Article: The control environment and the role of reconciliation procedures

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Introduction

As a statutory auditor (auditor) a practitioner shall endeavour to provide an opinion as to the truth and fairness of the financial statements of a company.

It is the auditor's responsibility to ensure that the relevant information is tested and where appropriate reconciliation procedures performed, so as to be able to form an opinion based on credible information.

This article looks at the control environment and specific audit procedures of reconciliation. It:

- Considers the importance of reconciliations in the audit process, and
- Works through sample reconciliations.

The process of reconciliation forms part of the control system. The control system, particularly the area of internal control comprises the:

- Control environment, and
- Control procedures.

It includes all the policies and procedures adopted by the directors and management of an entity to assist in achieving the objective of ensuring, as far as practicable, the orderly and efficient conduct of its business.
The importance of controls can be illustrated as they can assist in assuring:

- Internal policies are adhered to
- The safeguarding of assets
- The prevention and detection of fraud and error
- The accuracy and completeness of the accounting records, and
- The timely preparation of reliable financial information.

An auditor may use the understanding of internal controls in the following ways to:

- Identify types of potential misstatements
- Consider factors that affect the risks of material misstatement, and
- Design the nature, timing and extent of further audit procedures.

The auditor may choose to test the controls within the entity which will assist in making the overall audit more efficient as it may assist in reducing the level of substantive testing to be performed.

Why is the audit process of reconciliation important?
Reconciliations can be conducted in many facets of the audit. A selection of the areas that can be examined are considered here and for the purpose of this article we will consider inventory, payables and bank, although this is not an exclusive list. Other areas such as non-current assets and receivables can also be of primary importance.

The balances in these areas are normally material figures in the financial statements so are significant in terms of the audit report.

Reconciliation, to the auditor's satisfaction, of the information that supports these figures is an important aspect of the audit process.

Performance of audit of reconciliations - activities to be considered

Controls and reconciliation of inventory/stock count

Audit procedures that may be carried out by the audit team after the year-end inventory/stock count:

- Carry out analytical review procedures on inventory to obtain assurance about the completeness, accuracy and valuation assertions
- Ensure the adequacy of the presentation of the disclosure of inventory by checking to the underlying accounting records, and
- Check replies from third parties about inventory held by, or for, them.

The principal business activity (PBA) within the inventory cycle will be considered and the risk associated with this PBA should be borne in mind.

Controls and reconciliation of bank and cash (B&C)

If controls around revenue, receivables (R&R), purchases and payables (P&P) have been tested then it is likely the controls around cash receipts and payments have been tested within these cycles. Other controls around bank and cash which may be considered are those connected to bank reconciliations.

Due to the fact that 100% of bank accounts should be substantively tested by the auditor, a separate bank control testing phase is not normally observed by the auditor but instead incorporated into R&R and P&P activities.

Key documents around B&C include:

- Remittance advices
- Payment proposals
- Bank statements
- Bank Reconciliations
- Cheque books, and
- Bank Mandate.

Controls and reconciliation of payable ledger supplier balances

Auditing of supplier reconciliations are sources of audit evidence based on the following assertions:

- Completeness
- Accuracy
- Cut-off
- Existence, and
- Rights and Obligations.

The following is a simple example of the reconciliation of a payables ledger balance.

Jango Ltd. (Jango) the audit client has provided you, the auditor, with the following details concerning Philips Ltd (Philips) a significant payables ledger balance at the year-end, 30 June 2019.

Philips statement of account with Jango to June 30 2019 i.e. Philip's record of what Jango owes it to 30 June. (Remember a "dr" balance shows that Philips is owed money by Jango).

Date	Ref	Dr€	Cr€	Bal
1 June	Bal			58,000 dr
10 June	Sales Invoice (sinv) 789	24,000		82,000 dr
25 June	Sinv 825	38,000		120,000 dr
30 June	Bal			120,000 dr

Philip's account in Jango's payable ledger to 30 June 2019 i.e. Jango's record as to what it owes Philips which is part of its overall payables balance. (A "cr" balance shows that Jango owes money to Philips).

Date	Our ref	Their ref	Dr €	Cr €	Bal
1 June	Bal				58,000 cr
15 June	Purchase Invoice (pinv) 265	Sinv 789		24,000	82,000 cr
26 June	Cheque 411		21,000		61,000 cr
30 June	Bal				61,000 cr

We will reconcile the payables ledger balance to the statement of account balance as at 30 June 2019.

Approach: As with all reconciliations (e.g. a bank reconciliation) we will compare the two sets of records by "ticking off" all common items of both e.g. the opening balance at 1 June and highlighting any item in one of the statements which is UNMATCHED in the other record e.g. sinv 825 which is included in the statement of account but NOT in the payables ledger account.

