

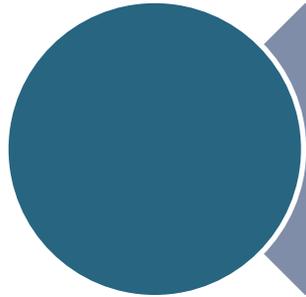
Auditing Prepaid Expenses (6 Series)

A Comprehensive Guide

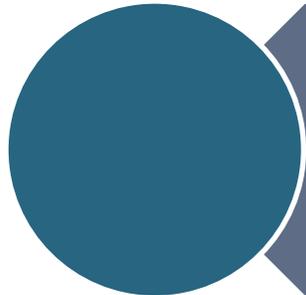
Prepaid expenses refer to payments made for goods or services to be received in the future. These are considered assets on a company's balance sheet until the corresponding benefit is realized over time. Auditing prepaid expenses involves assessing the risk of material misstatement and ensuring that the expenses are recorded accurately and appropriately. Below is an overview of fraud risks, internal controls, and substantive procedures related to auditing prepaid expenses.



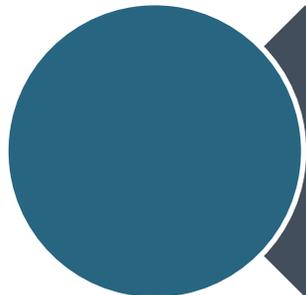
Fraud Risks in Prepaid Expenses



Inflated Prepaid Balances - Companies may overstate prepaid expenses to enhance financial results.

