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Name:

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ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Course: Auditing (481) • Level: ADC

Semester: Autumn 2026

Assignment No. 1 (Units 1–4)

Total Marks: 100 • Pass Marks: 50

SOLVED ASSIGNMENT GUIDE

(For Study & Reference)

Note: This guide is prepared for study and reference purposes. Students are advised to read the relevant units of the course book, understand the concepts, and write the assignment in their own words.

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Question 1: Valuation and the Objects of Correct Valuation (20 Marks)

Define valuation and describe the main objects of correct valuation.

Introduction

Every balance sheet is, in the end, a list of values. The cash, stock, machinery, buildings, debtors and goodwill shown in it are not merely counted or inspected; each item must also be expressed in money at a figure which fairly represents its worth to the business on the date of the balance sheet. The process by which those money figures are determined and examined is called valuation. Valuation is therefore one of the most delicate parts of an audit, because a small error in valuing a large asset, such as closing stock, can completely change the profit of the year and mislead every person who reads the accounts. This answer first defines valuation and distinguishes it from the related ideas of vouching and verification, and then describes in detail the main objects which correct valuation is meant to achieve.

Meaning and Definition of Valuation

Valuation means ascertaining the correct value of the assets and liabilities of a business as on the date of the balance sheet, according to recognised accounting principles, and checking that

the values at which they are shown in the books are proper, reasonable and fairly stated. In simple words, valuation answers the question: at what amount should this asset or liability stand in the balance sheet? An asset may have several different values at the same time. It has a cost price (what was paid for it), a market value (what it would fetch if sold in the open market), a replacement value (what it would cost to buy a similar asset today), a scrap or break-up value (what it would realise if the business closed down), and a book value (the figure at which it actually stands in the books after depreciation). Correct valuation does not mean picking any one of these mechanically; it means applying the value which is appropriate to the nature of the asset and to the going-concern assumption on which the accounts are prepared. Fixed assets held for use, such as plant and buildings, are normally shown at cost less depreciation; current assets held for sale or conversion into cash, such as stock and debtors, are shown at cost or net realisable value, whichever is lower.

Valuation must be distinguished from two neighbouring audit processes. Vouching checks a recorded transaction against its documentary evidence, such as an invoice or receipt, and is concerned mainly with whether the transaction occurred and was recorded correctly. Verification confirms the existence, ownership and possession of an asset as on the balance sheet date, normally by physical inspection and documentary proof. Valuation goes one step further: after the auditor is satisfied that the asset exists and belongs to the client, he must still satisfy himself that the money figure attached to it is correct. The three processes together are sometimes summarised as: vouching proves the record, verification proves the thing, and valuation proves the amount.

Table 1: Vouching, Verification and Valuation Compared

Aspect	Vouching	Verification	Valuation
Main question	Is the entry supported by evidence?	Does the asset exist and belong to the client?	Is the amount at which it is shown correct?
Stage	During checking of transactions	At the balance sheet date	At the balance sheet date
Main evidence	Vouchers, invoices, receipts	Physical inspection, title deeds, confirmations	Market prices, invoices, depreciation policy, expert reports
Example	Purchase entry matched with supplier invoice	Machinery seen in the factory and invoice in client name seen	Machinery shown at cost less proper depreciation

Main Objects of Correct Valuation

1. To Present a True and Fair View of the Financial Position

The first and most important object of correct valuation is that the balance sheet should show a true and fair view of the state of affairs of the business. A balance sheet is nothing but assets and liabilities stated at values; if the values are wrong, the whole picture is wrong, however neatly the books may have been kept. Over-valued assets make a weak business look strong, while under-valued assets hide its real strength. Correct valuation, based on consistent and recognised principles, is therefore the foundation on which the truth and fairness of the balance sheet rests, and it is for this reason that company law requires the auditor to report whether the balance sheet shows a true and fair view.

2. To Ascertain the Correct Profit or Loss

Profit cannot be measured correctly unless the assets used in earning it, and the closing stock in hand, are valued correctly. Closing stock is credited to the trading account, so an over-valued closing stock inflates gross profit and an under-valued stock reduces it. In the same way, if depreciation charged on fixed assets is too small because the assets are over-valued or their life

is over-estimated, the expenses of the year are understated and profit is overstated; excessive depreciation does the opposite and creates a secret reserve. Correct valuation of stock, work-in-progress and fixed assets, and correct provisions against doubtful debts, are therefore essential before anyone can say what profit the business has truly earned in the period.