Having matched all common items we will consider the following unmatched items:

Item on the statement of account that are not on the payables ledger account - sinv 525 for €38,000. If the ledger balance was "adjusted" for this invoice the statement and the ledger should agree.
Item on payables ledger account that are not on statement of account - cheque 411 for €21,000. If the statement balance was adjusted for this item both should agree.

There are various ways to layout the answer with the aim of arriving at two adjusted balances that are the same. The approach below adopts the idea of adjusting either the statement of account balance or the payables ledger balance for the items that are "missing" from them i.e. not on them as identified from our matching process.

The Reconciliation

	€
Balance per statement of account	120,000
Add(Deduct) Items on ledger not on statement	
Cheque 411	(21,000)
Adjusted Statement Balance	99,000

Balance per payables ledger	61,000
Add(Deduct) Items on statement not on ledger	
Sinv 825	38,000
Adjusted Statement Balance	99,000

Auditing the Reconciliation and Reconciling Items (To ensure that it has been correctly compiled and that the entries represent real items that have been followed up and adjusted in the client's records correctly).

1. Has the reconciliation been compiled correctly?

Issue	Action
Is the statement balance at 30 June the actual balance?	This should be checked to the original statement from the supplier.
Is the ledger balance at 30 June accurate?	This should be checked to the list of payable ledger balances that was reconciled to the payables control account at 30 June.
Have the reconciling items (cheque 411 and sinv 825) been correctly identified and correctly adjusted in the reconciliation?	Re-perform the reconciliation to confirm that these are the reconciling items.
Have the reconciling items been correctly added and subtracted in the reconciliation?	Confirm the adjusted balances total correctly.

However it could also have been accrued for i.e..

2. Invoices on supplier statement that are not on the payables ledger account.

Issue	Action
In this example we are considering sinv 825. Philips claim to have sold goods/services to Jango in June but Jango has not recorded any liability for this at 30 June. Jango's purchases/expenses and payables may all be understated due to it not recording this invoice by June 30.	Check the invoice to its good received note (GRN) date. When were goods/services received?
If the goods were received before June 30 then the invoice, ideally, should have been recorded.	If the goods / services were received prior to June 30 investigate why it was not recorded.
Jango's accountant may have recorded an accrual adjustment for this invoice.	Check whether the invoice been accrued or is an accrual required?

3.

Payments recorded in the payables ledger and that are not on the statement of account

Jango claims to have paid Philips €21,000 before June 30 (cheque 411) but Philips has not recorded this item in the statement of account before June 30.	
Issue	Action
Did this transaction actually occur before June 30? Did it ever occur?	Check if the transaction appears on Philips July statement of account
Assuming the transaction is on Philips July statement of account, is it related to a June or July Transaction?	Check the date it appears on the statement of account. If it is recorded late in the month, e.g. 25 July, this may indicate that the transaction occurred in July and it was recorded by Jango in June's payables ledger in order to 'window-dress' the payables balance.
Let us assume that due to time constraints (the audit has to be completed by say July 4) that it may not be possible to obtain the July supplier statement of account.	Check the cheque payments book and the bank statement to verify if, and when, the cheque was cashed. For a material balance, Philips could be contacted to verify that it had received the cheque and that the transaction was genuine.

4. Debit balances recorded in the payables ledger (examples not given in the reconciliation above)

These could arise for several reasons including: overcharging, over delivery, claiming refunds for faulty or defective goods that have been returned to the supplier, paying an invoice twice, overpayment of an invoice, recording DR notes or payments against the wrong supplier account. A debit note (DN) would be raised by the entity claiming the refund or reduction in the amount owing. There may be timing differences or other reasons why these transactions have been included on a supplier's statement of account. The auditor must ensure that there is not a deliberate or innocent attempt to misrepresent the accounts payable balance.	
Issue	Action
Verification of the debit balance in the payables ledger	If not included on the current supplier's statement of account, the balance should appear as a credit note on a subsequent statement.
The balance does not appear on a subsequent supplier's statement or the balance that is included is materially different.	Verify that the client is correct, or not, by: 1. Discussing with the client and reviewing the client's correspondence with the supplier, and / or 2. Contacting the vendor and requesting it to verify that it accepts the balance, and 3. Where there are differences in value request an explanation for them.
Debit balances could indicate recording errors in recording purchases and in the payables ledger.	Identify these debit balances. They should be obvious from the list of payables ledger balances that was reconciled to the payable control account balance. Ascertain from the client why they occurred and also their recoverability. i.e if an over payment occurred, will the supplier refund the over payment?
Have transactions been omitted from the purchases system and / or the payables ledger?	Identify the risk of unrecorded invoices. For example, was a payment made before the related purchase invoice was recorded? How likely or prevalent is this? Confirm directly with the supplier what its understanding is of the amount(s) it is due to receive or refund.