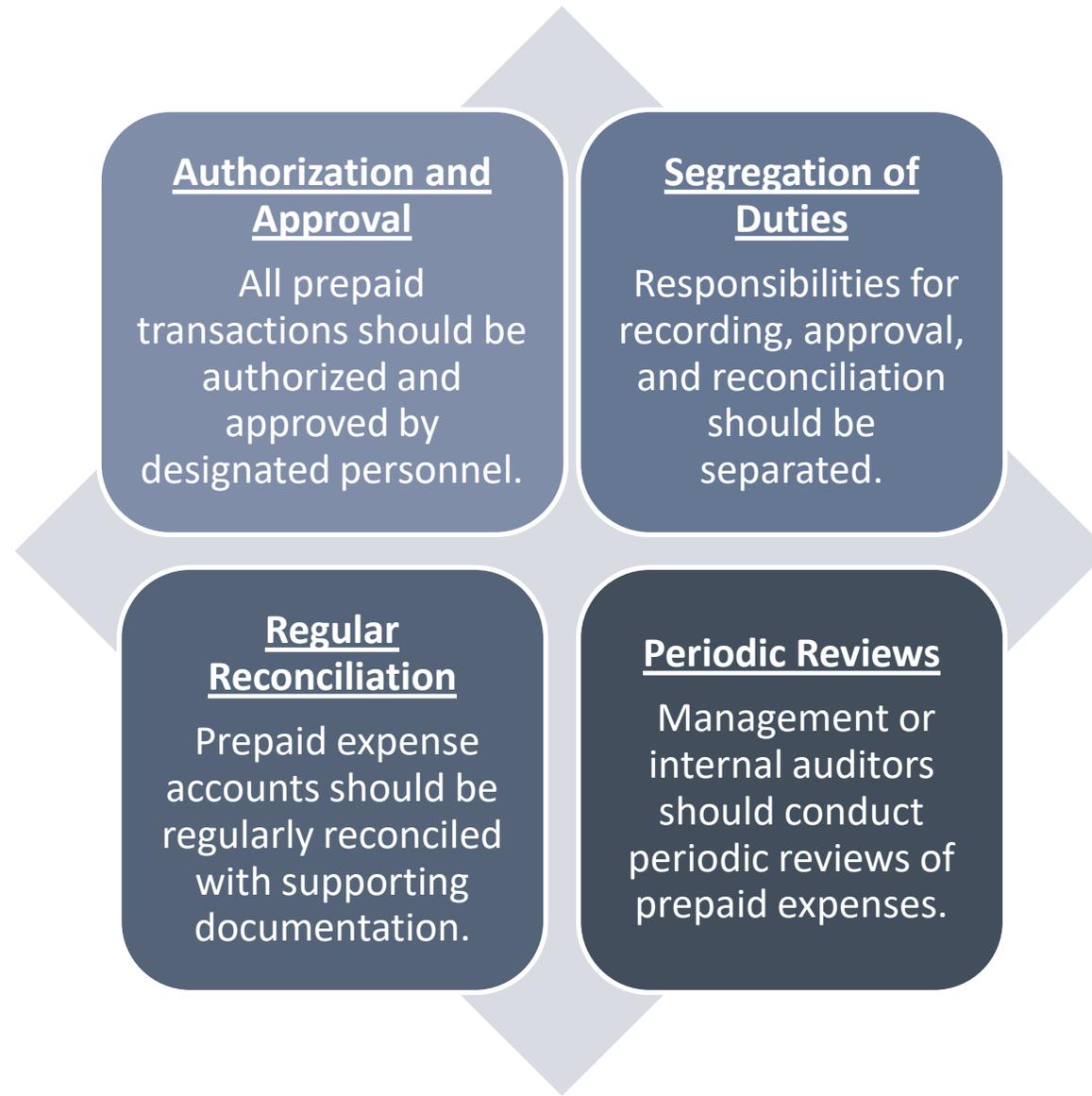


Improper Expense Recognition - There could be intentional misclassification of prepaid expenses as current period expenses.



Unauthorized Transactions - Unauthorized or fictitious prepaid expenses can be recorded to divert funds.

Internal Controls for Prepaid Expenses



Substantive Procedures for Auditing Prepaid Expenses

Documentation Examination

a.Objective: Verify the existence and accuracy of prepaid contracts or agreements.

b.Procedure:

- i. Review contracts, invoices, and receipts for legitimacy.
- ii. Ensure documentation supports recorded amounts and terms.
- iii. Check for discrepancies between recorded amounts and documentation.

Recalculation

a.Objective: Ensure accurate allocation of prepaid expenses over the relevant periods.

b.Procedure:

- i. Recalculate the amortization schedule to verify proper expensing over time.
- ii. Compare recalculations with the client's records.
- iii. Verify mathematical accuracy in amortization tables.

Substantive Procedures for Auditing Prepaid Expenses, Cont.

Analytical Procedures

- **Objective:** Identify unusual trends or discrepancies in prepaid expense balances.
- **Procedure:**
 - Analyze trends over multiple periods for abnormal fluctuations.
 - Compare prepaid expenses with industry benchmarks.
 - Investigate unexpected changes or outliers.

Cut-off Testing

- **Objective:** Ensure prepaid transactions are recorded in the correct period.
- **Procedure:**
 - Review transactions around year-end for proper period recognition.
 - Inspect documentation for transactions just before or after cut-off.
 - Trace transactions back to original documents.

Substantive Procedures for Auditing Prepaid Expenses, Cont.

Review of Journal Entries

- **Objective:** Identify and investigate irregular or unusual entries related to prepaid expenses.
- **Procedure:**
 - Review journal entries for the audit period.
 - Look for deviations from normal patterns.
 - Investigate the rationale and supporting documentation for unusual entries.

Subsequent Events

- **Objective:** Verify that prepayments are expensed appropriately in subsequent periods.
- **Procedure:**
 - Review early transactions in subsequent periods for accuracy.
 - Ensure alignment with the amortization schedule.
 - Investigate discrepancies or misclassifications.

Financial Statement Assertions Related to Prepaid Expenses

Existence

- **Description:** Prepaid expenses reported actually exist at the balance sheet date.
- **Importance:** This ensures that the prepaid expenses are genuine and not fictitious.

Completeness

- **Description:** All prepaid expenses that should have been recorded are included in the financial statements.
- **Importance:** Ensures that no prepaid expense have been omitted from the records.

Rights and Obligations

- **Description:** The entity has the right to the benefits and obligations of the prepaid expenses.
- **Importance:** This confirms that the entity legally owns the prepayments and is responsible for any associated obligations.

Financial Statement Assertions Related to Prepaid Expenses, Cont.

Valuation and Allocation

- **Description:** Prepaid expense are recorded at the correct amounts and are appropriately allocated over the periods they benefit.
- **Importance:** Ensures that prepayments are accurately measured and allocated, reflecting true economic benefit.

Presentation and Disclosure

- **Description:** Prepaid expenses are properly classified, described, and disclosed in the financial statements.
- **Importance:** Ensures that prepayments are reported in a manner that is consistent with accounting standards and provides all necessary information to stakeholders.

Financial Statement Presentation and Disclosure

Classification

Prepaid expenses are generally classified as current assets on the balance sheet. This classification reflects the expectation that these prepayments will be expensed within one year or the operating cycle, whichever is longer.