3. To Show the Correct Financial Position and Net Worth

Owners, partners and shareholders judge the worth of a business from its balance sheet: capital employed, net worth and the margin between current assets and current liabilities all come directly from valued figures. Correct valuation enables the proprietor to know the real value of his investment, enables partners to settle accounts fairly on admission, retirement or death of a partner, and enables shareholders to judge whether their capital is intact and growing. Without correct valuation, admissions and retirements of partners, and the settlement of a deceased partner share, would become a source of dispute and injustice between the parties concerned.

4. To Ensure Proper Depreciation and Replacement of Assets

Depreciation can only be calculated sensibly on a correct value spread over a correctly estimated useful life. If an asset is over-valued, the depreciation provided each year may still leave it standing in the books at more than its real worth; if it is under-valued, too little may be set aside out of profits to replace it when it is worn out. Correct valuation therefore protects the capital of the business: profits are not distributed as dividend out of capital in the mistaken belief that wasting assets are still worth their old figures, and funds are retained in the business in a planned way for the eventual replacement of plant, vehicles and equipment.

5. To Win the Confidence of Investors, Lenders and Creditors

Banks, debenture holders, trade creditors and prospective investors all lend or invest on the strength of the balance sheet. A bank deciding a loan application studies the value of the security offered and the current ratio shown by the accounts; an investor studies the net asset value behind each share. If assets are valued correctly and on a disclosed, consistent basis, these outsiders can trust the accounts and take sound decisions. Correct valuation thus supports the credit of the business in the market, while a reputation for inflated values destroys confidence and may expose the directors and the auditor to legal claims when the truth comes out.

6. To Provide a Correct Basis for Insurance, Sale and Amalgamation

Many practical transactions depend directly on valuation. Fire and other insurance policies should be taken for an amount close to the real value of the assets insured; under-insurance means the business bears part of every loss itself, while over-insurance wastes premium. When a business or a block of assets is sold, when companies amalgamate, or when shares are valued for transfer, gift or tax purposes, the price is negotiated on the basis of valued net assets and goodwill. Correct valuation at the balance sheet date provides a ready, reliable starting point for all such negotiations and settlements.

7. To Detect Errors, Fraud and Window Dressing

The work of examining values often brings hidden problems to light. A stock figure that has been deliberately inflated to show a better profit, debtors carried at full value although they are known to be bad, or investments shown at cost although their market value has permanently fallen, are all forms of window dressing which correct valuation exposes. Comparing the basis of valuation from year to year, enquiring into sudden changes in stock

values or margins, and testing values against market prices and subsequent realisations help the auditor to detect both honest mistakes and deliberate manipulation of the accounts.

8. To Comply with Legal and Accounting Requirements

Finally, correct valuation is a legal and professional duty, not a matter of choice. The Companies Act, 2017 in Pakistan, the accounting standards adopted in Pakistan (IFRS and, for smaller entities, the applicable financial reporting framework), and the disclosure requirements for listed companies all prescribe how particular assets and liabilities are to be measured and disclosed. Correct valuation ensures that the accounts comply with these requirements, that provisions and contingent liabilities are properly recognised, and that the auditor is able to give an unqualified report instead of qualifying it on grounds of improper valuation.

The Auditor and Valuation

A word must be added about the auditor position. The auditor is not a valuer and does not himself fix the values; that is the work of management and, where necessary, of expert valuers. His duty, as laid down in the well-known Kingston Cotton Mill case, is to exercise reasonable care and skill: he may accept the certificate of a responsible official or expert where there is no reason for suspicion, but he must check the basis of valuation, see that it is consistent with previous years and with accounting principles, test values against available evidence such as price lists and subsequent sales, and enquire fully into anything that appears unusual. If he signs the balance sheet without such care, he may be liable for negligence.

Conclusion

To conclude, valuation is the process of determining and examining the money amounts at which assets and liabilities are shown in the balance sheet. Its objects are wide and practical: a

true and fair view of the financial position, correct measurement of profit, protection of capital through proper depreciation, a fair basis for partner and shareholder settlements, insurance, sale and lending decisions, detection of error and fraud, and compliance with law and accounting standards. Because so much depends on it, correct valuation is not a formality but the very heart of reliable financial reporting, and both management and the auditor must give it their most careful attention.

Question 2: Audit — Definition and Types (20 Marks)

Define Audit and describe its types in detail.

