ASSIGNMENT No. 02

Auditing (5417) Bs Accounting and Finance

Spring, 2025

Q. 1 What is verification? Explain the importance of verification in audit and its basic techniques. (20)

The case for a tradable entitlements system is based on the advantages that it would offer over other politically feasible alternatives. In the short term, it offers the possibility of reaching the environmental goals at a lower cost than would be possible if each country were limited to reduction options within its own borders. Making it easier to reach the goals may encourage more countries to sign the Protocol and would probably increase compliance with those goals. Because it separates the issue of who pays for control from who implements control, it facilitates transboundary cost- sharing, an item of particular importance to both the developing countries and the transition economies of Eastern Europe. Tradable permits also facilitate the mobilization of private capital for controlling global warming; private capital is likely to be a critically important component of any effective global warming strategy for as long as there is insufficient public money to finance it.

The first level of reporting and coordinating allowance transfers with emissions is at the level of the Parties to the Convention. National monitoring is not only a physical necessity; it is probably the most effective system. All reports must be harmonized both in terms of reporting format and in terms of collection protocols to ensure comparability and reliability. The ultimate authority for aggregating, standardizing and interpreting reports from the Parties must remain with an authorized subsidiary body of the Conference of Parties.

Compliance and enforcement

Multiple commitment periods offer significant opportunities for enforcing compliance. The principal tools for enforcing compliance include declaring non-compliant Parties ineligible for trading and reducing assigned amounts in subsequent commitment periods; such tools work best, of course, if subsequent commitment periods are in place and assigned amounts defined.

Currently the Protocol establishes that there will be negotiations to fix assigned amounts in subsequent commitment periods, but it has perhaps not been generally recognized how important that task is in promoting compliance within the first commitment period. We believe that process should be given a much higher priority than has so far been the case. A wide range of enforcement and compliance instruments is available to domestic enforcers. The frequency and effectiveness of domestic environmental enforcement varies according to budgets, political will and legal constraints on the types of penalties that can be imposed. In some countries there may be an evolving norm in favor of stiffer penalties, including imprisonment and personal liability for the actions of organizations and firms, and administrators can now resort to a wider array of sanctions.

The key issue in enforcement - whether at domestic or international level - is deterrence, not just the reversal of non-compliance. There is empirical support for the proposition that the frequency of monitoring and inspection, as well as the level of penalties makes a difference, but comparisons between enforcement instruments are difficult.

Accountability

An accountability system must be established between sellers and buyers of allowances. Seller liability systems are all that is needed if compliance mechanisms are strong and any tons of exceeded emissions are restored to the environment. In general the principle of strict seller liability is preferable in a strong enforcement environment. It provides incentives for those creating the credits to ensure their validity, and it reduces risk and uncertainty in trading, significantly enhancing the tradability of permits.

Appropriation Account

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Capital Fixed Assets

Capital Fixed Assets are tangible assets which are permanent in nature with an economic useful life greater than one year, valued at a minimum of €1,000 and are held for purposes other than investment or resale. Heritage assets, the value of which cannot be adequately expressed in financial terms, are not included.

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Companies often make specific decisions on how to spend profits earned from operations. Any large expenditure may need appropriations from a company's capital. These include expanding facilities, purchasing equipment and developing new products. In many cases, a company will make appropriations as part of its budget process. Appropriations will reduce a company's retained earnings as funds go toward various projects.

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The appropriation process may be different for each company. Smaller companies can make decisions based on the owner's preference. Large businesses often need executives, committees or board members to approve the appropriation of funds for use. Publicly held companies may need the approval of a shareholder bloc for appropriating funds. Accountants typically have little say in deciding how a company appropriates capital.

Public Accounting

Government agencies are heavy users of appropriations. Federal and state governments often use budgetary accounting to run their agencies. Each activity or department will receive a certain amount of funds received to pay for its operations. Appropriations are necessary to separate funds received to each department. Once an agency makes an appropriation, they are often unable to reverse it unless a major change or vote occurs in the agency.

