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ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Course: Auditing (481) • Level: ADC

Semester: Autumn 2026

Assignment No. 2 (Units 5–9)

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: Verification — Meaning, Importance in Audit and Basic Techniques (20 Marks)

What is verification? Explain the importance of verification in audit and its basic techniques.

Introduction

At the end of the financial year the balance sheet lists assets such as land, buildings, machinery, stock, debtors and cash, and liabilities such as loans and creditors. Before the auditor can say that this list is true and fair, he must answer three practical questions about every material item: does it actually exist, does it belong to the client, and is it free from undisclosed charges? The audit process which answers these questions is called verification. Verification is the concluding and most visible part of audit work, because it takes the auditor out of the books and into physical contact with the assets themselves and with independent third parties. This answer defines verification, distinguishes it from vouching and valuation, explains its importance in an audit, and describes the basic techniques by which it is carried out.

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Meaning and Definition of Verification

Verification is the process by which the auditor satisfies himself, by physical inspection, documentary examination and confirmation from outside parties, that the assets and liabilities shown in the balance sheet actually exist, are owned (or owed) by the client, are in the client possession or control, and are disclosed correctly in the accounts as on the balance sheet date. In short, verification confirms existence, ownership, possession and freedom from charge. It covers liabilities as fully as assets: the auditor verifies that loans, creditors and capital shown in the balance sheet are genuine obligations of the business, stated at the correct amounts and completely recorded, because an understated liability falsifies the position just as surely as an overstated asset. Verification is performed as on a particular date, normally the balance sheet date, and it uses evidence obtained as near that date as possible.

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Verification must be distinguished from its two companion processes. Vouching examines the documentary evidence behind transactions recorded during the year; it proves that entries in the books are supported. Valuation determines the money amount at which an asset or liability should be shown; it proves the figure. Verification sits between and beyond them: it proves the thing itself. A purchase of machinery may be perfectly vouched by an invoice and yet the machine may have been sold, scrapped or never delivered; the books may value debtors carefully and yet some debtors may be fictitious. Only verification, by inspecting the machine and by confirming balances directly with debtors, closes these gaps. A complete audit therefore needs all three: vouching of transactions, verification of existence and ownership, and checking of valuation.

Table 1: What Verification Establishes

Point Verified	Meaning	Example
Existence	The asset was physically or legally in being at the balance sheet date	Machinery seen working in the factory; stock counted
Ownership	The asset legally belongs to the client	Title deed of land in the client name examined
Possession / control	The asset is held by the client or by an authorised party for the client	Securities held by bank as agent, confirmed by bank certificate
Freedom from charge	Any lien, mortgage or pledge over the asset is known and disclosed	Property mortgaged to bank disclosed in balance sheet
Completeness of liabilities	All obligations owed at the date are recorded	Creditors confirmed; unrecorded invoices searched for
Correct disclosure	Items are classified and described properly	Current and fixed assets separately shown as law requires

Importance of Verification in Audit

1. It Confirms the Truth of the Balance Sheet

The balance sheet is a statement of assets and liabilities, and its truth depends on those items being real. Verification is the only part of the audit which directly tests that reality, so without it the auditor opinion on the balance sheet would rest entirely on papers produced by the client own staff. By inspecting assets, examining title documents and obtaining outside confirmations, the auditor converts the balance sheet from a claim by management into a statement supported by independent evidence, which is the essence of his duty to the shareholders.

2. It Detects Fraud, Misappropriation and Window Dressing

Many frauds collapse at the verification stage. Cash misappropriated during the year cannot be produced at the count; stock stolen or fictitious stock entered to inflate profit is exposed by physical stock-taking; fictitious debtors cannot confirm their balances; assets pledged without

disclosure are revealed by enquiry from lenders. Verification also detects innocent errors, such as assets disposed of but never removed from the register, and deliberate window dressing, such as including goods held on consignment as owned stock. The knowledge that assets will be physically verified is itself a powerful deterrent to staff dishonesty.

3. It Protects the Auditor and Supports His Opinion

Company law and case law make the auditor responsible for exercising reasonable care in verifying the existence and ownership of material assets. Courts have criticised auditors who accepted book figures or certificates from interested officials without independent checking. Proper verification, documented in the audit file, is therefore both the basis of an honest opinion and the auditor best defence if the accounts later prove wrong. Conversely, an auditor who never inspects, never confirms and never examines title deeds has not performed the core of his engagement, whatever other checking he may have done.