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5. Other Unusual Items (examples not given above)

Examples could include old unpaid invoices or round-sum payments (i.e. €10,000, €5,0000).
• Old unpaid invoices may indicate errors, perhaps invoices posted to Philips account in error last year that have not been corrected.
• Round sum payments may indicate that the client is unable to keep the payables ledger up to date (as a result of not recording the purchase invoices on a timely basis). As a consequence the client is being forced by the supplier to pay before the liability has been recorded.
• These are evidence of erroneous accounting records which could indicate an issue with going-concern.
• The client could unwittingly pay for items more than once and subsequently be unable to get the money back from a supplier who, perhaps, has gone into liquidation.

6. No statement of accountant available from a supplier

Issue	Action
Supplier does not provide a statement of account.	Contact the supplier and request it confirms the balance owing, supporting this with a breakdown, if possible.
Incomplete or unsatisfactory response from supplier for confirmation of balance owing.	Substantiate the balance by tracing all entries in the payable account for that supplier to source i.e taking each purchase invoice recorded, checking that it appeared genuine, tracing it to: its good received note (and hopefully a delivery note from the supplier); and to its purchase order; and confirmation of the order from the supplier.

7. Purchases cut-off

At the period end it is important that the purchases cut-off procedures enable the recording of purchases received and purchases returned in the correct period.	
Issue	Action
Purchases received / returned not recorded in the correct period therefore inaccurate reporting of the liability (for purchases), or asset for purchases returns.	Select GRN's before the cut-off number (which should have been recorded when attending the stock take) Check when the liability i.e. the purchase invoice or accrual adjustment was recorded. Was it recorded in the same period that the GRN was received? Select GRN's after the cut-off date and repeat the test Select purchase invoices before and after the year end and check when the related goods were received. This is to check that purchase invoices were recorded in the same period as the GRN. Look at post year-end payments to check if payments were made for pre period-end expenses that might not be evidenced by purchase invoices e.g. sales person expenses. Look at unprocessed invoices at period-end. Check whether they have been accrued or not. Check to their GRN note and check the date. Examine post period-end credit notes from payables and check if they should have been recorded before the period-end.

This article has introduced a general review of common audit procedures in relation to the control environment and common reconciliations. The areas of inventory/stock count, bank and cash and supplier reconciliations are addressed.

The techniques suggested can also be potentially adapted to other areas of audit. Some other sample questions and answers follow.

Suggested Sample Questions and Answers

Question 1.

The client prepared the following summary of a number of supplier reconciliations at the year-end 31 December 2018.

	Ollie	Niall	Robbie
	€	€	€
Balance per supplier's statement of account	179,000	54,000	16,000
Balance per payables ledger	110,000	68,000	28,000
Add/deduct items on supplier's statement of account that ae not on the payables ledger			
Add invoice on supplier's statement of account that is not on the payables ledger	47,000 (inv 1274)		
Deduct cheque on supplier's statement of account that is not on payments ledger		5,000 (cheque 590)	
Add/deduct items on the payments ledger that are not on the supplier's statement of account			
Deduct invoice on the payment's ledger that are not on the supplier's statement of account		9,000 (inv 256)	19,000 (inv 258)
Add ash/debit note on the payables ledger that is not on the supplier's statement of account	22,000 (cheque 565)		7,000 (debit note 581)
Adjusted payables ledger balance	179,000	54,000	16,000
Difference	0	0	0

You are advised that as Robbie has not yet supplied a statement at 31 December 2018, the ledger account was reconciled to the 30 November 2018 statement balance.

Outline the audit work that should be carried out on the above 3 reconciliations.

Answer 1

Auditing the supplier reconciliations:
1. Agree all supplier statement of account balances to original statements.
2. Agree ledger balances to the ledger listing reconciled to the payables control account.
3. Compute and check any differences.
4. Invoice on supplier statement of account that is not on the Ledger: check to the relevant Goods Received Note (GRN) and check if it is listed on the accruals list and whether it should be accrued.
5. Cash/Debit Note on the supplier's statement of account not on the payables ledger: Check if this is a client cheque. If it is, investigate this breakdown in control. Discuss with the client to understand why it has not been recorded in the ledger.
6. .Invoice on the payables ledger that is not on the supplier's statement of account: Trace to subsequent supplier statements if available. Check to supporting documents and verify if these invoices are posted to the correct ledger accounts. Also check for cut-off.
7. Cash/debit note on the payables ledger not on the supplier's statement of account Trace to subsequent supplier statements of account if available. Trace to the cheque payments book and establish when it was ultimately cashed. Check the details to support the debit note. Decide if accounted for appropriately.