A new requirement for the Appropriation Account is to reconcile the movement in the State Funding Account from the prior year to the current year and to detail where the funding has come from. The reconciliation of the movement in the State Funding Account shows if and how the asset base of the Department (and therefore the investment of the State) was used in order to deliver the programmes of the reporting year.

Q. 2 What do you understand by events? Explain the events occurring after the balance sheet date. (20)

As an auditor, you must address all relevant events that take place after the balance sheet date but before you issue your report. For example, your audit client may be breathing a sigh of relief because a warehouse fire or a product liability lawsuit occurred after the balance sheet date. The client may assume an event like that doesn't have to be included in this year's audit report, but that's not necessarily true. This section gives you the lowdown on what types of events you may encounter, how to look for them, and how to know which ones are important.

Subsequent event is the accounting term for a financial transaction that occurs after completion of the balance sheet for a specified period but before the company's full set of financial statements is prepared. Subsequent events clarify information about a business' financial picture as reflected by the balance sheet, a financial report that includes all transactions through the report date. The Financial Accounting Standards Board, the authority entrusted with establishing generally accepted accounting principles, publishes detailed requirements for defining and recording subsequent events in financial records.

Subsequent Events

Accountants evaluate financial transactions or events that occur after the balance sheet has been prepared to determine if the events affect the picture reflected in the company's financial statements. In 2009, the Financial Accounting Standards Board changed elements of its official subsequent event guidance. The FASB lists two types of subsequent events -- recognized and non-recognized -- and the changes require companies to disclose the date through which subsequent events have been evaluated and whether the financial statement date is the issue date or the date on which the statements were available for issue.

Balance Sheets and Financial Statements

The balance sheet, usually prepared monthly, provides a summary of a company's assets, liabilities and equity. By dating and issuing a balance sheet a company represents that the summary includes all transactions and events recorded through the balance sheet date. Subsequent events can invalidate information used in the summary. The adjustment of records for subsequent events can improve a company's financial picture, an important consideration for a business that hopes to attract lenders or investors. The balance sheet is used by the company, investors and others who make decisions based on the company's financial health. Financial statements, the full set of which is usually released at the end of the company's fiscal year, include the balance, sheet, income statement, statement of cash flows and, if necessary, supplementary notes.

Recognized Events

Recognized subsequent events require adjustments to the financial statements, according to the Federal Accounting Standards Advisory Board. Recognized events, such as changes to assets or liabilities, add evidence about the financial picture reflected on the balance sheet date and alter the estimates or summarization of the financial information included in the report. An example of a recognized subsequent event is if your company resolves a legal case for an amount that differs from the expected liability recorded before the balance sheet date. A recognized subsequent event that adds information about an existing condition is the write-off of a long-standing overdue account when the customer closes his business or files bankruptcy. The Federal Accounting Standards Advisory Board recommends evaluating financial conditions affected by subsequent events if the information is known prior to issuing the balance sheet or the financial statements.

Non-Recognized Events

Non-recognized subsequent events do not require adjustments to the financial statements. Such events are those that relate to financial conditions that did not exist on the balance sheet date but arose after the date. A fire in your company plant that destroys inventory and other assets is a non-recognized subsequent event because conditions did not exist prior to the balance sheet date. Another example is the loss of expected income due to conditions suffered by a client. The Federal Accounting Standards Advisory Board cautions that while adjustments are not required, disclosure of certain non-recognized events might be necessary to avoid issuing misleading financial information. Disclosure might require reissuance of financial statements.

When doing an audit, two types of subsequent events require your attention. Following is a breakdown of these two types.

- **Type I events:** These events affect your client's accounting estimates and are on the books (but not confirmed) as of the balance sheet date. A good example is the client's estimate for uncollectible accounts. This estimate is on the books at the balance sheet date, but your client can't be sure of the estimate's resolution until a subsequent event occurs, such as a customer filing for bankruptcy. At that point, your client confirms that the amount is actually uncollectible.

If the confirming event (such as the bankruptcy) occurs after the balance sheet date but before the financial statements are finalized, your client has to adjust its financial statements. It zeroes out the allowance for uncollectible accounts relative to this customer and reduces accounts receivable for the same amount.

