

MINISTRY OF EDUCATION AND SCIENCE OF UKRAINE

KHARKIV NATIONAL UNIVERSITY OF ECONOMICS

**Guidelines for Practical Training
in the Academic Discipline**

"ACCOUNTING AND AUDIT"

**for full-time students of the training direction 6.030601 "Management"
of the specialization "Business Administration"**

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The tasks aimed at acquiring knowledge and mastering practical skills according to the thematic plan of the syllabus of the academic discipline are given in order to be performed during practical studies.

Recommended for students of the training direction 6.030601 "Management" of the specialization "Business Administration".

Наведено завдання для виконання на практичних заняттях з метою набуття і закріплення практичних знань та вмінь згідно з тематичним планом робочої програми навчальної дисципліни.

Рекомендовано для студентів напряму підготовки 6.030601 "Менеджмент" спеціалізації "Бізнес-адміністрування".

Introduction

The activity of entrepreneurs is impossible without a clearly established system of accounting and auditing. Accounting serves for monitoring, recording, and analyzing information about assets of a company, its liabilities and facts of economic activity, as well as financial results. Users of financial accounting information are primarily external parties, such as potential investors, suppliers and buyers, banks, tax and other government agencies.

The activity of entrepreneurs is impossible without a clearly established system of accounting, which is the object of academic discipline "Accounting and Audit". Accounting serves as a tool for identifying, measuring and communicating economic information to permit informed judgments and decisions of information users. Auditing is a systematic process of obtaining and evaluating objective data about economic actions and events that sets the level of compliance with specific criteria and presenting the results to interested parties

Discipline "Accounting and Audit" is a professional compulsory discipline, which is taught in accordance with the curriculum for managers of Bachelor degree.

The purpose of tasks is to deep knowledge of methodological fundamentals of organizing and conducting of accounting and auditing under the existing regulations, acquiring the ability to account complex business transactions. These tasks cover classification of assets, stockholders' equities and liabilities, balance sheet preparation process, reflection of business transactions with assets, liabilities and stockholders' equity on accounts, recognition of income and expenses, as well as determination of the financial results of enterprises.

This guidelines for practical training meet the syllabus of the academic discipline "Accounting and Audit" in themes of Module 2 "Fundamentals of Audit".

While performing the tasks for practical training one should keep in mind that these tasks are based on conventional data and have no direct connection with the actual facts of economic activity of specific companies, any match with real entities is random.

Module 2. Fundamentals of Audit

Theme 5. Audit as a Form of Business Activities Control

Audit is an independent examination of financial information of an entity, whether profit oriented or not, irrespectively of the size or legal form, when such an examination is conducted with a view to express an opinion thereon.

An independent audit has following advantages:

1. It improves the reliability of financial statements.
3. It helps in detecting internal control weaknesses.
4. It enables settlement of trade disputes.
5. In case of amendments to the constitution, it enables settlement of accounts.
6. It is useful for determination of losses.
7. It enables assessment of net worth of an entity for the investors.
8. It satisfies requirements for borrowings from financial Institutions
9. It acts as a basis for settlement of statutory dues namely taxes and duties;
10. It is useful for financial planning in subsequent years.

Audit has the following limitations:

- a) audit is test natured;
- b) audit evidence is more persuasive rather than conclusive;
- c) limitations of Internal control system;
- d) use of judgement.

The risk of a failure to detect a material misstatement arising out of a fraud is more than the risk of a failure to detect a material misstatement arising out of an error. Responsibility for detection of frauds and errors is primarily on those charged with Governance and management. Management should establish a good internal control system for prevention and detection of frauds and errors. An auditor is expected to exercise reasonable skills and care and audit procedures performed by an auditor should normally be capable of detecting frauds and errors. Existence of frauds and errors affects the true and fair view of financial statements.

Procedures in case of fraud or error indication:

A. If a suspicion is aroused an auditor should modify his audit procedures and perform additional audit procedures to confirm or dispel his suspicion.

B. If an auditor is unable to confirm or dispel his suspicion he may obtain a legal opinion and may even consider withdrawing from the assignment, if necessary.

C. An auditor should not assume that a fraud is isolated and should investigate other related areas.

D. If the fraud is established an auditor should report to those charged with governance and management.

E. If the management is involved in the fraud he/she may consider the appropriate level of authority to which he/she should report and may obtain a legal opinion.

F. An auditor should consider the fraud or error effect on the financial information and if material, he/she may consider qualifying their report.

Information is material, if its misstatement influences the economic decisions of financial statement users. The nature and size of an item and the particular circumstances in which it arises influence materiality. Materiality is viewed more as a cut-off level than as a primary qualitative characteristic. The concept of materiality recognises that certain items either individually or in a group is relatively important. Materiality should be assessed both at the overall financial statement level and at the individual transaction or balance level. Materiality is also influenced by legal or regulatory requirements. Qualitative characteristics should be considered in fixing an acceptable level of materiality. Certain items, which may not be material individually, may become material in the aggregate. Materiality has an inverse relationship with Audit Risk. An auditor's assessment of materiality at the planning stage may change at the time of evaluation of audit procedure results due to changes in information or auditor's knowledge. An auditor, in forming an opinion on financial statements, should consider the aggregate of uncorrected misstatements in financial statements, which is equal to the aggregate of misstatements detected and the best estimate of the misstatements not specifically detected (projected errors). Analytical procedure gives only an indication of whether a misstatement exists and its approximate magnitude and therefore is not suitable for projection of errors. Sampling procedure can be applied for projection of errors. If the aggregate of misstatements reaches the materiality levels an auditor should request the management to adjust the financial information and if the management refuses to adjust, an auditor should express a qualified opinion or an adverse opinion as may be appropriate.

Task 5.1

Match the terms with their correct descriptions in Table 5.1, fill in the gaps with Ukrainian terms.

Table 5.1

Basic terminology that corresponds to the Fundamentals of Audit

| Term | | | Definition | |
|------|------------------------|--------------|------------|--|
| | in English | in Ukrainian | | |
| 1 | 2 | 3 | 4 | 5 |
| 1 | Audit | | A | An auditing procedure, that establishes existence and ownership of assets and liabilities |
| 2 | Teeming and lading | | B | policies and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information |
| 3 | Internal evidence | | C | an independent appraisal activity within the organization for the review of financial, accounting and other operations done as a basis of service to the management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls |
| 4 | External evidence | | D | a method by which a cashier misappropriates receipts from customers by suppressing the receipt and subsequent receipts from other customers which are accounted as receipts from customers who have paid before. In this process a cashier misappropriates cash and makes good balances periodically thereby misusing the receipts. |
| 5 | Corroborative evidence | | E | Evidence means that an auditor has to obtain additional evidence to support the transaction from internal or external sources. |

Table 5.1 (the ending)

| 1 | 2 | 3 | 4 | 5 |
|----|-------------------|---|---|--|
| 6 | Internal control | | F | Evidence generated within the organization and reliable if there is a sound internal control system |
| 7 | Internal audit | | G | Evidence generated outside the organization and not influenced by the internal control system |
| 8 | Vouching | | H | An auditing procedure, that establishes the genuineness of a transaction and applies to income and expenditures |
| 9 | Verification | | I | a procedure for segregating the transaction at the end of the year for identifying transactions, which have taken place after the balance sheet date but which relate to the period prior to the Balance sheet date. |
| 10 | Cut-off procedure | | J | an independent examination of the financial information of an entity, whether profit oriented or not, irrespective of the size or legal form, when such an examination is conducted with a view to expressing an opinion thereon |

Task 5.2

Fill in the Table 5.2 with main differences between accounting, auditing and investigation.

Table 5.2

Main differences between accounting, auditing and investigation

| Basis | Accounting | Auditing | Investigation |
|------------|------------|----------|---------------|
| Scope | | | |
| Objective | | | |
| Legal | | | |
| Reporting | | | |
| Time limit | | | |
| Suspicion | | | |

Task 5.3

Decide whether statements listed in Table 5.3 are true or false.

Table 5.3

Statements of the essence of auditing

| Statement | True | False |
|--|------|-------|
| 1. Financial statements include profit/loss accounting and Balance Sheet but not include notes to accounts | | |
| 2. Audit is an independent examination of operations conducted by management | | |
| 3. Auditor's opinion is "true and fair view" of financial statements | | |
| 4. Auditor needs to be independent | | |
| 5. Audited financial statements help the lenders | | |
| 6. Auditor does not need communication skills, as he is only concerned with financial information | | |
| 7. Auditor must maintain confidentiality subject to certain exceptions | | |
| 8. Auditor does not need knowledge of accounting | | |
| 9. Auditor should have knowledge of computer information system | | |
| 10. Audit does not require knowledge of business operations | | |
| 11. Documentation is required to be kept by an auditor | | |
| 12. Auditor is responsible for prevention and detection of misstatements | | |
| 13. Financial statements are responsibility of management | | |
| 14. Sampling is a major inherent limitation of audit | | |
| 15. Disclosure of accounting policy, which is adopted in preparation of financial statements, is not required | | |
| 16. Disclosure of fundamental accounting principles in Notes to Financial Statements is necessary whether they are followed or not | | |

Task 5.4

Match the accounting assumptions (entity assumption, going-concern assumption, periodicity assumption, monetary unit assumption) with the appropriate explanations:

- 1) overcomes mixing alternative measurements into the financial statements;
- 2) a continuous business process can be segmented into discrete intervals;
- 3) provides an orderly allocation of costs and revenues over the extended time periods;
- 4) justification to consolidate the accounts of separate legal entities.

Task 5.5

Assign the content with the distinct accounting assumption in Table 5.4.

Table 5.4

Accounting assumptions fundamental for auditing

| The content of assumption | The name of assumption | | |
|---|------------------------|-------------|---------|
| | Going concern | Consistency | Accrual |
| When a business is set up it is assumed that the concern will continue in future. There should be a reasonable possibility of carrying on business in the foreseeable future. It is assumed that there is no intention to close the business or discontinue or curtail its operations | | | |
| Revenues and costs are recognized when they are earned or incurred but not when money is received or paid | | | |
| It is assumed that all accounting policies will be followed consistently from one period to another | | | |

Task 5.6

Match the accounting qualities (relevancy, faithful representation, comparability, consistency, verifiability, timeliness, understandability) with the appropriate explanations:

- 1) deviations in measured outcomes from period to period should be the result of deviations in underlying performance (not accounting quirks);
- 2) clear and concise to those with reasonable business knowledge;
- 4) available in sufficient time to be capable of influence;
- 5) even though different companies may use different accounting methods, there is still sufficient basis for valid comparison;
- 6) information must be truthful; complete, neutral, and free from errors;
- 7) information should be timely and bear on the decision-making process by possessing predictive or confirmatory (feedback) value;
- 8) different knowledgeable and independent observers reach similar conclusions.

Task 5.7

Assign the content with the distinct accounting concept in Table 5.5.

Table 5.5

Considerations to be applied in selection and application of accounting policies

| The content of accounting concept | The name of accounting concept | | |
|--|--------------------------------|---------------------|-------------|
| | Prudence | Substance over form | Materiality |
| Content of a transaction is more important than its form. Substance over Form should be considered while accounting for transactions and in presentation of financial statements | | | |
| Provision for known losses and recognition of gains only on realisation | | | |
| Relative importance and relevance of an item, knowledge of which item may influence the decisions of financial statements users | | | |

Task 5.8

Discuss differences between internal and external audit evidence, fill in Table 5.6.

Table 5.6

Differences between internal and external audit evidences

| Basis | Internal evidence | External evidence |
|-------------|-------------------|-------------------|
| Meaning | | |
| Source | | |
| Reliability | | |
| Example | | |

Task 5.9

Determine whether the documents listed below are internal or external evidence:

- 1) purchase order;
- 2) sale invoice;
- 3) bank statements;

- 4) legal opinions;
- 5) purchase bills;
- 7) receipts issued by customers;
- 8) goods received note.

Task 5.10

Comment on whether statements listed in Table 5.7 are true or false.

Table 5.7

Statements on the features of auditing evidence

| Statement | True | False |
|---|------|-------|
| 1. Evidence should be sufficient and appropriate | | |
| 2. Auditor should consider consistency of evidence | | |
| 3. Compliance procedure is undertaken to check transactions and balances | | |
| 4. Substantive procedures are carried out to check data produced by accounting system | | |
| 5. Auditor may use analytical review procedure at a planning stage | | |
| 6. Material items are only quantitative in nature | | |
| 7. There is inverse relation between materiality and audit risk | | |

Task 5.11

Fill in the gaps with the appropriate words:

1. All business activity feeds into the accounting system and the directors report results back to their ... in the annual report on performance and accompanying final accounts.

- A. audit committee;
- B. shareholders;
- C. bankers;
- D. auditors.

2. If management control drives the organization forward and also tackles all known ... that threaten this positive direction, then there is a good system of internal control in place.

- A. risks;
- B. external factors;
- C. occurrences;
- D. persons.

Task 5.12

Select the correct answer(s)

1. An external auditor:

A. Tests the underlying transactions that form the basis of financial statements. In this way he may form an opinion on whether or not these statements show a true and fair view.

B. Tests the underlying transactions that form the basis of financial statements. In this way he may ensure that these statements show a true and fair view.

C. Tests the underlying transactions that form the basis of financial statements. In this way he may form an opinion on whether or not these statements show a true view.

D. Tests the underlying transactions that form the basis of financial statements. In this way he may state that these statements show a true and fair view.

Task 5.13

Select the most appropriate statement:

A. An external auditor seeks to provide an opinion on whether the accounts show a true and fair view. Whereas an internal audit forms an opinion on the adequacy and effectiveness of risk management and internal control systems, which also relates to the main accounting systems.

B. An external auditor seeks to provide an opinion on whether the accounts show a true and fair view. Whereas an internal audit forms an opinion on the truth and fairness of risk management and internal control systems, many of which fall outside the main accounting systems.

C. An external auditor seeks to provide an opinion on whether the accounts show a true and fair view. Whereas an internal audit forms an opinion on the adequacy and effectiveness of compliance with internal control, many of which fall outside the main accounting systems.

D. An external auditor seeks to provide an opinion on whether the accounts show a true and fair view. Whereas an internal audit forms an opinion on the adequacy and effectiveness of systems of risk management and internal control, many of which fall outside the main accounting systems.

Task 5.14

Select the most appropriate statement:

A. An external auditor is expected to display a degree of astonishment when he discovers indicators of fraud and abuse that impact the reliability of financial accounts.

B. An external auditor is expected to display a degree of anxiety and react when he discovers indicators of fraud and abuse that impact the reliability of financial accounts.

C. An external auditor is expected to display cynicism and react when he discovers indicators of fraud and abuse that impact the reliability of financial accounts.

D. An external auditor is expected to display a degree of professional scepticism and react when he discovers indicators of fraud and abuse that impact the reliability of financial accounts.

Task 5.15

Name types of audit risks, which you know. Ascertain differences between them in Table 5.8.

Table 5.8

Main types of audit risk

| The essence of an audit risk | The name of an audit risk | | |
|---|---------------------------|--------------|----------------|
| | Inherent risk | Control risk | Detection risk |
| The risk of failure to detect material misstatements due to the failure of substantive procedures to detect material misstatements | | | |
| The risk of failure to detect material misstatements due to the absence of internal controls | | | |
| The risk of failure to detect material misstatements due to the lack of internal control system or failure of an accounting and internal control system to detect internal control weaknesses | | | |

Task 5.16

Decide whether statements listed in Table 5.9 are true or false according to the International Standards for the Professional Practice of Internal Auditing.

Table 5.9

Statements on internal auditing system essence and requirements

| Statement | True | False |
|---|------|-------|
| 1 | 2 | 3 |
| 1. Internal auditing is only concerned with compliance during assurance engagements | | |
| 2. The International Standards for the Professional Practice of Internal Auditing are developed by the Internal Audit Standards Board | | |
| 3. Position papers and practice guides for Internal Auditing are both strongly recommended guidance in international practice but these are not mandatory | | |
| 4. Each internal auditor assigned to an engagement must possess the necessary knowledge and skills to conduct the engagement properly | | |
| 5. Integrity, objectivity, confidentiality, and competency are relevant to the practice of internal auditing | | |
| 6. An internal auditor must have an understanding of finance | | |
| 7. Proficiency in accounting principles and techniques is required to recognize the materiality of deviations from good business practices | | |
| 8. Each internal auditor must be qualified in all disciplines needed to meet the internal audit's activities and responsibilities | | |
| 9. External service providers include actuaries, accountants, appraisers, culture or language experts, environmental specialists, fraud investigators, lawyers, engineers, geologists, security specialists, statisticians, information technology specialists, the organization's external auditors, and other audit organizations | | |
| 10. In assessing the relationship of external audit service provider to the organization to ensure independence and objectivity, the chief audit executive should determine that there are no financial, organizational, or personal relationships that will hinder the engagement | | |
| 11. It is beneficial for the chief audit executive to document the scope of the outside service provider's work in an engagement letter or contract | | |
| 12. An external service provider is always a person, independent of the organization, who has special knowledge, skills, and experience in a particular discipline | | |

Table 5.9 (the ending)

| 1 | 2 | 3 |
|--|---|---|
| 13. When an internal auditor exercises the professional care, all material misstatements and instances of fraud will be found | | |
| 14. Due care requires examinations and verifications to a reasonable extent | | |
| 15. An auditor who is performing assurance procedures cannot guarantee that all significant risks will be identified | | |
| 16. Internal-external information is created by an external party but subsequently processed by the engagement client | | |
| 17. The chief audit executive or designee is responsible for ensuring that appropriate supervision is provided throughout the engagement | | |
| 18. The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services | | |
| 19. As an alternative to an external assessment of an internal audit activity, a team directed by the chief audit executive may assess the internal audit activity and have an external reviewer validate the assessment | | |
| 20. One advantage of oral communication as an audit tool is an improved relationship between an auditor and a client | | |

Task 5.17

Select the appropriate response in compliance to the International Standards for the Professional Practice of Internal Auditing. Give clear explanation for the each case.

1. When assessing the objectivity and independence of outside service provider the chief audit executive considers:

A. a financial interest an external service provider may have in an organization;

B. the personal or professional affiliation an external service provider may have with the board, senior management, or others within the organization;

C. the relationship an external service provider may have had with an organization or activities being reviewed;

D. the expertise of an outside service provider;

E. the extent of other ongoing services an external service provider may be performing for an organization;

F. the compensation or other incentives that an external service provider may have.

2. According to The International Standards for the Professional Practice of Internal Auditing external assessments of an internal audit activity by a qualified, independent reviewer or review team from outside an organization must be conducted at least:

- A. quarterly;
- B. annually;
- C. once every three years;
- D. once every five years.

3. Internal auditors should use the phrase "conducted in accordance with the International Standards for the Professional Practice of Internal Auditing".

- A. in all reports;
- B. only if the results of the quality assurance and improvement program support this statement;
- C. only if the chief audit executive's professional level is certified by the International Institute of Internal Auditors;
- D. only if written permission of the International Institute of Internal Auditors is received.

4. The prerogative of setting the audit techniques for a consulting engagement is retained by:

- A. an external auditor;
- B. the audit committee of an organization;
- C. the Board of Directors of an organization;
- D. the chief audit executive.

Task 5.18

The following are grading examples that may be applied in relation to audit opinions. Assign the description with the distinct auditor opinion in Table 5.10.

Grading of auditor opinions according to Internal Control System

| The essence of auditor opinion | Grading of Auditor's Opinion | | | |
|---|------------------------------|-------------------------|--------------------------|----------------|
| | Effective | Some Improvement Needed | Major Improvement Needed | Unsatisfactory |
| A few specific control weaknesses were noted; however, controls generally evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met. | | | | |
| Controls evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met. | | | | |
| Controls evaluated are not adequate, appropriate, or effective to provide reasonable assurance that risks are being managed and objectives should be met. | | | | |
| Numerous specific control weaknesses were noted. controls evaluated are unlikely to provide reasonable assurance that risks are being managed and objectives should be met. | | | | |

Task 5.19

Select appropriate functions of the chief audit executive that may increase the quality of internal audit of an organization:

1. The CAE regularly evaluates the level of coordination between an internal audit activity and external auditors.
2. The CAE communicates the results of evaluations of coordination between the internal and the external auditors to senior management and the board, including relevant comments about the performance of external auditors.

3. The chief audit executive develops and maintains a quality assurance and improvement program that covers all aspects of an internal audit activity.

4. The chief audit executive is not accountable for providing reasonable assurance that an internal audit activity operates in an effective and efficient manner.

5. The chief audit executive establishes a structure of reporting results of internal assessments that maintains appropriate credibility and objectivity.

Task 5.20

Discuss the communication features and tools during auditing. Decide whether statements listed in Table 5.11 are true or false according to the International Standards for the Professional Practice of Internal Auditing.

Table 5.11

Communications as an audit tool

| Statement | True | False |
|---|------|-------|
| 1 | 2 | 3 |
| 1. Oral communications as an audit tool are considered to be objective when they are fair, impartial, and unbiased | | |
| 2. Oral Communications are concise when they avoid unnecessary elaboration and wordiness | | |
| 3. An error is defined as an intentional misstatement or omission of significant information | | |
| 4. An appropriate communication is tactful and objective | | |
| 5. The physical appearance of an internal audit communication is insignificant | | |
| 6. Discussion of conclusions and recommendations only occurs during the course of engagement | | |
| 7. The final engagement communications should be distributed to management of the activity under review | | |
| 8. If the communication of sensitive information results in a conclusion that management, by its inadequate or lack of actions, is exposing the organization to an unacceptable level of risk, the chief audit executive has the option to discuss his or her concerns about the risk exposure with senior management | | |
| 9. During consulting engagements, risk management, control, and governance issues may be identified | | |

Table 5.11 (the ending)

| 1 | 2 | 3 |
|---|---|---|
| 10. Reviews of drafts of communications with clients are courtesy to them and a form of insurance for an engagement | | |
| 11. An internal auditor may need to negotiate the opinion | | |
| 12. Final engagement communications should be distributed to everyone with a direct interest in an engagement | | |

Task 5.21

Discuss the role of consulting in enhancing quality of accounting and internal audit system. Decide whether statements listed in Table 5.8 are true or false according to the International Standards for the Professional Practice of Internal Auditing.

Table 5.12

Audit consulting essence and organization

| Statement | True | False |
|--|------|-------|
| 1. Many audit services have both an assurance and a consultative role | | |
| 2. Auditors in governmental audit organizations may recommend operational improvements | | |
| 3. When performing a consulting engagement in a governmental setting, auditors should keep their activities within boundaries that define the core elements of an audit function | | |
| 4. When offering advice to management regarding a consulting engagement, internal auditors should remain objective | | |
| 5. If an internal audit activity lacks knowledge and skills needed to perform a consulting engagement, one of possible decisions is to decline the engagement | | |
| 6. During consulting engagements, internal auditors should address significant risks, only if they are not consistent with the engagement's objectives | | |
| 7. Internal auditors should design the scope of a consulting engagement to ensure that professionalism will be maintained | | |
| 8. In establishing the scope of a formal consulting engagement, internal auditors may expand or limit the scope to satisfy management's request | | |
| 9. The communication of consulting engagement results is the same for every client | | |
| 10. Reporting requirements for consulting engagements are generally determined by those requesting the services | | |

Task 5.22

Discuss the impact of self-assessment control on an enhancing quality of accounting and internal audit system. Decide whether statements listed in Table 5.13 are true or false according to the International Standards for the Professional Practice of Internal Auditing.

Table 5.13

Statements on self-assessment control essence and organization

| Statement | True | False |
|--|------|-------|
| The basic philosophy of self-assessment control is that control is the responsibility of management and internal auditors. | | |
| Self-assessment control may be in the form of a facilitated team workshop using an objectives-based format. | | |
| Once an organization has made the decision to employ self-assessment control, the involvement of the internal audit activity is minimal. | | |

Theme 6. Organization of Financial Statement Audit

An important step in planning process is the establishment of a methodology that will be followed to evaluate the results of completed audit. This may involve assessing and rating individual audit findings and their significance related to the individual project, individual risks/risk categories, or an organization as a whole.

The following elements should be considered:

a) materiality, i.e. the magnitude or significance of a key business objective that is fundamental to the opinion. An internal auditor should consider the magnitude of the residual risk that a business objective will not be achieved;

b) impact, i.e. the implication of audit issues/findings is considered and fully understood in the context of an opinion to be given (i.e., micro versus macro). An audit opinion may be given a different level of importance using the same rating criteria depending on the impact to an organization. For example, some issues may have a material impact on the achievement of goals or mitigation of risks at a micro level, but not at a macro level (e.g., the failure to manage potential duplicate payments may be material to a subsidiary but not to an organization as a whole).

Another factor to be considered when rating the adequacy of control in a macro opinion is rating the level of risks provided by control so that management's objectives will be achieved.

Inherent and control risks arise even if an audit is not performed whereas the detection risk arises only at audit performance. Inherent and Control risks should be assessed together at a combined level because both these risks are caused by internal control system. Inherent risk and control risk cannot be reduced. However, while assessing of inherent and control risks it is necessary to determine the nature, timing and extent of substantive procedures to reduce detection risk to a low level. The objective of risk assessment is to reduce the overall Audit Risk to an acceptably low level. There is an inverse relationship between Detection Risk and the combined level of inherent and control risks.

When preparing financial statements, it is inevitable to estimate certain items due to inherent uncertainties in business activities. For example, estimates may be required for bad debts, inventory obsolescence or the useful life of depreciable assets. Change in an accounting estimate is not equivalent to a change in accounting policy. For example, change from straight-line method to cumulative method would amount to change in accounting policy; a change in useful life would be treated as changes in accounting estimate. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in: (a) the period of change affects the whole period; or (b) the period of change and future periods, if the change affects both. The nature and amount of a change in an accounting estimate which has a material effect within the current period, or which is expected to have a material effect in subsequent periods, should be disclosed.

An auditor may express different types of opinions in his/her report based on their judgment of the "true and fair view". Such opinions can be classified as follows: a) Clean opinion b) Qualified opinion c) Adverse opinion or negative opinion d) Disclaimer opinion.

An auditor shall include all the qualifications in the report and if any note in the accounts is the subject matter of a qualification then the note should be reproduced in the qualification but verbatim reproduction is not necessary. If qualifications are so material that may negate the expression of an opinion then an auditor should consider expressing an adverse or disclaimer opinion.

Task 6.1

Determine the consistency of audit process in Table 6.1

Table 6.1

Audit process

| Stage | Number of operation | The essence of operation |
|---------|---------------------|---|
| Stage 1 | | Preparing detailed audit programs for every aspect to be covered in audit |
| | | Formulating overall plan based on knowledge of client's business |
| Stage 2 | | Examining form and content of financial statements |
| | | Performing verification of balances |
| | | Conducting vouching of transactions |
| | | Analyzing significant ratios and trends |
| | | Ensuring appropriate disclosure of information |
| | | Examining system of internal control by performing compliance procedures |
| Stage 3 | | Determining substantive procedures |
| | | Ensuring that report complies with the statutory requirement, if any |
| | | Forming conclusions on the basis of evidences |
| | | Communicating the report to the appropriate authority |
| | | Providing report on truthfulness and fairness of financial statements |

Task 6.2

Match working papers of an auditor to their correct descriptions in Table 6.2.

Table 6.2

Audit working papers

| The name of working paper | | The essence of working paper | |
|---------------------------|------------------|------------------------------|---|
| 1 | 2 | 3 | 4 |
| 1 | Narrative record | A | a letter issued by the auditor to the management indicating the internal control weaknesses, irregularities and deficiencies observed by the auditor during the audit |

Table 6.2 (the ending)

| 1 | 2 | 3 | 4 |
|---|--------------------------------|---|--|
| 2 | Check list | B | a list of questions prepared by the auditor and answered by the management. It can be issued at any time and its objective is to evaluate the compliance by management and detect internal control weaknesses |
| 3 | Internal control questionnaire | C | a list maintained by the auditor that contains detailed description of the internal system and internal control weakness |
| 4 | Letter of Representation | D | a list of questions prepared by an auditor and answered by the audit staff. The objective of the list is to evaluate the performance of the audit staff and to detect internal control weaknesses. The list can be prepared only after the audit completion |
| 5 | Letter of Weakness | E | A diagrammatic graphical presentation that depicts the flow of operations, functions, documentation, authority and responsibility in internal control system. The objective of the document is to verify the flow of work or activities and to highlight the internal control weaknesses. |
| 6 | flow chart | F | a letter to be obtained by the auditor from the management, to make the management aware of its statutory responsibilities, to make the management commit in writing its representations made during the audit and to confirm transactions which are not supported by sufficient appropriate evidence. |

Task 6.3

Read the sample of auditor engagement letter listed below. Find out mistakes and misappropriates if there are any. Discuss the responsibilities of an auditor and management during audit procedures.

Engagement letter

We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of expressing our opinion on the financial statements. We will conduct our audit in accordance with the auditing standards. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining on a test basis, the evidence supporting the amounts and disclosures in the financial statements. An audit

also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if it exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems, which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or losses of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal control for safeguarding of the company assets and for the preventing and detecting fraud or other mistakes. We will request from management written confirmation concerning representations made during audit procedures.

We would like to pay your attention to the fact that our audit process is a subject of "peer review" The reviewer may examine our working papers during the course of a peer review.

We look forward to full cooperation with your staff and we trust that they will provide us with all the records; documentation and other information are requested in connection with our audit. Our fees will be billed as the work progresses.

This letter will be effective for future unless it is terminated, amended or superseded. Please sign and return the attached copy of this letter to indicate that it is written in accordance with your understanding of the arrangements for our financial statement audit.

Task 6.4

Distinguish between a checklist and an Internal Control Questionnaire in Table 6.3.

Table 6.3

Key features of a checklist and an Internal Control Questionnaire

| Key features | Checklist | Internal Control Questionnaire |
|--|-----------|--------------------------------|
| It is answered by the audit staff | | |
| It can cover more than one area | | |
| It can be issued only after an audit completion | | |
| It can be issued at any time | | |
| Its objective is to detect internal control weaknesses and to evaluate performance | | |
| It verifies compliance by the management, and detects internal control weaknesses | | |
| It covers only one area. The separate checklist is required for each area | | |
| It is answered by management | | |

Task 6.5

Discuss differences between test checking and routine checking, fill in Table 6.4.

Table 6.4

Differences between test checking and routine checking

| Basis | Test checking | Routine checking |
|-------------------|---------------|------------------|
| Meaning | | |
| Objective | | |
| Nature | | |
| Level of Function | | |
| Time element | | |

Task 6.6

Assign the description with the distinct type of an auditor opinion in Table 6.5.

Table 6.5

Types of auditor opinions

| The essence of auditor opinion | The name of auditor opinion | | | |
|--|-----------------------------|-------------------|------------------|--------------------|
| | Clean opinion | Qualified opinion | Negative opinion | Disclaimer opinion |
| The opinion means that an auditor is not satisfied with certain matters and has certain reservations and comments on such matters. She/he has an active disagreement with management on certain matters but such matters are not material enough to affect the True and Fair view of financial statements. | | | | |
| The opinion means that an auditor is fully satisfied with the True and Fair view and has no disagreement with management or comments or reservations. An auditor reports that the Balance Sheet and Profit and Loss Account give a True and Fair view. | | | | |
| The opinion means that an auditor is unable to express an opinion on certain matters or on financial statements. | | | | |
| The opinion means that the qualifications are material enough to affect the True and Fair view and an auditor is not satisfied with the True and Fair view of financial statements. | | | | |

Task 6.7

Select the appropriate response to questions listed below. Give clear explanation for each case.

1. Analytical auditing procedures do not include:
 - A. budgeting and forecasting of financial activity;
 - B. comparing current information with budgets or forecasts;

- C. comparing similar current and prior period information;
 - D. studying relationships of financial information with the appropriate nonfinancial information;
 - E. engagement of external audit service provider;
 - F. studying relationships of information elements (e.g., interest expense with debt);
 - G. comparing information of organizational units;
 - J. comparing information with that of the industry.
2. It is ordinarily regarded that the most reliable information for audit is:
- A. external information;
 - B. internal information.
3. Information that consists of an internal auditor's direct observation and inspection of activities or physical items is:
- A. testimonial information;
 - B. physical information;
 - C. internal-external information.
4. In case physical observation is the only information about a significant condition, it must at least be considered by:
- A. one internal auditor;
 - B. one internal auditor and one outside specialist;
 - C. two internal auditors;
 - D. three internal auditors.
5. Subcategory of detailed testing that entails verifying recorded amounts by examining the underlying documents from the final documents to the original documents is called:
- A. tracing;
 - B. vouching.
6. Subcategory of detailed testing that involves following transactions forward through the records from the original documents to the final summary amounts is called:
- A. tracing;
 - B. vouching.
7. Working papers of internal auditor:
- A. support recommendations and engagement results;
 - B. document analysis made;
 - C. are the basis for an external auditor's conclusion;
 - D. document the information obtained.

8. Engagement records or working papers of internal audit are the property of:

- A. an auditor;
- B. an auditee.

9. Retention requirements for internal audit working papers that are consistent with the organization's guidelines must be developed by:

- A. an external auditor;
- B. the audit committee of an organization;
- C. the Board of Directors of an organization;
- D. the chief audit executive.

10. Oversight of an external auditors' work is the responsibility of:

- A. an external auditor;
- B. the audit committee of an organization;
- C. the Board of Directors of an organization;
- D. the chief audit executive.

11. The internal audit activity's quality assurance and improvement program include an evaluation of:

A. conformance of an internal audit system with the Definition of Internal Auditing, the Code of Ethics, and the Standards, including timely corrective actions to remedy any significant instances of nonconformance;

B. adequacy of an internal audit charter, goals, objectives, policies, and procedures;

C. coordination between an internal audit and an external audit

D. contribution of an internal audit system to the organization's governance, risk management, and control processes;

E. compliance of an internal audit system with applicable laws, regulations, and government or industry standards;

F. effectiveness of continuous improvement activities and adoption of best practices of internal audit;

G. an extent to which the internal audit adds value and improves the organization's operations;

J. an extent to which an internal audit supports the optimization of tax payments.

12. The tools used in ongoing internal assessments include:

A. checklists and procedures (e.g., in an audit and procedures manual) to be followed;

B. feedback from audit customers and other stakeholders;

C. selective peer reviews of workpapers by staff not involved in the respective audits;

D. project budgets and timekeeping systems;

E. audit plan completion and reports on cost recoveries;

F. quality assurance and improvement program;

G. code of internal audit ethics.

13. The basis for periodic internal quality assessments is:

A. guideline of the audit committee of an organization;

B. recommendations of an external auditor;

C. requirements of the chief audit executive;

D. quality assessment manual;

14. Executives responsible for conducting ongoing and periodic reviews while performing the reviews should report to:

A. an external auditor;

B. the audit committee of an organization;

C. the board of directors of an organization;

D. the chief audit executive.

Task 6.8

Decide whether the statements listed in Table 6.6 are true or false according to the International Standards for the Professional Practice of Internal Auditing.

Table 6.6

Audit evidence essence and composition

| Statement | True | False |
|---|------|-------|
| 1 | 2 | 3 |
| 1. Evidence is more reliable if it is obtained directly from the engaged client | | |
| 2. Recomputing of quantitative data by auditors provides strong and unbiased information regarding accuracy but does not provide information about the reliability of the input | | |
| 3. Testimonial information may not be conclusive and should be supported by other forms of information when it is possible | | |

Table 6.6 (the ending)

| 1 | 2 | 3 |
|---|---|---|
| 4. Engagement of working papers of an internal auditor must be prepared in paper form | | |
| 5. Once the engagement is completed, all members of an organization have a right of access to the internal auditors' working papers | | |
| 6. The chief audit executive must be able to gain access to all working papers of the external auditors | | |
| 7. Duplication of effort by internal and external auditors is often beneficial in areas requiring an extra degree of assurance | | |
| 8. The internal audit activity's quality assurance and improvement program should be directly supervised by the audit committee | | |

Theme 7. Methods of Financial Statements Audit

An auditor's report on a company's accounts shall include a statement on the following matters, namely:

1) fixed assets:

a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

c) If a substantial part of fixed assets have been disposed off during a year, whether it has affected the going concern;

2) inventories:

a) whether physical verification of inventory has been conducted at reasonable intervals by management;

b) whether the procedures of physical verification of inventory are followed by the management reasonable and adequate in relation to the size of a company and the nature of its business? If not, the inadequacies in such procedures should be reported;

3) accounts receivable:

a) whether the company has accounts receivable. If so, give the number of parties and amount involved in transactions;

b) whether the company has doubtful debts;

c) whether reasonable steps have been taken by a company for recovery of the doubtful debts;

4) liabilities:

a) has the company taken any secured or unsecured bank loans? If so, give the number of parties and the amount involved in the transactions;

b) whether the rate of interest and other terms and conditions of secured or unsecured loans taken by the company; are prima facie prejudicial to the interest of a company;

c) whether payments of the principal amount and interest are also regular;

d) whether a company has given any guarantee for loans taken by others from banks or financial institutions, the terms and conditions whereof are prejudicial to the interest of a company;

e) whether term loans were applied for the purpose for which the loans were obtained;

f) whether the funds raised on short-term basis have been used for long-term investment; if yes, the nature and amount are to be indicated;

5) internal control system:

a) it there is an adequate internal control procedure for the purchase of inventory and fixed assets and for the sale of goods and services that is commensurate with the size of a company and the nature of its business;

b) whether there is a continuing failure to correct major weaknesses in internal control.

Task 7.1

Examine separately each case listed below. State an auditor decision/opinion for each case, give explanations and apply the provision with reasoning.

1. The directors of a company requested an auditor not to insist on confirmations from certain debtors with whom negotiations are held for settlement of disputes and request for confirmations would aggravate the negotiations.

2. Bonuses for the last three years were paid in the current year as a result of settlement with workers and was disclosed as an extra-ordinary item in the profit and loss account.

3. A relative of a director of a company was appointed as auditor of this company.

4. The Managing Director of a company has issued instructions to maintain the books of account of the company for the last five years in good condition.

5. A conflagration destroyed the entire plant and machinery of a company after the accounts of the company have been approved by the Board of Directors.

6. A major fraud relating to a prior period was detected in a company during an income tax raid and in the auditor's report this matter was not mentioned.

7. An auditor of a company while attending the annual general meeting of a company disclosed certain information, which he had not considered at the time of audit report and confirmed that his opinion would have been different if such information had been considered at the time of issue of his report.

8. While vouching travelling expenses of chief executives, an auditor of a company found that certain bills were not authorized by the director of a company.

9. After accepting audit of a company, an auditor purchased goods from a company on credit for 10 000 UAH. The credit period allowed to an auditor was the same, which is allowed to other customers of a company.

10. An auditor of a company, in addition to audit of accounts, accepted an engagement for consultancy services regarding tax matters of a company and the fees for such consultancy services was high in comparison with the fees charged for an audit.

11. The previous auditor of a company while replying to the communication of the incoming auditor provided details of frauds detected by him and stated that the detection of such frauds was the reason for change in an auditor.

12. A company has made excess provision for depreciation on certain assets and the excess depreciation has not been disclosed separately.

13. After re-appointment of the retired auditor at the annual general meeting of a company, it was found that an auditor had borrowed 50,000 UAH from the company. An auditor has accepted his appointment.

14. A legal claim was contested on the basis of expert legal opinion. In the next financial year, the case was decided against the company.

15. During an audit, it was found that certain sales invoices raised at the end of the financial year were cancelled at the beginning of the next year. This matter was also observed in the audit of previous years.

16. Small errors in posting of transactions into ledgers were ignored during an audit and were not reported to management.

Task 7.2

Due to a heavy fire, the books and vouchers of a company were destroyed. The company has obtained duplicate bills and receipts in support of all the transactions recorded. An auditor of the company has audited these duplicate bills and receipts and expressed a clean opinion on the accounts of the company, since he was satisfied with the evidence obtained by him. Decide, whether an auditor is guilty of professional misconduct. What opinion should have been expressed in this case?

Task 7.3

Examine separately each case dealing with a company's assets accounting and reporting. Decide, whether an auditor is required to express an adverse comment in this regard. State an auditor decision/opinion for each case, give explanations and apply the provision with reasoning.

1. The amount payable to suppliers of machinery under deferred payment arrangements has been shown as current liabilities. Fixed assets of a company were offered as collateral security.

2. A company changed its accounting policy on valuation of inventories within the current year by including administrative overheads in production costs for valuation of finished goods and the change was disclosed in the financial statements.

3. Purchases made at the end of the financial year for which goods have been received at the beginning of the next year have been included in the purchases of the next year.

4. A company export receivables have been blocked in the foreign country due to the exchange control restrictions.

5. An auditor of a company found differences in the production cost between cost records and financial books and requested the management to adjust the difference in financial books.

6. A company, which was consistently deferring advertisement expenditures in the previous years, has decided to write off the entire unamortized balance of advertisement expenditures in the current year due to uncertainty in estimating future benefits.

7. Subsidy received from the government for investment in plant and machinery was disclosed under Reserves and Surplus in the balance sheet of a company.

8. Future installments payable under a purchase agreement was disclosed under bank loans in the balance sheet of a company.

9. A company changed its method of depreciation from Straight-line method to Cumulative method and additional depreciation due to the change was included in the current year depreciation.

10. A debtor who was doubtful on the balance sheet date was subsequently declared insolvent.

11. A company sold certain investments during the financial year at a price less than its purchase price due to poor market conditions.

12. A machinery purchased during the year, which was eligible for 100 % depreciation, has been written off and no entry was made in the fixed assets register.

13. The managing director of a company is of the opinion that, since the company is not going to declare any dividend for the financial year, depreciation for fixed assets is not required.

14. A finance company has included high value stamps and postage in cash on hand.

15. Long-term investments of a company were valued at cost on the balance sheet date. Subsequently market prices of such investments declined.

16. A company paid interest out of capital at the rate of 12 % on paid up capital during construction period since the project takes substantial period of time for commencement of production.

17. A company has classified certain advances under deposits in its Balance Sheet.

18. Closing inventories of a company were valued at cost of production including taxes and duties paid on inputs. The company is of the opinion that it is not prudent to recognise any refund of taxes and duties unless it is realised.

Task 7.4

Mille Corporation's income statement revealed sales of 700,000 UAH; gross profit of 300,000 UAH; selling and administrative costs of 140,000 UAH; and income taxes of 45,000 UAH. The selling and administrative expenses included 10,000 UAH for depreciation. The following additional information is available in Table 7.1.

Table 7.1

Mille Corporation Balance Sheet on December 31, 2013 (selected items)

| Item | Beginning of Balance Period | End of Balance Period |
|---------------------|-----------------------------|-----------------------|
| Accounts receivable | 70,000 | 82,000 |
| Inventory | 50,000 | 41,000 |
| Accounts payable | 37,000 | 44,000 |

The company's operating activities generated positive cash flow of 129,000 UAH. Use the "direct" approach to demonstrate how this amount was calculated.

Task 7.5

Review the following technical comments about the presentation methodology for the statement of cash flows (Table 7.2). Identify if the comment pertains to the "direct" or "indirect" approach, or "both."

Table 7.2

Cash flows methodology

| