

ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Department of Commerce & Business Administration

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

Answer

1. Definition and Meaning of Verification

Verification is a primary auditing process applied to assets and liabilities shown in the balance sheet. In auditing terminology, verification is defined as:

'An analytical process by which the auditor satisfies himself regarding the actual physical existence, legal ownership, proper title, clear possession, freedom from encumbrances, realistic valuation, and correct presentation of assets and liabilities in the financial statements.'

Verification goes beyond vouching. While vouching checks the documentary accuracy of entries when recorded, verification ensures that assets recorded in books actually exist and are legally owned by the business on the balance sheet date.

2. Importance and Objectives of Verification

- **1. Proof of Physical Existence:** Confirms that assets appearing in the balance sheet physically exist and are not fictitious.
- **2. Confirmation of Ownership & Title:** Verifies that the client holds valid legal title and legal ownership of the property or asset.
- **3. Verification of Custody:** Ensures assets are held in the custody of the enterprise or authorized custodians.
- **4. Freedom from Encumbrances:** Confirms whether assets are free from undisclosed mortgages, pledges, liens, or charges.
- **5. Realistic Valuation:** Verifies that assets and liabilities are valued accurately in compliance with IAS/IFRS.
- **6. Prevention of Balance Sheet Manipulation:** Prevents management from misrepresenting financial health through asset inflation.

3. Basic Techniques of Verification

- **1. Physical Inspection & Examination:** Physically counting, inspecting, or observing assets (Cash, Stock, Plant, Machinery).
- **2. Direct / External Confirmation:** Obtaining written confirmations directly from third parties (Banks, Debtors, Creditors, Warehouses) under ISA 505.
- **3. Title Deed Inspection:** Inspecting legal title deeds, lease agreements, share certificates, and registration documents.
- **4. Valuation Verification:** Checking valuation math, depreciation calculations, and NRV assessments.
- **5. Analytical Review & Reconciliation:** Comparing asset balances with previous years, ratio analysis, and physical-to-book reconciliations.

4. Distinction Between Vouching, Valuation, and Verification

Feature	Vouching	Valuation	Verification
Primary Basis	Examining vouchers & invoices	Testing monetary estimation rules	Physical inspection & title check
Target Area	Income & Expense items	Carrying values in Balance Sheet	Assets & Liabilities in Balance Sheet
Timing	Done throughout the year	Done at year-end closing	Done at year-end closing
Main Goal	Check entry authenticity	Ensure accurate asset worth	Confirm existence, title & value

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

Answer

1. Definition & Scope of Subsequent Events

In financial accounting and auditing, 'Subsequent Events' refer to significant events, both favorable and unfavorable, that occur between the balance sheet date (reporting date) and the date when the financial statements are officially approved and authorized for issue by the Board of Directors.

The governing standard for handling these events is International Accounting Standard 10 (IAS 10) and International Standard on Auditing 560 (ISA 560).

2. Classification of Subsequent Events

Category A: Adjusting Events After the Balance Sheet Date

Adjusting events are those that provide additional evidence of conditions that existed at the balance sheet date. These events require retroactive adjustment of amounts recognized in financial statements:

- **1. Settlement of Pending Court Case:** A court ruling after year-end confirming a legal liability that existed on 31st December.
- **2. Bankruptcy of Customer:** Bankruptcy of a major trade debtor post-balance sheet date confirming irrecoverability of receivable.
- **3. Inventory Realization Below Cost:** Sale of inventory post-balance sheet date at prices below cost, confirming NRV write-down on 31st Dec.
- **4. Discovery of Fraud or Errors:** Discovery of fraud or material errors showing that financial records were inaccurate.