- **Type II events:** These events, also called nonrecognized events, aren't on the books before the balance sheet date and have no direct effect on the financial statements under audit. The purchase or sale of a segment of the company, losses due to a fire or flood, and big sales of stock all fall into this category.

If these events are material (that is, their inclusion or exclusion may cause a reasonable person to change his opinion about the information), they have to be disclosed as footnotes in the financial statements (and you may even want to add a paragraph to your report explaining the situation), but the financial statements don't have to be adjusted.

So what type of event is important enough to require either disclosure or pro forma treatment? With experience, you'll be able to apply your professional judgment to make that evaluation. When you first start working as an auditor, rely on your audit supervisor for help with this question.

Q. 3 What do you know about verification of assets? Explain the verification of stocks with an assessment of internal control. (20)

Establishing the existence of a business's fixed assets and evaluating their value is an essential auditing task. Despite this, many businesses do not do a great job of keeping track of fixed assets. A 2016 UK study of the problem estimated that almost one in five instances of small business fraud involve fixed assets, with an average loss of $70,000.

What Are Fixed Assets?

The fixed assets of a business are those assets used over a long term, such as land, buildings, and equipment. Another of their characteristics is their physicality. Unlike many equities they cannot be converted quickly into cash. Their substantial nature and the fact that they can't just be spirited away in a dishonest employee's pocket or through an online transaction possibly accounts for business owners' underestimating how easy it is to make off with a fixed asset in a way that will often go unnoticed until the business is audited.

Common Types of Fixed Asset Fraud

Most fixed asset frauds fall into one of the following categories:

Theft. Not all fixed assets are unmanageably large. Computers, disk drives and small-scale scientific equipment, are among the many types of business equipment that can fit into a backpack. Since most businesses don't keep all of their equipment in active service all of the time, it's very easy for a $10,000 microscope in a storage cabinet, for instance, to go missing without notice and, then, it's nearly impossible to establish when the theft occurred.

Acquisition and disposal. An employee in a purchasing department may "acquire" and pay for an asset that in reality doesn't exist. Or they may sell the asset for one value and log the sale at a lower value. Misrepresentation of asset value is a popular fraud for some businesses that have weakening financial positions. Double the value of a major fixed asset and, miraculously, the company's overall asset position improves.

Basic Accounting Procedures for Fixed Assets

The most basic of all fixed asset audit procedures is establishing that the asset exists. In forensic audits, the auditors may physically oversee the inventory procedure. Once the asset's existence is verified, its current value needs to be established, according to Generally Accepted Accounting Procedures (GAAP), beginning with a determination of acquisition costs, including invoice cost, verified freight costs and any taxes paid – most often, state sales taxes – and any other costs, such as set-up costs. When assets are contributed by one of the company's owners, their value needs to be established (and recorded in the company's records) by a CPA, ensuring that the value attributed to the asset is its fair market value at the time of acquisition. Similarly, when an asset is sold, its fair market de-acquisition price needs to be established and recorded in the company's records.

Depreciation of Fixed Assets

Almost every asset your business acquires has an appropriate depreciation schedule. The only common fixed asset that's not depreciated is land. Sometimes, as a business owner, you may feel that attaching a depreciation schedule to real estate is somewhat arbitrary, because in some U.S. markets, there's a long history of commercial buildings appreciating in value. And you're right: it is arbitrary in that it doesn't necessarily correspond to the building's probable current market value. But it's necessary to have a common way of accounting for assets that doesn't allow for subjective and possibly arbitrary or even dishonest valuations. All depreciable assets, therefore, are depreciated, using either a straight-line or an accelerated depreciation method. Details of these methods are beyond the scope of this article_, but, in brief, _straightline depreciation assigns the same fixed reduction amount to the asset for every year it's held; accelerated depreciation front-loads the depreciation in the early years that it is owned.

Establishing the correctness and appropriateness of the depreciation schedule for fixed assets is another essential fixed-asset auditing task. Auditors use different audit procedures to test management's assertions about a company's financial statements. The techniques employed depend upon the strength of the evidence desired, requirements of generally accepted auditing standards and the nature of the accounting being audited. Understanding some common audit procedures and and types of audit evidence can help you reduce uncertainty among your employees as your company completes its audit.

