out by the company for production wages and related costs and described as such in the financial accounting and costing records reached the persons for whom it was intended. • That the wages paid have been in return for services performed for the benefit of the company. • That the financial accounting and costing records contain an accurate, complete and valid record of production wages, including proper allocation within the costing system to revenue expense, fixed assets and stocks. 	
Global tests	Done by/ref
1. Summarize the labour costs for production wages by reference to departmental reports in terms of number of employees and amount for the year to date, the corresponding period last year and total for the whole of last year, the labour costs to be analysed as to grades of staff, amounts paid on a time basis and amounts paid for bonus, and incidental costs such as employer's social security contributions.	
2. Review the above information and obtain explanations from management on trends and changes, where systems work has not provided the required insights.	
3. Obtain summaries of production reports from the production control department and estimate total production wage costs on the basis of known labour content of production cost and compare that estimate with total of actual production wages to date.	
4. Estimate production bonus on the basis of normal production quantities and actual production quantities and bonus agreement, and compare with actual production bonus to date.	
5. Apply known wage percentage increases to corresponding period basic production wages total and compare to the same period in this year, after adjusting for known changes in numbers.	
6. Review the labour costs for selected products appearing in the costing records and enquire into any significant changes in costs as compared with previous periods this year and last. Review the company's variance analyses in conjunction with this work.	
Tests of detail	
(a) Select four weekly payrolls in the period to date on a random basis and check the gross amounts to the wages control account and the general ledger expense account. Check the net totals to the cash book entry.	
(b) Confirm that the selected payrolls have been signed by the two wages and salaries personnel and by the chief accountant.	
(c) Scrutinize the general ledger accounts containing entries emanating from the payroll (checked in (a) above) and enquire into any postings of an unusual nature, particularly those originating in the payroll.	
(d) Select two of the payrolls on a random basis and using audit software (CAAT 1) recreate the following listings: <ul style="list-style-type: none"> i) new staff ii) leavers iii) hours less than 40 iv) overtime hours v) overtime over ten hours vi) recorded production hours and total possible payroll hours and shortfall vii) bonus calculation and reconciliation to production report. CAAT 1 to include producing reports of new or dismissed/resigning employees for comparison with supporting documentation, and comparing date of entry on payroll with date of appointment or leaving (using data on separate files).	

FIGURE 10.4 (Continued)

(e) For the two payrolls check the casts and crosscasts and reconcile to recorded times using audit software (CAAT 2).	
(f) For the two payrolls check the mathematical accuracy of deductions using audit software (CAAT 3).	
(g) For selected employees (20) check names to tax cards and social security documentation.	
(h) For the selected employees check hours worked per the payroll to recorded times listing. (Note: This work should be backed up by proving the validity of the encoded clock cards of the selected employees held by them.)	
(i) Check listings (d) i) and ii) to the personnel master file hard copy. Back up this by checking the master file to the hard copy on a random basis, and for the selected employees check to employee contracts, and wage and bonus rates, ensuring that these are properly authorized.	
(j) Check listings (d) iii) to vii) to overtime authorization forms and production reports and related BETs, checking that OAFs have been approved by the head of PCD and that BETs bear the signatures of group heads, employees and inspector. (Obtain specimen signatures for the purpose of this work.) Check sequence of the BETs. (Note: It may be possible to use audit software to test the reconciliations to the production reports and costing records generally.)	
(k) Review the accounting records for deductions in the general ledger and check: i) That the details agree with returns submitted to the departments and bodies entitled to the deductions. ii) That payments appear to be on a timely basis. iii) That reconciliations are regularly made between returns and the relevant accounting records.	
(l) For the selected employees, check to copies of the bank transfer forms and to entries in the cash book and bank statements.	