4. It Serves Owners, Lenders and Other Users

Shareholders learn from a verified balance sheet that the capital they contributed is represented by real assets. Banks verify the same figures before lending against security, tax authorities rely on them in assessment, and a purchaser of the business relies on them in fixing the price. Verification performed by an independent auditor gives all these users a common, dependable starting point and reduces disputes between partners, and between buyers and sellers, about what the business actually owns and owes.

Basic Techniques of Verification

1. Physical Inspection and Counting

The auditor (or his staff) physically inspects tangible assets: he attends the stock-taking and test-counts stock, counts cash in hand in the presence of the cashier, inspects plant and machinery in the factory, and examines valuable documents such as share certificates and title deeds. Physical inspection is the strongest evidence of existence, although it does not by itself prove ownership or value, so it is combined with the other techniques. Surprise counts during the year add to its effectiveness against temporary concealment of shortages.

2. Confirmation from Third Parties

For balances held or owed by outsiders, the auditor obtains direct written confirmation under his own control: debtors confirm amounts receivable, creditors amounts payable, banks confirm balances and securities held, and solicitors or agents holding documents confirm what they hold. The requests are sent and received by the auditor office so that replies cannot be intercepted or altered. Confirmation is the principal technique for debtors, bank balances and many liabilities.

3. Examination of Documentary Evidence

Ownership and obligations are proved by documents: title deeds and registration records for land and buildings, vehicle registration books, invoices and hire-purchase agreements for plant, share certificates and broker notes for investments, loan agreements and mortgage deeds for borrowings, and minutes and contracts for commitments. The auditor examines originals where possible, notes in whose name documents stand, and records details of charges created, which he also cross-checks with the register of charges and, for companies, with the record maintained by the Securities and Exchange Commission of Pakistan.

4. Reconciliation, Reperformance and Enquiry

The auditor reconciles physical and confirmed figures with the books: the stock sheets with the stock records, the bank confirmation with the bank reconciliation statement, the fixed asset register with the general ledger, and he re-performs calculations such as depreciation and interest accruals. Enquiry of management and staff, supported by a written management representation letter, is used for matters which cannot be directly observed, such as contingent liabilities or assets held by third parties, but enquiry is always corroborated by other evidence wherever possible.

5. Cut-Off and Subsequent-Events Review

Verification is completed by cut-off checking, ensuring that goods received before the year-end are included in stock and purchases and that goods despatched are excluded and invoiced in the right period, and by reviewing events after the balance sheet date: receipts from debtors after the date support their existence and recoverability, payments to creditors support recorded liabilities, and disposals of assets after the date may confirm or contradict their year-end position.

Conclusion

To conclude, verification is the auditor confirmation, by inspection, documentary examination and outside confirmation, that balance sheet assets and liabilities exist, belong to or are owed by the client, and are properly disclosed at the balance sheet date. Its importance lies in converting management figures into independently supported facts, detecting fraud and error, and grounding the auditor opinion and his legal position. Its basic techniques, physical inspection, third-party confirmation, documentary examination, reconciliation and reperformance, enquiry, and cut-off and subsequent review, are applied together to every

material item, and together with vouching and valuation they complete the evidence on which a true and fair opinion can be given.

Question 2: Events Occurring After the Balance Sheet Date (20 Marks)

What do you understand by events? Explain the events occurring after the balance sheet date.

Introduction

Accounts are prepared as on a fixed date, the balance sheet date, but they are not finalised on that date. Weeks or months pass while the books are closed, the audit is performed and the accounts are approved and issued, and during that interval the world does not stand still: a major debtor may fail, stock may be destroyed by fire, a court case may be decided, or a large contract may be signed. Some of these later events throw light on conditions which already existed at the balance sheet date and must change the figures; others arise from entirely new conditions and must not change the figures, although they may need to be described. The rules for sorting these events, and the auditor duties in respect of them, form the subject of subsequent events, dealt with in auditing standard ISA 560 and accounting standard IAS 10. This answer explains the meaning of events in this context, classifies events occurring after the balance sheet date, and sets out the duties of management and the auditor in each period.

Meaning of Events

An event is any significant occurrence, transaction or development, favourable or unfavourable, which affects or may affect the financial position, results or disclosures of an enterprise. Events may be internal, such as the discovery of a fraud or error, a strike, or the loss of an uninsured asset, or external, such as the failure of a customer, a change in tax law, a sharp fall in the market value of investments, or the destruction of a factory by flood. In ordinary auditing

language, when accountants speak simply of "events" in connection with final accounts, they normally mean events occurring after the balance sheet date (also called subsequent events): those significant events which happen between the date of the balance sheet and the date on which the financial statements are authorised for issue, together with facts which become known to the auditor even after that. The central question such events raise is always the same: do the accounts, prepared as on the earlier date, need to be adjusted or supplemented in the light of what has since become known?