Observation

Auditors seeking to validate the existence and, to some extent, the valuation of fixed assets often use observation as part of their audit procedures. They do this by physically observing the company's assets in good working order. Because this form of audit evidence is generated by the auditor, not by the entity being audited, observation is considered to be strong evidence for existence. However, because auditors can usually only tell if an asset is severely dilapidated, it is normally considered only weak evidence for testing valuation.

Confirmation

Accounts receivable, cash and other investments are often tested via third-party confirmation. To test via confirmation, the auditor makes selections of assets from the accounting records and sends a request for a third-party verification of the asset balance. The strongest form of confirmation is the blank positive confirm. A blank positive confirm asks the third-party to report the client's asset balance back to the auditor without the prompt of the company's recorded balance. This guards against the third-party agreeing with the reported balance out of convenience.

Examination of Documentation

One of the most common audit procedures is the examination of documentation. This audit procedure involves requesting supporting documentation for business transactions and verifying the inputs and outputs of the documentation. For example, to test a loan balance that the client owes to a bank, the auditor will request a copy of the signed promissory note. This document will tell the auditor the terms and conditions of the loan, as well as the proceeds and repayment terms. The auditor can then reconcile these amounts into the company's bank statements, which are audited as part of cash procedures.

Management Inquiry

One of the weakest forms of audit evidence is management inquiry. Management inquiry is when the auditor simply asks management about an accounting transaction. While this is not an appropriate audit procedure on its own, it is useful when used with other procedures. For example, auditors often use management inquiry to learn more about the company's transaction flows and internal control testing. These inquiries are then corroborated as the auditors examine more convincing audit evidence. However, if the additional evidence does not corroborate statements made by management, auditors should plan additional procedures.

Q. 4 Define share and describe verification of share capital in detail. (20)

As for verification, auditors are normally required to see that the supporting documents are verified whilst auditing. Verification is normally done by a nominated person in the company which involves reviewing, inspecting and checking to ensure that the documents conform to specific requirements. On the other hand, there's another physical verification which is done by the auditors themselves. This is an auditing procedure whereby an auditor inspects the actual assets of the company to make sure that they are the same with the written records. It is a substantive audit procedure which deals with examination of BALANCE SHEET transactions/items whether they are assets or liabilities are properly stated. Normally we do this by selecting samples or in some audit firms, setting a scope. For example, we do stock takes.

Various techniques used in verification:

As we have already discussed in the previous lectures that at the verification stage of the audit, the auditor is typically presented with a set of draft financial statements prepared by the client.

The role of the auditor is to generate evidence to allow a conclusion to be reached as to whether the information contained in these financial statements, and the way the information is presented and disclosed, give a true and fair view.

We already know that audit evidences are generated by the auditor performing audit tests. Here, in verification work, the auditor will use substantive testing procedures, designed to give evidence relating to the figures in the financial statements, rather than control test, dealing with the systems that produced those figures. However, the testing procedures available to the auditor here are the same as those we saw earlier. As a reminder, audit-testing procedures available to the auditor are:

1. Inspection

This covers the physical review or examination of records, documents and tangible assets. An example in substantive testing is examining purchase invoices to ensure that they have been properly recorded and analyzed in the financial statements.

2. Observation

This procedure is mainly applicable to tests of control, but may also be used in substantive testing, such as the auditor observing the client's inventory count to gain evidence that the inventory figure in the financial statements had been arrived at accurately.

3. Enquiry Seeking relevant information from knowledgeable persons inside or outside the enterprise. An example in substantive testing is asking management for an explanation as to why a receivable has, or has not, been treated as bad.

4. Computation

Checking the arithmetical accuracy of records or performing independent calculations, for example computing or re-computing the depreciation expense for the year.

5. Analytical procedures

You should note that these procedures are mainly used in substantive testing rather than as a test of controls. They may help the auditor to understand relationships between figures in the financial statements. This is sometimes referred to as the business approach to auditing.