Introduction

The word audit comes from the Latin word audire, which means to hear. In early times the accounts of an estate or business were read out and heard by an independent person, who questioned the steward and satisfied himself that the money entrusted to him had been honestly accounted for. From that simple beginning, auditing has grown into a systematic professional examination of books, accounts and vouchers, performed in every sizeable business and required by law for companies. This answer defines audit, explains the essential features contained in the definition, and then describes the main types of audit in detail, classified on the basis of law, scope, time and object.

Definition of Audit

An audit may be defined as an independent and systematic examination of the books of account, vouchers and other financial and supporting documents of an organisation, conducted by a qualified person, in order to verify the accuracy of the recorded transactions, to confirm the existence and value of the assets and liabilities, and to express an opinion whether the

financial statements present a true and fair view of the profit or loss and the financial position of the organisation for the period under review. Professional definitions express the same idea in shorter form: auditing is an intelligent and critical scrutiny of the accounts of a business by an independent person, so that he may report whether the balance sheet and profit and loss account are properly drawn up and show the true financial position. Every word of the definition carries meaning, as the next section shows.

Essential Features of an Audit

- **Independent examination.** The auditor must be independent of the persons who prepared the accounts. He is appointed by the owners (in a company, by the shareholders) and not by the managers whose work he examines, so that he can report fearlessly.
- **Systematic and planned work.** An audit is not a casual look at the books. It is carried out according to a planned audit programme, using recognised techniques such as vouching, verification, confirmation, analytical review and test checking.
- **Evidence-based.** The auditor collects sufficient and appropriate audit evidence from vouchers, documents, physical inspection and third-party confirmations before forming his opinion.
- **True and fair opinion.** The final product of an audit is the audit report, in which the auditor states whether the financial statements give a true and fair view and comply with the applicable law and accounting standards.
- **Qualified auditor.** For companies, the audit must be performed by a chartered accountant (or a firm of chartered accountants) holding a valid certificate of practice, as required by the Companies Act, 2017 in Pakistan.

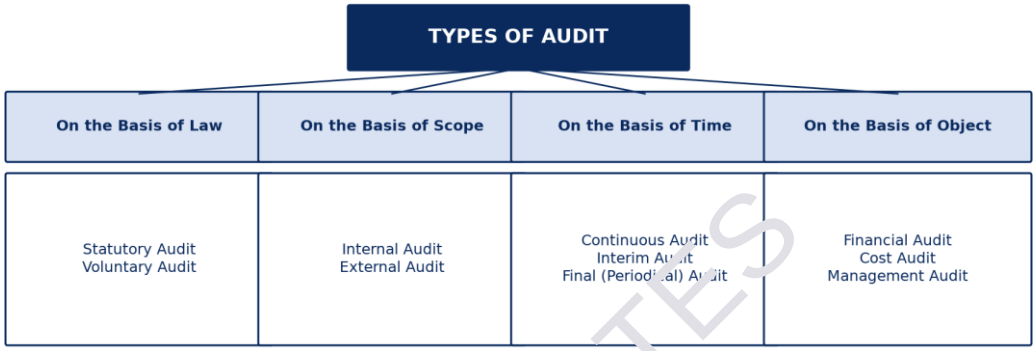


Figure 1: Classification of the types of audit.

Types of Audit

A. On the Basis of Law

A statutory audit is an audit made compulsory by law. The audit of every public company and of specified private companies under the Companies Act, 2017, the audit of banks under banking law, and the audit of government departments by the Auditor-General of Pakistan are examples. Its scope, the appointment and removal of the auditor, and the form of his report are all governed by the statute. A voluntary or non-statutory audit, by contrast, is carried out not because law demands it but because the owners themselves want it. Sole traders, partnership firms and trusts usually fall in this class: the owners fix the scope of the work by agreement with the auditor, and they obtain the benefits of reliable accounts for taxation, for raising loans, and for settling disputes among partners.

B. On the Basis of Scope and Organisation

An internal audit is conducted by an employee (or a separately engaged team) working inside the organisation as part of its own system of control. It is a continuous review of operations, records and controls, designed to help management by detecting errors promptly, checking

compliance with policies, and suggesting improvements. Its scope is fixed by management and may extend beyond accounts into operational efficiency. An external audit is conducted by an independent auditor from outside the organisation, normally for the benefit of the owners and other stakeholders. The external auditor examines the financial statements and reports to the shareholders; his independence is his chief strength, although he works for a limited period and mainly on financial records. Large organisations use both: the internal auditor keeps a watch throughout the year, and the external auditor may place reliance on that work after evaluating it.