Separation by Type

Depending on the materiality, prepaid expenses may not be relevant. In other cases, they may be further broken down into specific categories such as prepaid insurance, prepaid rent, or prepaid services.

Significant Accounting Policies

The financial statements should include a note on the accounting policies related to the recognition, measurement, and amortization of prepaid expenses. This ensures users understand how such expenses are treated in the financial statements.

Financial Statement Presentation and Disclosure, Cont.

Nature and Terms

Disclosure should include the nature and terms of significant prepaid expenses. This might include details about significant contracts or agreements that give rise to the prepayment.

Amortization Method

Any methods used for the allocation of prepaid expenses over time (e.g., straight-line amortization) should be disclosed to provide clarity on how expenses are recognized over the periods they benefit.

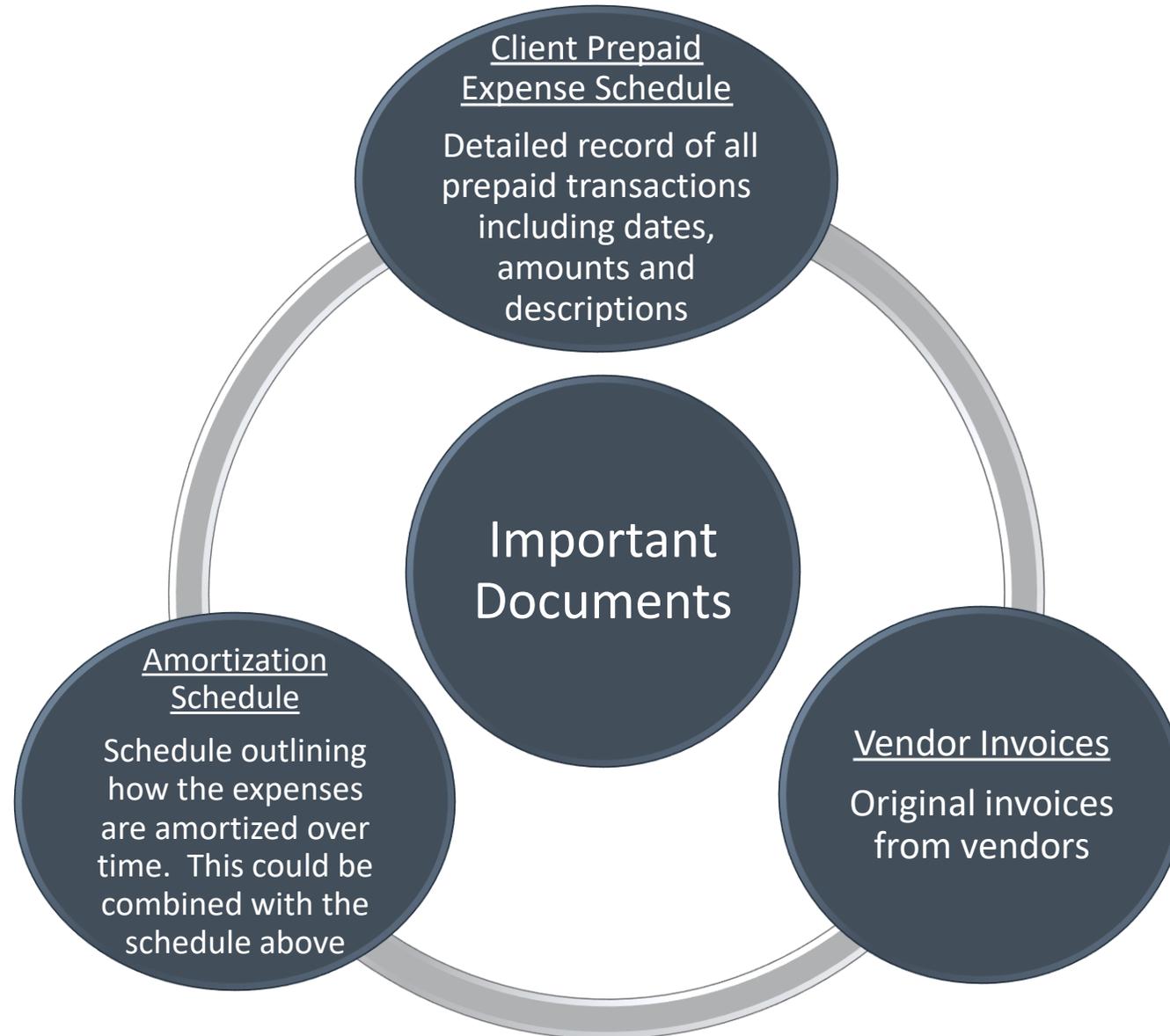
Concentration Risks

If any significant risk is associated with prepaid expenses due to concentration with a particular vendor or service provider, this should be disclosed to inform stakeholders of potential business risks.