Physical existence and valuation of assets

The organizing function of management involves the designation of departments and staff for specific functional roles and assigning the roles of supervisory personnel in each department. Physical assets refer to tangible fixed assets, such as office buildings, stores, manufacturing equipment, computers and office furniture. The organizing function of physical asset management depends largely on the complexity of the organization and the number and type of physical assets.

Basics

According to the U.S. Department of Transportation, asset management involves maintaining, upgrading and operating physical assets in a cost-effective way. By leveraging information technology, physical asset management facilitates an organized and systematic approach to decision-making. Although physical asset management does not involve the design or construction of buildings or equipment, it does support asset planning, acquisitions and maintenance services. For a small business, physical asset management may be the responsibility of the president or the chief financial officer. However, a large company or a government organization may have a separate department staffed by managers and staff from diverse backgrounds, such as technical, accounting, legal, procurement and engineering.

Characteristics

An asset management system should be customer focused, mission driven, flexible and user friendly, according to the U.S. Department of Transportation. It should allow a small business owner the flexibility to scale up efficiently as the business grows. At a minimum, it should include a way to track the physical location, performance and value of a company's assets. Organizational integration is a key part of asset management, which includes the capability to communicate real-time information and coordinate actions across different business units. The organizing function also means being responsive to changes in business conditions, technological developments and asset acquisitions or divestments.

Significance

Physical asset management provides qualitative and quantitative data on available resources, current performance metrics and estimates of future performance. For example, a growing retail business may decide it needs a larger warehouse to keep pace with increased demand. A small restaurant owner may decide to invest in commercial kitchen equipment to serve its growing clientele and support a planned catering service line extension.

Process

According to the U.S. Department of Transportation, the first step in a physical asset management process is to establish organizational policies, including strategic objectives and budgets. This helps to determine a company's future requirements. The second step involves collecting and analyzing the current asset inventory and performance. The difference between where the company wants to be and where it is today is the company's strategic asset gap, which indicates where the company needs to make improvements. The third step involves evaluating alternatives for bridging these gaps. The final step involves continual monitoring of asset performance and readjusting the asset mix as required.

Q. 5 Define the profit& loss account and also explain the verification of income items and expenses. (20)

Certified public accountants (CPAs) engage in many types of accounting practices. One of the fields in which a CPA may work is auditing. The type of auditing associated with profit-and-loss statements is a little different from the examination of tax returns that we often associate with auditing. While a tax-return audit is a selective process by the Internal Revenue Service or state tax authority, a profit-and-loss or financial statement audit is required for all public corporations every year. In addition, some lenders require that nonpublic companies present audited financial statements before they can proceed with lending applications and funding.

Independent Opinion

The primary functions of a CPA who performs an audit on a profit-and-loss statement are to generate an independent opinion of the income and expense items reported and to express his opinion in a written statement. CPAs who perform audits are third-party reviewers of profit-and-loss information. There are several items an auditor must examine and consider before expressing an opinion on the financial statement.

Consistency and Comparability

Audited financial statements are examined to ensure that profit and loss items reported are consistent with the supporting transaction documents supplied by the company, and that the profit-and-loss statement in question uses consistent accounting practices when compared with those of prior years. If an auditor's comparison shows that inconsistent methods were used during the years or periods analyzed, he must discover the reason the inconsistency exists and report his findings in the independent opinion report.

Qualified Auditor

Qualified auditors must be CPAs who have completed the education and experience requirements to perform independent examinations. When examining profit and loss statements, auditors are required only to apply the knowledge and expertise of an auditor. This means that the auditor's independent opinion contains only a report on the soundness of the company's financial statements and does not express opinions on the value or necessity of certain income or expense streams. Nor does the statement make legal statements outside of the Generally Accepted Auditing Standards (GAAS) rules.

Management of Profit and Loss Statement

An auditor receives profit-and-loss statements from the company that prepares them and often operates in an external relationship. This means the CPA is not an employee of the company that produces the financial statements under audit. As an external, independent party, the CPA does not manage the profit and loss statement and does not create the statement for the company. This is to prevent biased or fraudulent opinions from being expressed in the auditor's statement.

Uses of tradable entitlements system

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