

ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Department of Commerce & Business Administration

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Q.1: Define valuation and describe the main objects of correct valuation. (20)

Answer

1. Introduction and Definition of Valuation in Auditing

Valuation is a critical and indispensable phase in the financial audit process. In professional auditing, valuation refers to the critical, analytical, and objective examination of the methods, principles, and figures applied to ascertain the true financial worth or economic value of an enterprise's assets and liabilities as presented in the balance sheet at the end of the financial period.

While verification confirms the physical existence, ownership, and custody of an asset, valuation determines its accurate monetary value based on recognized accounting principles (such as Historical Cost, Net Realizable Value, Fair Value, or Replacement Cost). An asset may physically exist, but if it is recorded at an inflated or inaccurate value, the financial statements will fail to convey a 'true and fair view' of the business.

2. Main Objects / Objectives of Correct Valuation

The primary objective of asset and liability valuation is to ensure that financial reports reflect the realistic financial state of the business. The core objects of correct valuation include:

- **1. Presentation of True and Fair Financial Position:** Correct valuation ensures that the balance sheet presents an authentic picture of the enterprise's solvency, capital structure, and net worth on the reporting date.
- **2. Accurate Determination of Profit or Loss:** Accurate calculation of net profit or loss depends heavily on proper valuation of assets (e.g., inventory and fixed asset depreciation). Overvaluing closing stock artificially inflates profits, while undervaluation suppresses earnings.
- **3. Prevention of Misrepresentation and Fraud:** Proper valuation prevents management from artificially inflating asset values to attract investors or hiding losses (overstatement), as well as understating assets to evade taxation or create secret reserves (understatement).
- **4. Protection of Stakeholder & Investor Interests:** Shareholders, creditors, financial institutions, and potential investors rely on audited financial statements. Correct valuation protects these stakeholders from relying on fictitious or watered capital figures.
- **5. Compliance with Accounting Standards and Law:** Valuation must adhere strictly to International Financial Reporting Standards (e.g., IAS 2 for Inventories, IAS 16 for Property, Plant & Equipment, and IFRS 13 for Fair Value Measurement) and domestic statutory requirements.
- **6. Safeguarding Against Secret Reserves & Watered Stock:** Correct valuation prevents the unauthorized creation of secret reserves (by under-valuing assets) or 'watered stock' (where asset values are far lower than book values).
- **7. Facilitation of Credit Assessment & Business Valuation:** Banks and lenders evaluate asset valuation before approving commercial loans or credit facilities. Credible valuation reports enhance the borrowing capacity and credit rating of the firm.
- **8. Consistency and Period Comparability:** Applying consistent valuation rules across financial years ensures that accounting records can be reliably compared over time.

3. Legal Position and Auditor's Duty Regarding Valuation

An auditor is not expected to act as a professional valuer or technical surveyor. However, the auditor has a solemn legal duty to exercise reasonable care, skill, and professional skepticism when reviewing valuation figures. Landmark legal cases clarify this duty:

- **Kingston Cotton Mills Co. Case (1896):** Judge Lopes famously stated that 'an auditor is not a valuer... he is a watchdog, not a bloodhound.' The auditor is entitled to rely upon trusted certificates from responsible officers unless there are suspicious circumstances.
- **Re London & General Bank Case (1895):** It was established that the auditor must satisfy himself that the valuation principles applied are sound, consistent, and compliant with recognized accounting frameworks.

4. Summary Comparison: Bases of Asset Valuation

Valuation Basis	Accounting Principle	Applicable Asset Class	Audit Purpose
Historical Cost	Original acquisition cost minus accumulated depreciation	Fixed Assets (Plant, Machinery, Buildings)	Reflects original investment
Net Realizable Value (NRV)	Estimated selling price less completion & disposal costs	Current Assets (Stock-in-trade, Receivables)	Prevents overstatement of profit
Replacement Cost	Cost to replace asset at current market rates	Insurance valuation & Managerial decision	Evaluates current asset backing
Fair Value	Market-based exit price under arms-length transaction	Financial Instruments, Investments	Reflects active market values

Q.2: Define Audit and describe its types in detail. (20)

Answer

1. Definition and Fundamental Concept of Auditing

The term 'Audit' originates from the Latin word 'Audire', which means 'to hear'. Historically, auditors listened to accounts read by accountants to detect discrepancies. In modern commercial practice, auditing is defined as:

'A systematic, independent, and objective examination of the financial books, records, accounts, vouchers, and statutory registers of an enterprise, conducted by a qualified independent professional, to express an expert opinion on whether the financial statements present a true and fair view of the entity's financial position and operating results.'