Category B: Non-Adjusting Events After the Balance Sheet Date

Non-adjusting events are those that reflect conditions that arose after the balance sheet date. These events DO NOT require adjustment to numbers in financial statements, but must be disclosed in Notes if material:

- **1. Major Fire or Natural Disaster:** Destruction of a major manufacturing plant by fire or flood after year-end.
- **2. Corporate Restructuring / Merger:** Significant corporate mergers, acquisitions, or restructuring announced after year-end.
- **3. Decline in Market Value of Investments:** Sudden drop in market values of held shares or foreign exchange rates after reporting date.
- **4. Major Capital Issuance:** Issuance of new share capital or bonds after balance sheet date.

3. Summary Comparison Table: IAS 10 Subsequent Events

Event Type	Condition Origin	Financial Statement Action	Typical Example
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Adjusting Event	Condition existed ON or BEFORE Balance Sheet Date	ADJUST numbers in Balance Sheet & Income Statement	Customer bankruptcy confirming bad debt
Non-Adjusting Event	Condition arose AFTER Balance Sheet Date	NO ADJUSTMENT to numbers; DISCLOSE in Notes to Accounts	Factory destroyed by fire after year-end

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

Answer

1. Verification of Assets - General Framework

Verification of assets is an auditing procedure where the auditor checks physical existence, legal ownership, proper custody, realistic valuation, and disclosure of assets in the balance sheet. Assets must be verified systematically using physical counts, title deed checks, and third-party confirmations.

2. Verification of Stock-in-Trade / Inventory (IAS 2 & ISA 501)

Stock-in-trade is often the largest current asset in commercial and manufacturing enterprises. Because inventory directly impacts Cost of Goods Sold and Gross Profit, its verification is of critical importance:

- **A. Attendance at Physical Stock Count:** The auditor must attend the physical stock count performed by management at year-end. The auditor performs test counts, inspects damaged stock, and verifies count procedures.
- **B. Cut-off Testing:** Examining sales and purchase documents immediately before and after year-end to ensure inventory, sales, and purchases are recorded in the correct accounting period.
- **C. Valuation Verification (Lower of Cost or NRV):** Under IAS 2, stock must be valued at the LOWER OF COST AND NET REALIZABLE VALUE (NRV). The auditor verifies FIFO or Weighted Average cost calculations and checks selling prices.
- **D. Third-Party Stock Confirmation:** Obtaining direct confirmation for stocks held by third parties (public warehouses, consignees) under ISA 505.

3. Assessment of Internal Control Over Inventory

To rely on client inventory records, the auditor must evaluate internal controls governing stock:

- **1. Perpetual Inventory System:** Verifying whether the perpetual inventory system operates effectively with continuous bin cards.
- **2. Segregation of Duties:** Ensuring storekeeping, purchasing, receiving, and accounting duties are assigned to separate employees.
- **3. Physical Security & Storage:** Checking physical security, restricted store access, fire protection, and insurance coverage.
- **4. Authorization Controls:** Ensuring goods are dispatched only against authorized Goods Dispatch Notes (GDNs).

4. Auditor's Checklist for Stock Verification

Audit Phase	Key Verification Step	Primary Document Checked	Risk Mitigated
Pre-Count	Review client stocktaking	Written Stock Count	Uncoordinated / double

	instructions	Guidelines	counting
During Count	Perform independent test counts	Physical Inventory / Bin Cards	Fictitious / omitted stock items
Post-Count	Verify Cut-off & Costing (Lower of Cost/NRV)	Supplier Invoices, GRNs, Price Lists	Overstated stock value & profit

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

Answer

1. Definition and Types of Shares

According to Company Law, a 'Share' represents a fractional unit of the capital of a company, expressing the proprietary relationship between the shareholder and the enterprise. Shares are broadly classified into:

- **1. Ordinary / Equity Shares:** Equity shares carrying voting rights, variable dividend rates, and residual ownership risk.
- **2. Preference Shares:** Shares enjoying preferential rights regarding dividend payment (fixed rate) and repayment of capital upon liquidation.