C. On the Basis of Time

A continuous audit is one in which the auditor attends at regular intervals throughout the year and checks the transactions as the year progresses; it suits large organisations with a heavy volume of transactions, where final results are needed quickly after year-end and a strong running check on staff is desirable. An interim audit is conducted for a part of the accounting period, for example for the first six months, usually in connection with an interim dividend, a loan application or to spread the work of the final audit. A final or periodical audit (also called a completed or balance sheet audit in its narrower sense) is started after the close of the financial year and continued without break until it is finished; it is economical and convenient for small and medium organisations, although errors discovered late may be harder to correct and there is a risk of figures being altered after checking, which the auditor guards against by secret marks and by checking alterations.

D. On the Basis of Object

A financial or general audit is the ordinary audit of financial statements described above. A cost audit is the verification of cost accounts and cost records to ensure that the cost of products is correctly ascertained and that the costing system follows the prescribed rules; it is valuable in manufacturing and regulated industries for price fixation and cost control. A management audit appraises the quality of management itself: policies, organisation, decision-making and efficiency at all levels, in order to point out weaknesses and improve performance. Closely related are operational or efficiency audits, which examine whether operations are carried out economically and effectively; tax audits, conducted or required under income tax and sales tax law to verify taxable income and tax payments; and social audits, which examine the social costs and benefits of an organisation's activities. Government audit, performed under the Auditor-General, examines the accounts of government departments to ensure that public money has been spent for the purposes authorised by the legislature.

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Table 1: Internal Audit and External Audit Compared

Point of Difference	Internal Audit	External Audit
Appointed by	Management of the organisation	Shareholders / owners (for companies, at the annual general meeting)
Status	Employee or engaged staff of the organisation	Independent professional from outside
Scope	Fixed by management; may cover operations and efficiency	Fixed by law and engagement; mainly financial statements
Timing	Continuous, throughout the year	Usually after the close of the year, or as engaged
Report to	Management	Shareholders / owners
Main purpose	Improve controls and help management	Express opinion on true and fair view

Conclusion

To conclude, an audit is an independent, systematic, evidence-based examination of accounts ending in an opinion on their truth and fairness. Its types are best understood through classification: statutory and voluntary by law; internal and external by organisation and scope; continuous, interim and final by time; and financial, cost, management, tax, government and social audit by object. Each type answers a different need, and together they form the system by which owners, managers, lenders and the state obtain trustworthy financial information.

Question 3: Scope and Objects of Auditing; Qualities of an Auditor (10 + 10 Marks)

Explain the following: (i) Scope and objects of auditing. (ii) What are the major qualities of an auditor?

Introduction

This question has two parts. The first asks what auditing covers (its scope) and what it seeks to achieve (its objects); these two ideas are closely related, because the scope of the work is fixed by the objects it must fulfil. The second part turns from the work to the worker: auditing is only as reliable as the auditor himself, so the personal and professional qualities he must possess are of direct public importance. Both parts are answered in turn below.

Part (i): Scope of Auditing

The scope of auditing means the extent and boundaries of the auditor work: what he is required to examine, how deeply he must examine it, and what he is responsible for reporting. In a company audit the scope is determined mainly by the Companies Act, 2017 and by auditing standards; in a non-statutory audit it is determined by the agreement (engagement letter)

between the auditor and his client. Within that scope, the auditor examines the books of original entry, ledgers and final accounts; vouches transactions with documentary evidence; verifies assets and liabilities; evaluates the system of internal control; checks compliance with law, accounting standards and the memorandum and articles of the company; and applies analytical and enquiry procedures to anything unusual. The scope has widened greatly over time. The early auditor was expected mainly to detect cash defalcations; the modern auditor is expected to form an opinion on the financial statements as a whole, to consider fraud risk, going concern and related-party transactions, and in larger audits to review controls and compliance as well. At the same time, scope has limits: the auditor gives reasonable, not absolute, assurance; he works largely by test checking in big organisations; and he is a watch-dog, not a blood-hound, so he is not bound to suspect fraud where nothing excites suspicion, though he must remain professionally alert throughout.

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Part (i): Objects of Auditing

The objects of auditing are usually divided into the main (primary) object and subsidiary objects. The primary object is to express an independent opinion on the financial statements: whether the profit and loss account shows a true and fair view of the profit or loss for the period and the balance sheet shows a true and fair view of the financial position at its date, and whether they have been prepared according to law and applicable accounting standards. Everything the auditor does is directed to this opinion, which he expresses in his report to the shareholders.