2. Detailed Classification & Types of Audit

Audits can be classified into distinct categories based on legal requirements, timing, operational scope, and specialized objectives:

Category A: On the Basis of Organizational / Legal Structure

- **1. Statutory Audit:** Mandated by specific statutory legislation (e.g., Companies Act 2017 in Pakistan). Public and private limited companies, banking enterprises, and insurance firms are legally required to undergo a statutory audit annually.
- **2. Non-Statutory / Private Audit:** Conducted voluntarily by non-statutory entities such as sole proprietorships, partnership firms, clubs, and private trusts for internal governance, tax verification, or bank credit.

Category B: On the Basis of Timing and Continuity

- **1. Continuous Audit:** An audit where the auditor's staff is continuously or at regular intervals engaged in checking accounts throughout the financial year. Ideal for large organizations with complex operations.
- **2. Final / Annual / Periodical Audit:** Conducted at the close of the accounting year after all books of accounts have been balanced and financial statements finalized.
- **3. Interim Audit:** Executed between two annual audits, generally to review half-yearly performance or declare an interim dividend.
- **4. Balance Sheet Audit:** A specialized examination focusing primarily on verifying the balance sheet items (assets, liabilities, reserves, and capital).

Category C: On the Basis of Scope, Purpose & Specialization

- **1. Internal Audit:** A continuous appraisal function established within an organization by management to review internal controls, operational efficiency, and policy compliance.
- **2. Cost Audit:** Independent examination of cost accounts and cost statements to ensure compliance with cost accounting principles and statutory cost records rules.
- **3. Management / Operational Audit:** Comprehensive evaluation of managerial performance, operational structure, organizational goals, and executive decision-making efficiency.

- **4. Forensic Audit:** Deep investigation aimed at uncovering corporate fraud, embezzlement, white-collar crime, or financial misrepresentation for legal proceedings.
- **5. Tax Audit:** Conducted to verify taxable income and ensure proper compliance with statutory tax laws (Income Tax / Sales Tax).

3. Comparative Matrix of Key Audit Types

Audit Type	Legal Mandate	Conducted By	Primary Objective	Report User
Statutory Audit	Compulsory by Law	External Chartered Accountant	Opinion on True & Fair View	Shareholders & Regulators
Internal Audit	Management Discretion / Code	Internal Audit Employee / CA	Evaluate Controls & Efficiency	Management & Board
Cost Audit	Statutory for specific sectors	Cost & Management Accountant	Verify Cost Statements & Efficiency	Government & Management
Forensic Audit	Court / Regulator Order	Forensic Accounting Specialist	Detect & Prove Financial Fraud	Judiciary & Law Enforcement

Q.3: Explain the following: (10+10)

- i. Scope and objects of auditing.
- ii. What are the major qualities of an auditor?

Answer

Part (i): Scope and Objects of Auditing

1. Scope of Auditing

The scope of an audit refers to the boundary and extent of audit procedures necessary to achieve the audit objectives. The scope is determined by statutory requirements, relevant auditing standards (ISAs), and terms of engagement:

- **Comprehensive Record Examination:** Examining the reliability and sufficiency of accounting records and underlying source documents.
- **Internal Control Evaluation:** Testing the design and operating effectiveness of client's internal accounting control systems.
- **Compliance with Standards:** Verifying whether the financial statements comply with applicable accounting frameworks (IFRS/IAS) and statutory laws.
- **Verification & Valuation:** Confirming the physical existence, legal ownership, and realistic valuation of assets and liabilities.
- **Reporting Responsibility:** Reporting formal audit findings and issuing an audit opinion to shareholders.