The Two Classes of Subsequent Events

1. Adjusting Events

Adjusting events are those which provide additional evidence of conditions that existed at the balance sheet date. Because the accounts claim to state the position as on that date, better evidence about that position, whenever it arrives, must be used to correct the figures. The financial statements are therefore adjusted for such events. Standard examples are: the bankruptcy or insolvency of a debtor shortly after the year-end, confirming that the debt was already doubtful and requiring a provision; the settlement of a court case after the date, fixing a liability which existed at the date; the sale of stock after the date at below cost, showing that net realisable value at the date was lower than cost; the determination of the cost or sale proceeds of an asset bought or sold before the date; and the discovery of fraud or errors showing that the statements were already incorrect. In each case the event does not create the condition; it merely reveals or measures it.

2. Non-Adjusting Events

Non-adjusting events are those which are indicative of conditions that arose after the balance sheet date. They do not change the position as it stood at that date, so the figures are not adjusted. However, if such an event is so significant that its non-disclosure would influence the decisions of users, it must be disclosed by way of note, stating its nature and an estimate of its financial effect (or that such an estimate cannot be made). Examples include: destruction of a major plant by fire or flood after the date; a major purchase or disposal of assets or a business combination after the date; announcement of a plan to discontinue an operation; major ordinary share transactions after the date; and abnormally large changes in asset prices or exchange rates after the date. One special situation overrides the classification: if events after the date show that the enterprise is no longer a going concern (for example, management decides to liquidate, or the business is destroyed with no realistic alternative), the financial statements must not be prepared on the going-concern basis at all, which is a fundamental change, not a mere adjustment.

Table 1: Adjusting and Non-Adjusting Events Compared

Point	Adjusting Events	Non-Adjusting Events
Nature	Evidence of conditions existing at the balance sheet date	Conditions arising after the balance sheet date
Treatment	Figures in the financial statements are adjusted	Figures are not adjusted; material events disclosed by note
Examples	Debtor bankrupt after date; court case settled; stock sold below cost	Fire destroying factory after date; major acquisition after date
Effect on audit	Auditor ensures adjustment is correctly made	Auditor ensures adequate disclosure is made

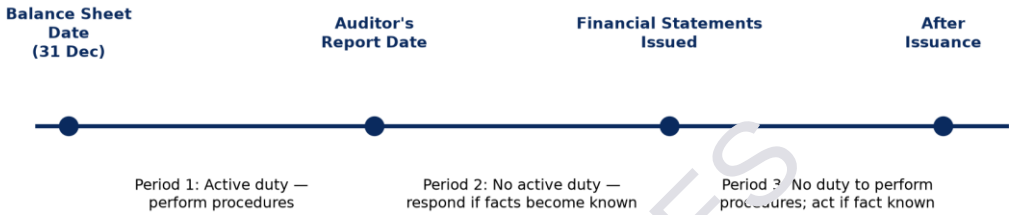


Figure 1: The three periods for events after the balance sheet date and the auditor's duty in each.

Duties of the Auditor: The Three Periods

Period 1: Up to the Date of the Auditor's Report

In this period the auditor has an active duty. He must perform procedures designed to obtain sufficient appropriate evidence that all events up to the date of his report which require adjustment or disclosure have been identified. These procedures include understanding management procedures for identifying subsequent events, enquiring of management and those charged with governance, reading minutes of shareholders, directors and committee meetings held after the date, reading the latest interim accounts, budgets and cash-flow forecasts, enquiring of the client lawyers about litigation, and reviewing correspondence and subsequent receipts and payments. If he identifies a material adjusting event which management has not adjusted, or a material non-adjusting event not disclosed, he must ask management to correct it; if management refuses, he modifies his audit report accordingly. He also obtains a written representation from management that all subsequent events have been disclosed to him.

Period 2: After the Report Date but Before the Statements Are Issued

In this period the auditor has no obligation to perform procedures, but if a fact becomes known to him which, had it been known at the report date, might have caused him to amend his report, he must discuss it with management, determine whether the statements need amendment, and if they are amended, carry out the necessary procedures, extend his subsequent-events review to the new report date, and issue a new or amended report (with an emphasis-of-matter or dual dating as appropriate). If management refuses a necessary amendment, he takes steps to prevent reliance on his report, including informing those charged with governance and, where applicable, the regulators and the users to whom the statements are to be issued.

Period 3: After the Financial Statements Have Been Issued

After issuance the auditor again has no duty to perform procedures, but if a fact becomes known which would have changed his report, he discusses with management whether the statements need revision. If management revises them, he audits the revision and issues a new report drawing attention to the revision; if management does not take appropriate steps, he notifies those charged with governance that he will seek to prevent future reliance on his report, and takes such further action, including legal advice, as his rights and obligations require.

Conclusion

To conclude, "events" in this context are significant occurrences affecting an enterprise, and events occurring after the balance sheet date are divided into adjusting events, which evidence conditions existing at that date and change the figures, and non-adjusting events, which arise afterwards and, if material, are disclosed by note, with the going-concern rule standing above

both. The auditor duty is active up to his report date, responsive in the interval before issuance, and protective after issuance, so that users never knowingly rely on statements which later knowledge has shown to be materially wrong.

Question 3: Verification of Assets and Verification of Stocks (20 Marks)

What do you know about verification of assets? Explain the verification of stocks with the assessment of internal control.

Introduction

Assets form one whole side of the balance sheet, and the auditor cannot report that the balance sheet is true and fair until he has verified them: satisfied himself that they exist, that they belong to the client, that they are properly valued and that any charge over them is disclosed. Different assets need different verification methods, because land cannot be counted like cash and debtors cannot be inspected like machinery. Stock (inventory), however, deserves special treatment in this answer, both because it is usually the largest current asset and because its quantity and condition can only be established by a physical process which the auditor does not himself control. The answer first states the general principles of verification of assets and then explains the verification of stocks together with the assessment of the internal control over stocks on which that verification depends.

Verification of Assets: General Principles

Verification of assets is the process of confirming, as on the balance sheet date, four things about each material asset. First, existence: the asset is physically or legally in being, proved by inspection, count or confirmation. Second, ownership: the asset belongs to the client, proved

by title deeds, registration documents, invoices in the client name and similar evidence; assets held for others, such as goods on consignment or customers goods for repair, must be excluded. Third, valuation: although valuation is a separate process, verification includes checking that the asset stands in the books at a figure arrived at on a proper and consistently applied basis, and that depreciation or provisions have been made where required. Fourth, disclosure and freedom from charge: the asset is correctly classified and described, and any mortgage, lien or pledge over it is ascertained and disclosed. The techniques used are those described in general audit practice: physical inspection, confirmation from third parties, examination of documents of title, reconciliation of registers (such as the fixed asset register) with the ledger, and enquiry supported by management representations. For fixed assets the auditor also checks additions and disposals of the year with vouchers and minutes, and inspects a sample of assets against the register in both directions, from register to floor (existence) and from floor to register (completeness).

Verification of Stocks

Nature and Importance of Stock

Stock (inventory) comprises raw materials, work-in-progress and finished goods held for sale or consumption in production. It is normally the most difficult asset to verify because it is bulky, varied, constantly moving and entirely in the custody of the client staff; it is also the asset through which profit is most easily manipulated, since closing stock is credited to the trading account and every rupee added to stock adds a rupee to gross profit. The auditor responsibility, under ISA 501, is to obtain sufficient appropriate evidence of the existence and condition of

stock, principally by attending the physical counting, unless impracticable, and of its completeness and valuation through further procedures.

Attendance at Stock-Taking

The auditor attends the client stock-taking, normally held at or near the year-end, and before the count he obtains and reviews the client written stock-taking instructions. During the count he observes whether the instructions are actually followed: whether counting is done by teams of two, whether stock sheets are controlled and numbered, whether damaged, obsolete and third-party goods are separately identified, and whether movements of goods stop or are controlled during counting. He performs test counts in both directions (from stock sheets to the floor and from the floor to the stock sheets), records his test counts, notes the condition of stock and the last goods received and despatch note numbers for cut-off testing, and obtains copies of the final stock sheets, ensuring later that figures are not altered after the count, by keeping his own record of totals and test items.

Valuation, Cut-Off and Completion Procedures

After the count the auditor tests the stock sheets: casts and extensions are checked, quantities are agreed with his test counts and with stock records, and prices are tested to suppliers invoices for raw materials, to cost records for work-in-progress and finished goods, and to post-year-end selling prices to confirm that stock is stated at the lower of cost and net realisable value. Provision is checked for slow-moving, damaged and obsolete items identified at the count and in the stock records. Cut-off procedures match the last goods received notes before the year-end with purchase invoices (goods in stock must be in purchases, and vice versa) and match last despatches with sales, so that stock is neither double-counted nor omitted. He also

checks goods in transit, stock held by third parties (by confirmation) and third-party stock held by the client (excluded), reviews gross profit percentages against prior years for reasonableness, and ensures stock is not pledged undisclosed, enquiring about charges to banks against stock (a very common security) and confirming disclosure.

Assessment of Internal Control over Stocks

The auditor can only place reliance on the stock figures, and limit his own tests, if the internal control over stock is sound, so assessment of that control is an integral part of stock verification. He studies and tests the control system over each stage of the stock cycle. Over purchases and receipts: orders placed only on authorised requisitions, goods received inspected and recorded on pre-numbered goods received notes by a receiving department independent of the storekeeper, and invoices matched with orders and goods received notes before payment. Over storage and custody: stock kept in locked, organised stores under a responsible storekeeper, access restricted, bin cards and perpetual inventory records maintained by persons independent of custody, and insurance against fire and theft. Over issues and despatches: materials issued only against authorised requisitions, despatches only against approved orders and gate passes, with sales invoicing matched to despatch records. Over recording and review: a perpetual inventory system with continuous or rotating stock checks by staff independent of the stores, investigation of differences between book and physical stock, and periodic management review of slow-moving and obsolete stock reports.

The assessment is made by the standard methods of control review: enquiry, study of manuals and documents, an internal control questionnaire for the stores cycle, observation of receiving, storage and despatch in operation, and compliance tests such as tracing a sample of goods

received notes into the stock records and testing evidence of authorisation on requisitions. Weaknesses found, for example the storekeeper also keeping the stock records, or no independent stock checks, lead the auditor to extend his stock procedures, increase test counts, insist on a full year-end count, and report the weakness in his management letter. Strong control, proved by tests, justifies reliance on the perpetual records and the client count, with the auditor role centred on observation and testing rather than recounting everything.

Table 1: Internal Control over Stocks and the Auditor's Test

Stage	Expected Control	Auditor's Check
Receipts	Goods received notes pre-numbered; inspection independent of stores	Trace GRNs to records; test numbering sequence
Storage	Locked stores; restricted access; bin cards by independent clerk	Observe stores; compare sample bin cards with physical stock
Issues	Issues only on authorised requisitions	Inspect sample requisitions for authorisation
Despatches	Gate passes matched with invoices	Match sample despatches with sales invoices
Recording and review	Perpetual inventory; independent rotating counts; differences investigated	Review count records and difference reports

Conclusion

To conclude, verification of assets establishes their existence, ownership, proper valuation basis and disclosure, using inspection, confirmation, documents of title and reconciliation. Stock, the most sensitive asset, is verified by attending and testing the physical count, checking cut-off, quantities, prices and the lower-of-cost-and-net-realisable-value rule, and confirming stock held elsewhere. Because these procedures rest on the client system, the auditor simultaneously assesses internal control over receipts, storage, issues, despatches and recording, and

calibrates the extent of his own verification to the strength of that control. Properly combined, the two give reasonable assurance that the stock figure, and with it the profit of the year, can be believed.

Question 4: Share and Verification of Share Capital (20 Marks)

Define share and describe verification of share capital in detail.

Introduction

Share capital is the foundation figure of a company balance sheet: it represents the permanent contribution of the owners, fixes their rights and their liability, and stands first among the items on the equity and liabilities side. An error or fraud in share capital, such as shares recorded as fully paid when calls are unpaid, bonus shares never properly authorised, or capital altered without legal authority, goes to the legal existence of the company itself. The auditor must therefore verify share capital with particular care, most strictly of all in the first audit after incorporation or after any change in capital. This answer first defines a share and the kinds of share capital, and then describes the verification of share capital in detail, for a first audit and for subsequent audits, and for the special transactions which change capital.

Definition of a Share

A share is a unit of the share capital of a company, representing the interest of its holder (the shareholder) in the company, measured by a sum of money, together with the rights and obligations attached to it by the Companies Act, 2017 and the company memorandum and articles of association. Under the Act, a share is movable property, transferable in the manner provided by the articles, and each share is distinguished by its number. In simple words, when the total capital of a company is divided into small equal units so that many persons can each

contribute a part, each such unit is a share, and its holder is a part-owner of the company to the extent of his shares. The two main classes of shares are equity (ordinary) shares, whose holders are the real owners, receive dividend after preference shareholders, carry voting rights and bear the ultimate risk, and preference shares, which carry a preferential right to a fixed rate of dividend and to repayment of capital on winding up and whose terms (cumulative or non-cumulative, participating or not, redeemable or not) are set out in the articles and the terms of issue. Shares may be issued at par, at a premium (above face value, the premium being credited to a share premium account) or, subject to legal restrictions, originally at a discount in limited circumstances; shares may also be issued for consideration other than cash, which the auditor must specially examine.

Kinds of Share Capital

- **Authorised (nominal) capital.** The maximum capital the company is authorised to issue by its memorandum; capital beyond this cannot be issued without altering the memorandum.
- **Issued capital.** The part of the authorised capital actually offered and allotted to shareholders.
- **Subscribed capital.** The part of the issued capital which the public or allottees have agreed to take up.
- **Called-up capital.** The part of the subscribed capital which the company has called upon shareholders to pay.
- **Paid-up capital.** The part of the called-up capital actually received; called-up capital minus calls in arrears gives paid-up capital. Amounts received in advance of calls are shown separately.

The auditor verification is directed to proving that the figures under each of these heads in the balance sheet agree with the statutory records, that every movement between them during the year was legally authorised, and that unpaid amounts and calls in arrears are correctly shown.

Verification of Share Capital: First Audit

In the first audit after incorporation the auditor performs a complete verification from the foundation documents. He examines the memorandum of association to ascertain the authorised capital and its division into shares, and the articles of association for the rights of each class and the rules for issue, calls, forfeiture and transfer. He inspects the certificate of incorporation and, for a public company which invited public subscription, the prospectus (or statement in lieu of prospectus) and the commencement-of-business requirements, and he verifies that the issue was made in accordance with them and with the Act, including listing and SECP requirements where applicable. He then examines the application and allotment book (or the records of the share registrar and the central depository for listed shares), agreeing applications received with bank records of application money, allotments with directors minutes authorising allotment, and the return of allotment filed with the registrar. The cash book and bank statements are checked for application, allotment and call money received; letters of allotment and share certificates are tested against the register of members, and the total shares allotted are reconciled with the issued capital in the balance sheet. Where shares were issued for consideration other than cash, such as to promoters or in payment for property, he examines the contracts filed with the registrar, the board minutes and the valuation basis, and ensures the fact is disclosed. Where shares were issued at a premium he

checks that the premium is credited to the share premium account and applied only for purposes allowed by law.

Verification in Subsequent Audits and for Changes in Capital

In subsequent years the opening share capital is agreed with the previous year audited balance sheet, and the auditor concentrates on verifying every change during the year. For a fresh issue he repeats, for that issue, the checks described above: authority in the memorandum and articles, directors and (where required) shareholders resolutions, prospectus or offer documents, receipt of money traced into the bank, allotment records, return of allotment, and entries in the register of members. For calls made during the year he examines the call notices and board resolutions, checks receipts in the cash book and bank, and verifies the schedule of calls in arrears, ensuring arrears are deducted from called-up capital in the balance sheet and that interest on arrears, where charged, is accounted for; for calls received in advance he confirms they are shown as a liability and not as paid-up capital. For forfeiture of shares he inspects the articles (which must authorise forfeiture), the notices served on defaulting shareholders, the board resolution of forfeiture, and the accounting entries: the amount originally paid is credited to a forfeited shares account, and on re-issue of forfeited shares he checks the re-issue authority, the amount received, and that any surplus on re-issue is transferred to capital reserve while any discount on re-issue does not exceed the amount forfeited. For a bonus issue he verifies the shareholders resolution, the availability of free reserves or share premium legally usable, the capitalisation entries, and compliance with SECP directives. For redemption of redeemable preference shares he checks that redemption is out of profits or a fresh issue as the Act requires, that a capital redemption reserve is created where

necessary, and that premium on redemption is properly provided. For a reduction or buy-back of capital, rare and strictly regulated, he verifies the special resolution and the confirmation or approval of the court or SECP as applicable. Finally he agrees the closing register of members with the share capital ledger, confirms the balance sheet discloses authorised, issued, subscribed and paid-up capital separately as required by the Act, and obtains a management representation and, where shares are held by nominees or a central depository, appropriate confirmations.

Table 1: Verification of Share Capital — Documents Examined

Area	Documents and Records	What Is Proved
Authorised capital	Memorandum of association; alteration resolutions and filings	Capital issued does not exceed authorised limit
Issue and allotment	Prospectus, application and allotment book, board minutes, return of allotment	Shares validly issued and allotted
Money received	Cash book, bank statements, paying-in records	Application, allotment and call money actually received
Shareholder record	Register of members, share certificates, depository records	Shares recorded in correct names and totals agree
Changes in capital	Resolutions, contracts for non-cash issue, forfeiture notices, redemption records	Every change legally authorised and correctly recorded
Balance sheet figures	Share capital ledger, schedule of calls in arrears	Authorised, issued, subscribed and paid-up capital correctly disclosed

Conclusion

To conclude, a share is a unit of company capital representing a shareholder proportionate ownership interest, rights and limited liability, and share capital is described through its authorised, issued, subscribed, called-up and paid-up stages. Its verification rests on the constitutional documents and statutory records of the company: the auditor examines the

memorandum and articles, prospectus, allotment records, minutes, cash and bank records and the register of members in the first audit in full, and in later audits verifies every change, fresh issues, calls, arrears, forfeitures, bonus issues, redemptions and reductions, with strict attention to legal authority. Only then can he be satisfied that the capital figure on which the whole balance sheet stands is genuine, complete and lawfully constituted.

Question 5: Profit and Loss Account and Verification of Income and Expenses (20 Marks)

Define the profit & loss account and also explain the verification of income items and expenses.

Introduction

If the balance sheet shows where a business stands, the profit and loss account shows how it got there: it matches the income earned during a period with the expenses incurred in earning it, and the difference is the profit or loss on which dividend, tax and managerial reputation all depend. Precisely because profit is so important, the items composing it are tempting targets for manipulation: sales can be inflated, expenses can be hidden or pushed into the next year, and provisions can be quietly adjusted to produce the desired result. The verification (audit) of income and expense items is therefore not a mere re-checking of vouchers; it is a directed examination of completeness, cut-off, proper classification and genuine business purpose. This answer defines the profit and loss account, states the general principles applied to all its items, and then explains the verification of the main income items and the main expense items in turn.

Definition of the Profit and Loss Account

The profit and loss account (statement of profit or loss) is a financial statement prepared for an accounting period which records the revenues and gains earned and the expenses and losses incurred by an enterprise during that period, in order to ascertain the net profit earned or net loss suffered. Its first part, often presented as the trading account or, in company format, as cost of sales deducted from revenue, gives gross profit: sales (net of returns and discounts) less the cost of goods sold (opening stock plus purchases and direct expenses, less closing stock). Below gross profit are charged the operating and other expenses of the period, administration, selling and distribution, and finance costs, and are added other incomes such as interest, dividend and rent received, to arrive at profit before tax; after taxation and appropriations such as dividends, the balance is carried to reserves. The account is prepared on the accrual basis: income is recognised when earned, not merely when cash is received, and expenses are matched against the income of the period to which they relate, with outstanding and prepaid amounts adjusted. For companies its form and contents are governed by the Companies Act, 2017 and applicable accounting standards, which require, among other things, separate disclosure of material and unusual items, depreciation, finance costs and directors remuneration.

General Principles for Verifying Income and Expenses

Five general principles govern the verification of every profit and loss item. First, vouching and authority: every material item is vouched with its documentary evidence and traced to its authorisation, on the lines described for vouching generally. Second, completeness: the auditor looks for omissions, using tests in the direction opposite to overstatement, for example

agreeing despatches to sales and goods received to purchases, reviewing post-year-end invoices and payments for unrecorded liabilities, and comparing ratios (gross margin, expense-to-sales) with prior years to spot missing or abnormal items. Third, cut-off: transactions just before and just after the year-end are examined so that income and expenses are recorded in the correct period. Fourth, classification and the capital-revenue distinction: capital receipts and payments must not pass through the profit and loss account, repairs must not be capitalised nor improvements charged to revenue, and personal expenses of proprietors or directors must be excluded or disclosed. Fifth, analytical review and consistency: each head is compared with the previous year and with budgets, unusual fluctuations are enquired into and explained, and the basis of recognition is checked for consistency and compliance with accounting standards and, in companies, with the disclosure requirements of law, including separate disclosure of auditors remuneration, donations and other specified items.

Verification of Income Items

Sales

Sales are the largest income item and the first target of verification. The auditor tests the internal control over ordering, despatch and invoicing, vouches a sample of sales invoices with orders and goods outward records, checks prices to price lists and terms to contracts, tests casts of the sales book, and agrees returns with credit notes and goods inward records. He performs cut-off tests on the last despatches and invoices of the year, reconciles sales with sales tax records, analyses gross profit percentage by product or month against prior years, and confirms a sample of debtor balances, since fictitious sales normally leave fictitious debtors.

Cash sales are checked against till records, deposit slips and stock movement, with attention to suppression of receipts.

Other Income Items

Interest received is verified from interest certificates, bank advices and loan agreements, recomputing amounts from principal, rate and period, and ensuring accrued interest at the year-end is recorded. Dividend income is checked with dividend warrants and the investments register, confirming the shares were held on the record date and that tax deducted at source is accounted for. Commission received is agreed with agency agreements and statements from principals, rent received with tenancy agreements and rent receipts (with outstanding rent provided for), and profit on sale of fixed assets with the disposal documents and asset register, ensuring only the profit, not the whole proceeds, is credited and that it is treated as a capital or other income as appropriate. Miscellaneous receipts, such as scrap sales, insurance claims and discounts received, are vouched with their supporting papers and enquired into for completeness, because small, irregular receipts are easily diverted. For every income head the auditor also checks that income has not been netted off against expenses and is shown gross where standards require.

Table 1: Verification of Main Income Items

Income Item	Main Evidence	Key Check
Sales	Invoices, orders, despatch records, sales tax returns	Cut-off; gross margin analysis; debtor confirmation
Interest received	Loan agreements, bank advices, certificates	Recompute from principal, rate and period; accrue unpaid interest
Dividend income	Dividend warrants, investment register	Shares held on record date; tax deducted accounted for
Commission and rent	Agency and tenancy	Agree rates; provide for

	agreements, statements, receipts	amounts accrued but not received
Profit on disposal of assets	Sale documents, fixed asset register	Only profit credited; asset removed from register

Verification of Expense Items

Purchases and Direct Expenses

Purchases are verified in parallel with sales: control over ordering and receipt is tested, invoices are vouched with goods received notes and orders, returns are agreed with debit notes, and cut-off is tested so that goods received before the year-end are recorded as purchases and stock, while goods not received are excluded. Wages and direct expenses are vouched with wages records and muster rolls (watching for dummy names), carriage inward with transport documents, and factory expenses with their bills, each compared with production and prior-year levels for reasonableness.

Operating and Other Expenses

Rent, rates and taxes are vouched with agreements and receipts, with prepaid and outstanding amounts adjusted; salaries are checked from appointment letters, increment records and payroll, reconciled in total with the previous year after allowing for joiners and leavers, and statutory deductions (income tax, social security, employees old-age benefits) are agreed with payments to the authorities. Repairs and maintenance are examined to ensure capital expenditure is not charged as repairs and large items are enquired into; insurance premiums are agreed with policies and prepaid portions carried forward. Interest paid is recomputed from loan agreements and bank statements and matched with the verified loan balances; bank charges are agreed with the bank statement. Depreciation is verified by examining the policy and rates for consistency and adequacy, recomputing the charge, and checking that it is

charged on all assets in use and disclosed as law requires. Directors fees and remuneration are agreed with the articles, board and shareholder resolutions and statutory limits, and auditors remuneration is agreed with the appointment resolution and disclosed separately. Bad debts written off are examined for proper authorisation and evidence that the debts are genuinely irrecoverable (and not written off to favour a debtor) while provisions for doubtful debts are assessed for reasonableness. Travelling, advertising, donations and sundry expenses are vouched with bills and authorisations, donations being checked for legal compliance and disclosure in company accounts, and any unusual, personal or abnormally large item is specially enquired into and, where required, separately disclosed. Outstanding expenses and accrued liabilities at the year-end are verified from post-year-end payments and invoices, completing the matching of expenses to the period.

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Table 2: Verification of Main Expense Items

Expense Item	Main Evidence	Key Check
Purchases	Invoices, goods received notes, orders	Cut-off with stock; returns agreed with debit notes
Wages and salaries	Payroll, muster rolls, appointment records	Dummy workers; reconcile totals with prior year
Rent and insurance	Agreements, policies, receipts	Adjust prepaid and outstanding amounts
Interest paid	Loan agreements, bank statements	Recompute; agree with verified loan balances
Depreciation	Policy, asset register, calculations	Consistent rates; charge on all assets in use
Directors and auditors remuneration	Articles, resolutions, statutory limits	Proper authority; separate disclosure

Conclusion

To conclude, the profit and loss account is the period statement which matches income earned with expenses incurred on the accrual basis to show the net profit or loss of the enterprise.

Verification of its items applies common principles, vouching, completeness, cut-off, correct capital-revenue classification and analytical comparison, and then adapts them to each head: sales are tested through control, despatch matching, margins and debtor confirmation; interest, dividend, commission and rent are recomputed and agreed with agreements and warrants; purchases, wages, rent, salaries, interest, depreciation and managerial remuneration are vouched, recomputed and checked for authority, adjustment and disclosure. Performed in this way, verification of the profit and loss account gives the auditor reasonable assurance that the reported profit is neither inflated by fictitious or premature income nor swollen by hidden or deferred expenses, but is the true result of the period.

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