The subsidiary objects support the primary object and describe the benefits which the audit produces on the way. First, detection and prevention of errors: errors of omission, commission,

principle and compensating errors, and arithmetical mistakes, are located during checking, and the very fact that an audit will take place discourages staff from making careless or dishonest entries (this moral check is itself a preventive object). Second, detection and prevention of fraud: misappropriation of cash, misappropriation of goods and manipulation of accounts (window dressing) are the three broad classes of fraud the auditor keeps in view; his duty is to plan the audit so that material fraud has a reasonable chance of being detected, and to report what he finds. Third, verification of assets and liabilities and confirmation that they are properly valued and disclosed. Fourth, examination of the adequacy of internal control, with suggestions to management for improvement, usually through a management letter. Fifth, compliance objects: helping the client meet requirements of company law, tax law and lenders, and providing reliable accounts for purposes such as admission of a partner, sale of the business, insurance claims and loan applications. It must be clearly understood that detection of every error and fraud is not the primary object and cannot be guaranteed; these are subsidiary to the opinion on truth and fairness, although in practice they are the benefits clients value most.

Part (ii): Major Qualities of an Auditor

The qualities of a good auditor fall into two groups: professional competence and personal character, and both are essential; a clever but dishonest auditor is dangerous, and an honest but incompetent one is useless.

Professional Qualities

- **Thorough knowledge of accounting and auditing.** He must be a qualified chartered accountant, expert in book-keeping, accounting principles, auditing standards and techniques such as vouching, verification, sampling and analytical review.

- **Knowledge of law.** He must know the Companies Act, 2017, income tax and sales tax law, and the general principles of contract, agency and negotiable instruments law which arise in business records.
- **Knowledge of the client business.** He should understand the industry, technology and common practices of the business he audits, so that he can judge what is normal and what is suspicious.
- **Tact, judgement and common sense.** He must decide how much checking is enough, where the risks lie, and how to obtain information from staff without creating hostility or panic; blind rule-following is no substitute for judgement.
- **Ability to communicate and report.** He must draft a clear, precise audit report and discuss findings firmly but courteously with directors and staff.

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Personal Qualities

- **Honesty and integrity.** He must be a man of unimpeachable character who will report the truth as he finds it, uninfluenced by fee, friendship or pressure from directors.
- **Independence.** He must be independent in fact and in appearance: no financial interest in the client, no close relationship with its officers, and no other service that compromises his objectivity.
- **Patience, vigilance and a questioning mind.** Audit work is detailed and repetitive; the auditor needs patience to pursue small discrepancies, vigilance to notice alterations and unusual items, and professional scepticism to verify rather than merely accept explanations.

- **Confidentiality and impartiality.** He learns the client secrets and must never disclose them without authority, and he must be fair to all parties: management, shareholders, staff under enquiry and outsiders alike.
- **Courage and firmness.** When he finds material error or fraud he must have the courage to qualify his report or report to the shareholders, even at the risk of losing the appointment.

Conclusion

To conclude, the scope of auditing covers the planned examination of books, vouchers, assets, liabilities and controls within the limits set by law or engagement, and its objects are, primarily, an independent opinion on the truth and fairness of the financial statements and, subsidiarily, the detection and prevention of errors and frauds, verification of assets and liabilities, and improvement of control. These objects can only be achieved by an auditor who combines professional knowledge of accounting, auditing and law with the personal qualities of honesty, independence, patience, vigilance, tact and courage. That combination is precisely why the law restricts company audits to qualified, regulated professionals.

Question 4: Internal Control and the Auditor's Methods of Reviewing It (20 Marks)

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.

Introduction

No auditor of a sizeable business can check every single transaction. He must instead ask a prior question: how reliable is the system inside the business which produces the records? If duties are divided so that one clerk work is automatically checked by another, if documents are

authorised and numbered, and if cash and stores are physically protected, then the records are likely to be dependable and the auditor can rely on the system, testing it by samples. If the system is weak, he must extend his own checking. That system is called internal control, and reviewing it is a standard, early stage of every modern audit. This answer defines internal control, describes its main features, and then explains the methods an auditor uses to review the internal control procedures of his client.