2. Objects / Objectives of Auditing

The objectives of auditing are classified into Primary and Secondary Objectives:

- **A. Primary Objective:** To express an independent professional opinion on whether the financial statements convey a true and fair view of the financial performance and balance sheet position.
- **B. Secondary Objective (1) - Error Detection:** Detection and prevention of accounting errors (Errors of Omission, Commission, Principle, Compensating errors, and Clerical errors).
- **C. Secondary Objective (2) - Fraud Detection:** Detection and prevention of fraudulent activities, including misappropriation of cash, theft of goods/inventory, and intentional manipulation of financial statements (Window Dressing).

Part (ii): Major Qualities of an Auditor

An auditor occupies a position of public trust and fiduciary responsibility. To discharge duties effectively, an auditor must possess a blend of professional technical skills and personal ethical virtues:

1. Professional and Technical Qualities

- **Professional Expertise:** Thorough mastery of financial accounting principles, International Financial Reporting Standards (IFRS), and International Standards on Auditing (ISAs).
- **Legal Knowledge:** In-depth understanding of corporate law, tax statutes, mercantile law, and industry-specific regulations.

- **Commercial & Business Acumen:** Clear comprehension of the client's business environment, operational workflows, and commercial practices.
- **Certified Qualification:** Holding valid statutory qualifications (e.g., CA, ACCA, CPA) recognized by law.

2. Personal and Ethical Qualities

- **Integrity & Unbending Honesty:** Uncompromising honesty, moral uprightness, and adherence to high ethical standards.
- **Professional Independence & Objectivity:** Remaining unbiased, impartial, and free from financial or personal interest in the client entity.
- **Confidentiality:** Maintaining strict secrecy regarding client trade secrets and financial information.
- **Professional Skepticism & Vigilance:** Approaching audit evidence with an inquiring mind, critically assessing validity without being overly suspicious or complacent.
- **Tact, Courtesy & Firmness:** Communicating effectively and diplomatically with client staff while maintaining audit authority.

Q.4: Define Internal Control and also explain the methods to be used by an auditor to review the internal control procedures being used by his clients. (20)

Answer

1. Definition and Meaning of Internal Control

Internal Control is an integrated operational process instituted by an organization's board of directors, management, and personnel. According to the COSO Framework and International Standards on Auditing (ISA 315), Internal Control is defined as:

'A process designed, implemented, and maintained by those charged with governance and management to provide reasonable assurance regarding the achievement of an entity's objectives concerning the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.'

Components of Internal Control

- **1. Control Environment:** Sets the tone of the organization, influencing control consciousness (governance, ethics, management philosophy).
- **2. Risk Assessment:** Identifying and analyzing business risks that threaten financial reporting integrity.
- **3. Control Activities:** Policies and procedures (approvals, reconciliations, physical security, segregation of duties) to mitigate risks.
- **4. Information & Communication:** Operational systems ensuring timely recording and communication of financial transactions.
- **5. Monitoring:** Ongoing managerial assessment of internal control performance over time.

2. Methods Used by an Auditor to Review Internal Control Procedures

Before finalizing the audit plan, an auditor must evaluate the client's internal controls. The primary methods used to review internal control procedures include:

- **Method 1: Internal Control Questionnaire (ICQ)** - A comprehensive, pre-printed set of questions covering all operational departments (Cash, Sales, Purchases, Payroll). Questions are structured to elicit 'Yes', 'No', or 'N/A' responses. A 'No' response highlights a control weakness.
- **Method 2: Flowchart Method** - A graphic visual representation detailing the flow of transactions, paperwork, authorization points, and physical custody across departments. Flowcharts allow quick visual identification of bottlenecks and missing controls.
- **Method 3: Narrative Notes / Written Description** - A written narrative description detailing the step-by-step working of internal control procedures. Useful for small businesses with simple operational workflows.
- **Method 4: Internal Control Checklist** - Standardized checklists provided to audit assistants to verify whether specific control steps have been performed by client employees.
- **Method 5: Walkthrough Tests & Tests of Controls** - Tracing a few selected transactions through the entire accounting system from initiation to final posting to confirm the practical application of recorded controls.