Change in Accounting Estimate

Any changes in accounting estimates related to prepaid expenses (e.g., changes in the period over which prepayments are amortized) should be disclosed, along with their impact on the financial statements.

Auditing Prepaid Expenses



Auditing Prepaid Expenses Example

Step 1: Obtain Client's Prepaid Expense Schedule – Request a detailed schedule of prepaid expenses from the client. This schedule should include all prepaid accounts with their respective balances and supporting documentation. Once received, ensure total prepaid balance matches ending GL balance or is below the audit's Clearly Trivial Threshold (CTT).

Vendor	Type	Start	End	Days Prepaid	Date Paid	Premium	Prepaid
Example Vendor	State Insurance	11/17/2023	11/17/2024	322	12/7/2023	\$50,658.00	44,690
Example Vendor	Liability Insurance	12/1/2023	12/1/2024	336	12/28/2023	\$ 5,914.00	5,444
Example Vendor	Property Insurance	12/1/2023	12/1/2024	336	12/28/2023	\$12,186.00	<u>11,218</u>
						Total recalculated	61,352
						Difference: Pass Minor	<u>1,236</u>
						Balance per GL	<u><u>62,588</u></u> TB

Auditing Prepaid Expenses Example

Step 2: Review additions made during audit period – Request and examine supporting documents such as invoices, contracts or agreements to confirm that these payments were made in advance for future benefits.

Vendor	Type	Start	End	Days Prepaid	Date Paid	Premium	Prepaid
Example Vendor	State Insurance	11/17/2023	11/17/2024	322	12/7/2023	\$50,658.00	44,690
Example Vendor	Liability Insurance	12/1/2023	12/1/2024	336	12/28/2023	\$ 5,914.00	5,444
Example Vendor	Property Insurance	12/1/2023	12/1/2024	336	12/28/2023	\$12,186.00	11,218

Policy Number: HAPI-756-238627-2023

Invoice Number: HP00124169

Coverage

Coverage	Effective Date	Expiration Date	Amount Due
Accounts Receivable	12/01/2023	12/01/2024	\$.00
Commercial Property	12/01/2023	12/01/2024	\$11,832.00
Earthquake	12/01/2023	12/01/2024	\$.00
Equipment Breakdown	12/01/2023	12/01/2024	\$354.00
Flood	12/01/2023	12/01/2024	\$.00
Ordinance or Law	12/01/2023	12/01/2024	\$.00
Spoilage	12/01/2023	12/01/2024	\$.00
Valuable Papers	12/01/2023	12/01/2024	\$.00

Total Amount Due: \$12,186.00

Insurance Services, Inc.

Date
12/28/2023

PO Number

Check Number: 17113

Item Description

Property Insurance 12/1/23-12/1/24

Date: 12/28/2023

Item Amount
\$12,186.00

Amount: \$12,186.00

Discount
\$0.00

Paid
\$12,186.00

Auditing Prepaid Expenses Example, Cont.

Step 3: Recalculate amortization – Verify the amortization calculations for prepaid expenses to ensure the expenses are recognized over the appropriate period. To begin, identify the total prepaid amount (1) paid in advance for goods or services that will be utilized in future periods. Next, establish the coverage period (2), which is typically defined by the terms of the contract, agreement, or invoice. Divide the total prepaid amount (1) by 365 and then multiply by the days prepaid (3) to calculate the monthly or periodic expense.

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Total recalculated							61,352
Difference: Pass Minor							1,236
Balance per GL							<u>62,588</u> TB

(1) Total prepaid amount

(2) Coverage period

(3) Days Prepaid = Number of Days between Date Paid and year-end

Total Prepaid Amount = $(12,186/365) \times 336$ days prepaid = \$11,218

Summary

By addressing these areas, auditors ensure that prepaid expenses are accurately reported, free from material misstatement, and compliant with accounting standards, thus maintaining the financial statement's reliability and protecting against potential fraud.