Definition of Internal Control

Internal control is the whole system of controls, financial and otherwise, established by the management of an organisation in order to carry on its business in an orderly and efficient manner, to secure adherence to management policies, to safeguard its assets, and to secure, as far as possible, the completeness and accuracy of its records. The definition has four objects built into it: orderly and efficient conduct of business; adherence to policies; safeguarding of assets; and complete and accurate records. Internal control is wider than internal check and internal audit, which are parts of it. Internal check is that part of internal control which arranges the duties of staff so that the work of one person is independently checked by another and no single person can carry a transaction through from beginning to end alone; internal audit is the appraisal activity performed by the organisation own staff to review operations and controls. A good system of internal control normally includes a clear organisation chart and division of duties, authorisation and approval of transactions by responsible officials, arithmetical and accounting controls such as double entry, reconciliations and control accounts, physical controls over cash, stock and documents, personnel controls (proper recruitment, training and supervision), pre-numbered documents, budgetary control, and an internal audit function.

Control must also cover computerised systems through access passwords, input and processing controls and audit trails.

Why the Auditor Reviews Internal Control

The auditor reviews internal control for three connected reasons. First, evaluation of the system tells him how much he can rely on the records, and therefore decides the nature, timing and extent of his own substantive tests: strong control means smaller samples, weak control means detailed checking. Second, the review itself reveals errors, weaknesses and possible frauds, because a gap in control is exactly where mistakes and misappropriation occur. Third, the auditor can serve his client by reporting the weaknesses he finds, with recommendations, in a management letter (letter of weakness). The review is therefore performed at the planning stage of the audit and its results are recorded in the audit file.

Methods Used by the Auditor to Review Internal Control

1. Enquiry and Discussion with Management and Staff

The review normally begins by enquiry: the auditor discusses the system with the client management and with the staff who actually operate it, asking how transactions are initiated, authorised, recorded and checked in each area such as purchases, sales, wages, cash receipts and payments. Enquiry is quick and gives the overall picture, but answers describe how the system is supposed to work, so enquiry alone is never sufficient and must be supported by the other methods below.

2. Study of Organisation Charts, Manuals and Documents

The auditor obtains and studies the client organisation chart, procedure manuals, job descriptions, lists of authorised signatories and specimens of the documents in use (order

forms, goods received notes, invoices, cheques). These show the formal division of duties, the levels of authorisation, and whether documents are pre-numbered and designed so as to prevent omission or duplication of entries. Comparing the documents across a complete transaction cycle shows whether the paperwork itself enforces control.

3. Internal Control Questionnaire (ICQ)

The most widely used method is the internal control questionnaire: a standard list of detailed questions, arranged by area (cash, purchases, sales, wages, stock and so on), designed so that a "No" answer reveals a weakness. Typical questions are: Are receipts banked intact daily? Are cheques signed by two officials? Are duties of the cashier separated from those of the ledger clerk? The questionnaire is completed through enquiry and observation, ensures that no important control point is overlooked, gives a permanent record in the audit file, and can be used by junior staff under supervision. Its limitation is that standard questions may not fit every business, so it must be adapted and supplemented.

4. Internal Control Checklist

A checklist is a shorter companion document listing the controls which a good system ought to contain in each area; the auditor ticks off which controls are actually present in the client system. Where the questionnaire asks questions, the checklist states the ideal controls, so the two together show both what exists and what is missing. It is especially useful for smaller clients where a full questionnaire would be disproportionately long.

5. Flow Charts

A flow chart presents the system diagrammatically: the flow of documents and information through departments, the copies of each document, the checks applied and the points where

duties change hands are shown by standard symbols in a single picture. Flow charts make complicated systems easy to grasp, expose at a glance such weaknesses as one person holding incompatible duties or a document copy going nowhere, and are quick to update in later years. Their preparation takes skill and time, so they are most common in large, computerised audits.

6. Narrative Notes (Memorandum Description)

In a narrative record the auditor simply writes down, in words, a description of the system as he finds it: who does what, in what order, using which documents and checks. This method is flexible and suits small businesses with simple systems, but long narratives are hard to follow, weaknesses are easy to miss within the text, and the record is difficult to update. In practice auditors often combine methods: narrative notes for small areas, questionnaires and flow charts for the main cycles.

7. Walk-Through Tests and Observation

To confirm that the system described on paper is the system actually working, the auditor performs walk-through tests: he selects a few transactions of each type and traces them through every stage of the system, examining the documents at each step, and he observes procedures in operation, for example watching the opening of mail and listing of receipts, or attending the wages pay-out. Observation and walk-through convert the paper system into tested fact and frequently reveal that formal procedures are being ignored in practice.