3. Comparison of Internal Control Evaluation Methods

Review Method	Structure / Format	Best Suited For	Key Advantage	Main Limitation
ICQ	Structured Yes/No Questions	Medium to Large Enterprises	Comprehensive & Systematic	Risk of mechanical / routine fill
Flowchart	Diagrammatic Workflow Map	Complex Automated Systems	Clear Visual Bottleneck View	Requires technical drawing skill
Narrative Notes	Written Descriptive Prose	Small Simple Entities	Easy to draft & understand	Cumbersome for complex systems
Walkthrough Test	Transaction Tracing	All Audits (Verification)	Confirms real-world operation	Limited to sample size

Q.5: Define vouching and explain its techniques and application to the books of accounts. (20)

Answer

1. Definition and Meaning of Vouching

Vouching is universally acknowledged as the 'backbone, essence, and soul of auditing'. In auditing terminology, vouching is defined as:

'The meticulous, critical, and documentary examination of entries recorded in the primary books of accounts by comparing them with supporting documentary evidence (vouchers) such as receipts, invoices, agreements, cash memos, goods received notes, and bank statements.'

The fundamental objective of vouching is to establish that every recorded transaction is authentic, properly authorized, correctly classified, accurate in amount, and genuinely relates to the client's business enterprise.

2. Fundamental Techniques and Principles of Vouching

When performing vouching, the auditor must strictly apply the following auditing techniques:

- **1. Date Verification:** Inspecting the date on the voucher to ensure the transaction belongs to the current accounting period.
- **2. Entity Name Verification:** Checking that the voucher is made in the official name of the client enterprise.
- **3. Executive Authorization:** Ensuring every voucher carries the approval signature of an authorized officer.
- **4. Business Purpose:** Verifying that the transaction falls within the legitimate business operations of the entity.
- **5. Amount Accuracy:** Comparing amounts written in words and figures on the voucher with journal entries.
- **6. Proper Classification:** Ensuring expenditure is correctly categorized as Capital or Revenue expenditure.
- **7. Voucher Cancellation:** Stamping or signing every inspected voucher ('CANCELLED / AUDITED') to prevent duplicate submission.

3. Application of Vouching to Books of Accounts

A. Vouching of Cash Book (Cash Receipts & Payments)

- **Cash Sales:** Compare with carbon copies of receipts, counterfoils, sales manager summaries, and bank deposit slips.
- **Collections from Debtors:** Cross-check with official receipts, customer statements, and bank paying-in slips.
- **Salaries & Wages:** Verify against payroll sheets, attendance registers, wage slips, and bank transfer advice.
- **Payments to Suppliers:** Examine supplier invoices, Goods Received Notes (GRNs), and payment receipts.

B. Vouching of Purchases & Sales Books

- **Purchases Book:** Verify with supplier invoices, GRNs, purchase orders, and stock entry registers.
- **Sales Book:** Examine sales invoices, goods dispatch notes (GDNs), customer orders, and dispatch logs.

C. Vouching of Journal Proper

- **Opening & Closing Entries:** Vouch opening entries with previous audited balance sheet, and closing entries with trial balance and ledger accounts.
- **Rectification & Adjustment Entries:** Examine journal vouchers approved by Chief Accountant, supporting schedules, and ledger corrections.

4. Summary Table of Vouching Application

Book of Account	Transaction Type	Primary Voucher Document	Key Audit Checkpoint
Cash Book	Cash Sales	Cash memo, Daily sales summary, Bank Slip	Verify cash register tally & bank deposit date
Cash Book	Supplier Payments	Supplier Invoice, GRN, Stamp Receipt	Check authorization & voucher cancellation stamp
Purchases Book	Credit Purchases	Vendor Invoice, Purchase Order, GRN	Verify trade discount & stock register entry
Journal Proper	Depreciation Entry	Depreciation Schedule, Fixed Asset Register	Check calculation accuracy & IAS 16 compliance