2. Detailed Verification Procedure for Share Capital

A. First Audit / New Company Share Capital Verification

- **1. Constitutional Documents:** Inspect the Memorandum of Association to verify Authorized Capital, and Articles of Association for share issuance rules.
- **2. Prospectus Verification:** Verify the prospectus or statement in lieu of prospectus filed with the Registrar of Companies.
- **3. Board Resolutions & Allotment:** Check Board of Directors' resolutions for share allotment and examine the Allotment Register.
- **4. Cash Receipts & Bank Confirmation:** Vouch application, allotment, and call money received with bank passbooks, cash book, and CDC records.

B. Subsequent Audit / Continuing Company Verification

- **1. Opening Balance Reconciliation:** Reconcile opening share capital balances with previous year's audited balance sheet.
- **2. Share Transfer Verification:** Inspect Share Transfer Register, transfer deeds, stamp duty compliance, and CDC transaction reports.
- **3. Forfeiture & Re-issue of Shares:** Check Board resolutions authorizing forfeiture, verify notice sent to defaulting shareholders, and ensure re-issued shares are priced within legal limits.

3. Summary Matrix: Audit Steps for Share Capital

Capital Category	Verification Focus	Source Document	Statutory Compliance
Authorized Capital	Verify maximum legal share limit	Memorandum of Association	Companies Act provisions
Allotted Capital	Verify Board approval & cash received	Allotment Register & Bank Statement	SEC / Registrar filing

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Calls in Arrears

Verify unpaid amounts
from shareholders

Members' Ledger & Bank
Reconciliation

Disclosure as deduction
in Balance Sheet

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

Answer

1. Definition and Nature of Profit & Loss Account

The Profit & Loss Account (also termed the Income Statement or Statement of Comprehensive Income) is a principal financial statement that summarizes revenues earned, gains realized, expenses incurred, and losses sustained by an enterprise during a specified accounting period.

The primary auditing objective when verifying the Profit & Loss Account is to confirm that revenues and expenses are properly matched (Matching Principle), recorded on an accrual basis, correctly classified between Capital and Revenue, and comply with International Financial Reporting Standards (IFRS 15 for Revenue).

2. Verification of Income / Revenue Items

- **1. Credit Sales & Operating Revenue:** Vouch sales entries with sales invoices, Goods Dispatch Notes (GDNs), and customer ledger balances. Perform cut-off tests to verify sales near year-end.
- **2. Interest Income:** Examine fixed deposit receipts, bank interest statements, and tax deduction certificates.
- **3. Dividend Income:** Verify dividend warrants, counterfoils, bank credits, and investee company dividend announcements.
- **4. Rental Income:** Examine rent agreements, lease deeds, tenant receipts, and bank deposit vouchers.

3. Verification of Expense Items

- **1. Purchases & Direct Material:** Vouch purchase entries with vendor invoices, Purchase Orders, and Goods Received Notes (GRNs).
- **2. Salaries & Wages:** Vouch payroll sheets, attendance registers, wage sheets, income tax withholding, and bank transfer advice.
- **3. Rent, Rates & Utilities:** Verify lease agreements, landlord receipts, electricity/gas bills, and insurance policies.
- **4. Depreciation & Amortization:** Verify depreciation schedules, fixed asset registers, and compliance with IAS 16 depreciation methods.

4. Summary Table: P&L Verification Audit Procedures

P&L Item	Classification	Verification Document	Key Audit Test
Sales Revenue	Operating Revenue	Sales Invoice, GDN, Customer Conf.	Cut-off test & revenue recognition timing
Payroll Expense	Operating Expense	Payroll Summary, Bank	Check attendance, approval &

		Transfer Slip	tax withholding
Interest Income	Non-Operating Income	Bank Advice, Tax Certificate	Verify accrual basis & bank rate
Depreciation	Non-Cash Expense	Asset Register, Calculation Sheet	Recalculate rate & verify IAS 16 compliance