8. Compliance Tests (Tests of Control)

Finally, the auditor carries out compliance tests: detailed tests on samples of transactions to establish whether the key controls identified have actually operated throughout the period. For example, he inspects a sample of payment vouchers for evidence of authorisation, checks that

goods received notes are matched with invoices before payment, and re-performs bank reconciliations. The results decide his evaluation: if compliance tests pass, control risk is low and substantive testing can be reduced; if they fail, he treats the control as unreliable, extends substantive procedures, and reports the weakness to management.

Table 1: Methods of Reviewing Internal Control at a Glance

Method	What the Auditor Does	Main Advantage
Enquiry and discussion	Interviews management and staff about procedures	Quick overall picture of the system
Study of charts, manuals and documents	Examines organisation chart, manuals, signatories, forms	Shows formal division of duties and authorisation
Internal control questionnaire	Completes standard questions; a "No" shows weakness	Nothing important overlooked; permanent record
Checklist	Ticks off controls that ought to exist	Simple and quick for small clients
Flow charts	Draws the document flow diagrammatically	Whole system visible at a glance
Narrative notes	Writes a description of the system	Flexible; suits simple systems
Walk-through and observation	Traces sample transactions; watches procedures working	Confirms paper system operates in practice
Compliance tests	Tests samples for evidence that controls operated	Decides how far the auditor may rely on the system

Conclusion

To conclude, internal control is management whole system of financial and other controls designed for orderly business, adherence to policy, safeguarding of assets and reliable records. The auditor reviews it by a combination of enquiry, study of charts, manuals and documents, questionnaires, checklists, flow charts and narrative notes, and he confirms his picture by walk-through tests, observation and compliance tests. The evaluation he reaches governs the whole shape of the rest of the audit and produces practical recommendations for the client, which is

why the review of internal control is regarded as the foundation of the modern, risk-based audit approach.

Question 5: Vouching — Techniques and Application to the Books of Account (20 Marks)

Define vouching and explain its techniques and application to the books of accounts.

Introduction

Every figure in the books of account begins life as a transaction, and every transaction should be supported by documentary proof: an invoice, a receipt, a cheque counterfoil, a contract or a minute. The process of comparing the entries in the books with that documentary proof is called vouching, and because it tests the very foundation of the accounts it has been described as the backbone, and even the essence, of auditing. If the entries themselves are fictitious, omitted or wrongly recorded, no amount of later verification of the balance sheet can make the accounts reliable. This answer defines vouching, explains what the auditor checks on each voucher, describes the techniques he applies, and then shows how vouching is applied to the main books of account.

Definition of Vouching

Vouching is the examination of the documentary evidence (called vouchers) in support of the entries appearing in the books of account, in order to satisfy the auditor that each transaction is genuine, properly authorised, correctly recorded in amount and account, and relates to the business and to the accounting period under audit. A voucher is any document which supports an entry: a supplier invoice supports a purchase, a receipt issued supports cash received, a cheque counterfoil and payee receipt support a payment, and a resolution or contract supports

larger or unusual transactions. Vouching is wider than mere ticking of entries against papers. In vouching, the auditor goes behind the books to the documents from which the entries were made, and he reads the documents critically: a correct total copied from a forged or unauthorised invoice is still a wrong entry. Properly performed, vouching establishes five things about every transaction tested: occurrence (it really happened), authorisation (a responsible person approved it), accuracy (amount, date and account are correct), completeness of recording (nothing supported by a voucher has been left out), and propriety (it is a genuine business transaction of the client, not a personal or fictitious one).

Techniques of Vouching: Points Checked on Every Voucher

- **Name and address of the client.** The voucher must be in the name of the client organisation. An invoice in the name of a director or employee personally may indicate that a private purchase has been charged to the business.
- **Date and period.** The date on the voucher must fall within the accounting period under audit; vouchers of the previous or following period point to cut-off errors or deliberate shifting of income and expenses.
- **Amount in words and figures.** The amount on the voucher must agree with the amount recorded; words and figures on the voucher itself must agree with each other, and alterations must be initialled by a responsible person.
- **Authorisation.** The voucher should bear the signature or initials of the official authorised to approve that transaction and, for payments, evidence that the amount was passed for payment.

- **Account head and revenue or capital nature.** The entry must be posted to the correct account, and capital and revenue expenditure and receipts must be correctly distinguished, since confusion between them directly falsifies profit.
- **Genuineness and condition of the voucher.** The auditor examines the voucher itself for signs of forgery or tampering: differences in ink or handwriting, missing serial numbers, unstamped receipts for large payments, and duplicates produced where originals should exist. Printed, numbered vouchers from outside parties carry more weight than internal, handwritten ones.
- **Cancellation of used vouchers.** Vouchers once checked are stamped or marked with a special tick so that they cannot be produced again to support a second, fictitious entry; the auditor uses distinctive ticks and colours so that his own work cannot be imitated.
- **Missing vouchers and duplicates.** Every gap in a numbered series is enquired into. Where an original voucher is missing, a duplicate or certificate is obtained, but the auditor treats the matter with extra care because missing vouchers are a common cover for misappropriation.

Alongside these point-by-point checks, the auditor applies the general techniques of modern audit work in vouching: test checking (examining a scientifically chosen sample instead of every item where internal control is strong), surprise checks, scrutiny of unusual, large and round-sum items in full, and comparison of related records, for example matching a payment not only with its voucher but also with the corresponding entry in the bank statement obtained independently. Routine checking of casts, postings and carry-forwards supports the vouching by proving the arithmetical accuracy of the records themselves.

Application of Vouching to the Books of Account

Cash Book: Receipts Side

Receipts are vouched with counterfoils of receipts issued, carbon copies, correspondence, contracts and bank paying-in slips. The auditor checks that receipts are issued for all money received, that the amounts are banked promptly and intact, that discounts allowed are authorised, and that no receipt has been omitted, a fraud known as teeming and lading (lapping), in which a later receipt is used to cover an earlier theft; comparing dates of receipts with dates of bank deposits is the standard test against it. Cash sales are checked against till rolls, sales summaries and stock records.

Cash Book: Payments Side

Payments require the strongest evidence because cash paid out is the easiest to misappropriate. Each payment is vouched with the payee receipted invoice or bill, cheque counterfoils and the bank statement, and the auditor checks authorisation, the payee name, and that supporting documents are stamped paid to prevent re-use. Wages are vouched with the wages book, muster rolls and appointment and increment records, with attention to dummy workers; petty cash is vouched with petty cash vouchers and is checked by surprise physical count of the float.

Purchases Book and Sales Book

Credit purchases are vouched with suppliers invoices, supported by goods received notes and purchase orders, so that the auditor is satisfied the goods were ordered, received and priced as agreed; statements received from suppliers are reconciled for confirmation. Credit sales are vouched with copies of sales invoices, matched with orders received and goods outward (gate)

records, proving that every despatch was invoiced and every invoice relates to a real despatch; credit notes for returns are checked against goods inward records.

Journal, Other Books and Ledger

Journal entries, which can be used to manipulate accounts because they bypass the routine books, receive special attention: every journal entry should be supported by a narration and documentary authority, such as a board resolution for transfers and adjustments, correspondence for bad debts written off, and invoices for assets purchased on credit. The bills receivable and bills payable books are vouched with the bills themselves and the bank or acceptor records. Finally, vouching extends into the ledger through checking postings from the books of original entry on a test basis, so that the whole chain from voucher to book to ledger to final accounts is proved unbroken.

Table 1: Vouching Applied to the Main Books

Book	Principal Vouchers and Evidence	Special Points Watched
Cash book – receipts	Receipt counterfoils, paying-in slips, correspondence	Daily banking intact; teeming and lading
Cash book – payments	Receipted invoices, cheque counterfoils, bank statement	Authorisation; vouchers stamped paid; no re-use
Purchases book	Suppliers invoices, goods received notes, orders	Goods actually received; supplier statements reconciled
Sales book	Invoice copies, orders, goods outward records	Every despatch invoiced; returns supported by credit notes
Journal	Resolutions, contracts, correspondence, calculations	Full authority for adjustments; no manipulation entries
Wages and petty cash	Wages book, muster rolls, petty cash vouchers	Dummy workers; surprise count of petty cash float

Conclusion

To conclude, vouching is the critical comparison of book entries with their documentary evidence to prove that transactions are genuine, authorised, correctly recorded and proper to the business and the period. Its techniques centre on the disciplined examination of every voucher for name, date, amount, authorisation, account head and genuineness, reinforced by test checking, cancellation of checked vouchers and enquiry into missing documents. Applied systematically to the cash book, purchases and sales books, journal and ledgers, vouching gives the auditor his assurance over the transactions of the year, on which the verification of the balance sheet and his final opinion securely rest.

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