Question 2

You received a copy of the year-end bank reconciliation, details of which are reproduced below, from Harrison Ltd who has just engaged you as its statutory auditor.

	€
Bank Statement Balance @ 28 June	105,000
Add Outstanding Lodgements	
Cash Receipt 26 June	25,000
Cash Receipt 2 June	7,000
Deduct Outstanding Cheques	
Cheque dated 15 January	16,000
Cheque dated 14 June	24,000
Adjusted Bank Statement Balance	97,000
Nominal Ledger Balance	97,000

REQUIREMENT:

(a) Outline the audit work that should be performed on the bank reconciliation.
(b) Discuss the extent to which auditing the client's year-end bank reconciliation can provide evidence about receipts and payments cut-off.
(c) Why is it important to check outstanding cheques at the year end?

Answer 2

(a)

	€	**Audit Work**
Bank Statement Balance @ 28 June	105,000	Check to the bank confirmation
Add Outstanding Lodgements		
Cash Receipt 26 June	25,000	Check when received and when lodged.
Cash Receipt 2 June	7,000	Check when received and when lodged. Enquire as to reason for delay in lodgement
Deduct Outstanding Cheques		
Cheque dated 15 January	16,000	Check to see if cashed subsequently. Check payee if delay seems unusual
Cheque dated 14 June	24,000	Check to see if cashed subsequently. Check payee if delay seems unusual
Adjusted Bank Statement Balance	97,000	Check tot
Nominal Ledger Balance	97,000	Check to trial balance and bank T account.

(b)Auditing a client's year end bank reconciliation enables the auditor to verify Cut-offwhen money was received and paid around the year-end and to compare it to when the lodgements and the payments occurred.
A significant difference between the dates recorded in the ledger accounts and the dates on the bank statement may indicate be a cut-off issue which the auditor must investigate.

(c) Outstanding cheque need to be scrutinised to assess if any window dressing has taken place or errors have occurred. Unscrupulous clients have been known to write cheques on or before year-end and deliberately not forward them to suppliers and or other debtors. Thus understating payables.

Question 3

You are auditing the inventory system of Tommy Ltd and wish to place reliance upon it to provide the details of the year-end closing inventory. The following is an example of one of the computerised reports available for any of the firm's inventory.

Inventory Movements; December 2018; Item; VX Memory Chips

Date	Document Reference	Units In	Units Out	Balance in units
1 December	Opening Balance			500
10 December	Despatch Note 256		180	320
14 December	Good Received Note No 789	75		395
20 December	Despatch Note 282		190	205
29 December	Good Received Note No 891	80		285
31 December	Despatch Note 302		200	85

The last goods received note for the year was goods received note number 880 and the last despatch note for the year was 300. The client operates an integrated accounting system i.e. an entry for a despatch note in inventory generates a sales invoice and entries in the receivables and nominal ledger. An entry for a goods received note in inventory generates a purchase invoice entry in the purchases and nominal ledger. The sales price of the units is €100 per item and the cost price was €60.

(i) Describe the audit tests that should be carried out on this inventory movement report to establish that the details recorded are authorised, accurate and complete.
(ii) Identify any cut-off errors for VX Memory Chips in the report above and show the adjustments required to correct the accounts.

Answer

(i)

Item	Authorised	Complete	Accurate
Opening balance	Is this an item that the client purchases?	Does this balance continue from previous balances?	Is this the correct balance carried forward from November?
Despatch Notes	Vouch these details to copy despatch notes that are authorised by the warehouse manager/	Take a sample of despatch notes in December and trace all relevant details to this inventory card.	Do the details on the inventory card correspond to the despatch note details?
Goods received Notes	Vouch these details to original goods received notes that are authorised by the warehouse manager/	Take a sample of the goods received notes in December and trace all relevant details to this inventory card.	Do the details on the inventory card correspond to the good received note details?

(ii)
Cut-off errors: GRN 891 and DN 302 are both post year-end items that should not be recorded pre year-end.
Need to reverse the purchases and sales recorded from both transactions.

Account	Debit €	Credit €
Payables	4,800 (80 X €60)	
Purchases		4,800
Sales	€20,000 (200 X €100)	
Receivables		€20,000

Bibliography

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ISA 220 – Quality control for an audit of financial statements.
ISA 300 – Planning an audit of financial statements.
ISA 315 - Identifying and assessing risks of material misstatement through understanding the entity and its environment.
ISA 320- Materiality in planning and performing an audit.