- (c) Regarding global tests, we have assumed that the auditors would prepare statistical information but, if this information is available in the company's computerized information system, they might download it to their PC and review it there. Troston produces a listing of recorded production hours and these could be used for reconciliation purposes. We assume that the company keeps all information in computer files, including back-up, so that the auditor might be able to use computer software to interrogate these files. We have incorporated into the programme a number of steps using the computer for selection and comparison.
- (d) The programme refers to documents and records in existence in the company (for instance, batch/equipment tickets) and reflects the processing system in use, indicating that it has been tailor-made to the organization.
- (e) Regarding level of testing, you may have asked how we decided to make our selection of payrolls and employees. In Chapter 11 we discuss statistical sampling in detail but note at this stage that the important matters to be taken into account when selecting transactions or balances for detailed testing are:
- Designing the sample, including its size, to meet your desired objectives.
 - Selecting the sample – which items are to be tested individually.
 - Examining the sample – testing, for instance, for accuracy.
 - Sample evaluation – forming conclusions about the population based on the sample.
- (f) Many firms of auditors do not regard the wages and salaries area as high risk in itself. However, production cost and its relation to inventory appearing in the financial statements may well be high risk and the auditor will normally wish to be sure that labour costs have been properly determined.
- (g) Note in particular that the system is the one in operation at the present time and not the system that may be in existence in the future because of any recommendations the auditor may care to make.

Note at this juncture that accounting records form the basis for the preparation of the accounts upon which the auditor is reporting so forming conclusions on their acceptability is vital. The audit conclusions following substantive procedures must be based on good evidence recorded in the working files. It is normal practice for auditors to prepare audit depth test schedules for this purpose and we set out an example for Troston plc production wages in Figure 10.5. This kind of schedule would be typically prepared using a spreadsheet.

APPENDIX 10.2: SUBSTANTIVE AUDIT PROGRAMME FOR CASH/BANK: COUNTY HOTEL LIMITED

We set out below a number of detailed audit programme steps that would be suitable for some aspects of the audit of cash/bank transactions in the County Hotel Limited. We will first direct our attention to the proper recording of income and expense as control over cash received and cash paid is best achieved by accurate and complete recording of such income and expense. We shall

consider the programme steps to test that cash as an asset is being properly safeguarded.

You should refer to Case study 5.4: County Hotel Ltd, to help you understand our suggested steps.

Complete and accurate recording

Accommodation income

This income will be collected in cash immediately or be charged to a customer's account for subsequent collection. The control procedures to ensure accurate and complete recording of accommodation income are an important element in the control of cash. You will agree that the easiest way to misappropriate cash will be not to record it in the first place. The particular problem for the auditor (and management) in relation to accommodation income is the variety of rates and the fact that rooms may be let at rates other than the standard.

Programme step. Review the accommodation income work programme and confirm that our work has enabled us to conclude that *such income is genuine and fully and accurately recorded.*

FIGURE 10.5 Audit depth test: production wages (Troston plc)

Employees		Rates basic OT		Hrs		Bonus		Gross		Tax		NIC		Trade union		Deduc- tion		Net		Personnel records		Tax cards		NIC records		Payroll no.
Hanwell	✓	8.00	×	40	<	59	α	499.00	α	93.40	α	29.94	γ	4.00	>	127.34	>	371.66	β		β	β				3
W	✓	12.00	×	10																						
Hassan	✓	6.00	×	40	<	41	α	353.00	α	60.20	α	21.18	γ	4.00	>	85.38	>	267.62	β		β	β				10
R	✓	9.00	×	8																						
Sykes	✓	7.00	×	35	<	38	α	283.00	α	41.70	α	16.98	γ	4.00	>	62.68	>	220.32	β		β	β				25
E	✓	10.50	×	0																						
Popat	✓	5.00	×	40	<	25	α	277.50	α	42.20	α	16.65	γ	4.00	>	62.85	>	214.65	β		β	β				31
A	✓	7.50		7																						
Nelson	✓	5.00	×	40	<	24	α	261.50	α	38.60	α	15.69			>	54.29	>	207.21	β		β	β				48
A	✓	7.50	×	5																						

- ✓ Checked to pay agreements
- ×
- ×
- < Checked to bonus agreement and BETs
- α Checked calculations
- γ Checked to personnel files (agreement to have TU dues deducted from salary)
- > Checked crosscasts
- β Checked to records indicated

The audit programme in the accommodation income section should include the following steps (assuming that you have already concluded that the accounting and internal control systems are adequate):

- Review accommodation income for the year to date and the corresponding period last year and enquire into any significant changes in total income and room usage.
- Using management information and statistics, discuss with management the reasons for the changes (in particular the drop in room usage from 76 per cent in 2009 to 74 per cent in 2010). Enquire into correlation between restaurant income and accommodation income.
- Trace reception record details to accommodation records, including copy invoices, invoice register and housekeeping records.
- Select 30 entries at random from the housekeeping records of room usage and check to reception record register and accommodation income records.

Note that apart from these audit programme tests, forming part of other audit programmes, when performing a cash audit programme, the auditor will normally test from the bank documentation backward to the source documentation. For instance, a payment to a supplier of lamb or beef for the kitchen will be traced back to invoices, goods received notes, orders, etc. In other words, the auditor will choose to approach transactions from the point of view of the movement on the bank account and will attempt to verify that all movements selected (receipts and payments) are properly supported. This is because the auditor at this point wishes to verify the validity of recorded cash transactions.

Proper safeguarding of cash

Proper recording of the transactions forming the basis for cash payment and receipt is a prerequisite of cash control, although it is not sufficient in itself. The auditor also tests to ensure that

payment is made to the right individuals and that receivables are, in fact, received. For this reason the following tests should be carried out:

- Review cash receipt and payment records for unusual items and enquire into them. For instance, the auditor of the County Hotel Ltd should pay particular attention to payments made on account or finally to the building firm carrying out the bathroom conversions.
- Compare totals of cash collected at the various cash points in the hotel – reception, restaurant, bars, etc. – with the amounts recorded in the bank paying-in book and bank statement. Enquire into any discrepancy.

In the Horton Ltd example in Chapter 7, the company required *all* cash received to be deposited in the bank. This is a very useful general rule for cash control: *all monies received should be banked intact*, and is particularly important where coins and banknotes are received. They should not be used to pay expenses or costs merely because it seems easier to do so, as this will make reconciliation between monies received and cash banked more difficult.

- Test the accuracy of individual cash receipts as recorded (for instance, receipts from customers for a wedding reception held in the hotel) by checking remittance advices, paying-in slips and posting to the customer's account. The auditor would in this instance be testing that no teeming and lading was occurring. Note that this kind of test may be performed on a surprise visit basis, the auditor checking cash receipts before they have been banked, enabling names on cheques received to be compared with the customer's account.
- Banks no longer return cheques to customers but on occasion auditors may wish to obtain selected cancelled cheques for audit purposes.

This would normally be at the request of the client.

The cancelled cheques should be tested as follows:

- (a) Check signatures on the cheques to list of authorized cheque signatories. (This would highlight any apparently unauthorized signing of cheques.)
 - (b) Compare payees, amounts and dates to the cash book and creditors ledger entries and other supporting documentation.
- The next two audit tests are typical year-end verification tests but may be performed at interim examinations as part of the programme for checking the record and safeguarding of cash is satisfactory:

Such tests are outlined in some detail in Chapters 12 and 13.

- (a) Cash counts: in the County Hotel example, in view of the large number of cash points, it would be necessary to arrange for sufficient audit firm staff to visit the hotel at the same time so that no transfers can be made between cash points to hide deficiencies. It is usual for such cash counts to be carried out on a surprise basis, having identified all cash items under the control of various custodians. Matters to which the auditor should pay particular attention are:
 - (i) Comparison of counted cash with the record of cash balances.
 - (ii) Count to be carried out in the presence of the custodian of the cash, a written record of the count details and that no other funds are held to be signed by the custodian at the close of the count.
 - (iii) Check that cash held temporarily prior to deposit in the bank is deposited in the bank intact.

- (iv) Check that petty cash balances held are reasonable, review the petty cash book and ascertain that a responsible official checks that receipts and payments appear reasonable.

We have already noted that many auditors do not observe petty cash counts because they are not material in the context of the financial statements. However, where large quantities of cheques and bank notes have been received from customers, it may be a useful step to count and compare with the records of income received.

- (b) Confirmation from the bank of balance on hand and such matters as overdraft limit, accounts opened and closed in the year, guarantees by and for third parties, security for overdraft and so on.

In this section we have covered some major matters that should be included in a cash audit programme during the interim examination. The main matter to emphasize is that the programme should be specifically designed to meet the programme objectives determined by the auditor before the detailed work commences. Set out below is a suggested audit conclusion for cash and cash transactions.

On the basis of the work performed on cash balances and handling as set out in the cash audit programme on working paper C100, as supported by working papers C101 to C131, I can conclude that, within reasonable limits; (i) all cash which the County Hotel should receive, has been received and safeguarded; (ii) payments are only made on the instructions of authorized officials of the company as the result of proper documentation produced by the accounting system; and (iii) that the accounting records can be relied upon to give a true record of the cash balances and transactions. Note that the audit programme was prepared on the basis of scope decisions recorded in working paper C10, supported by systems notes in the permanent audit files (section C).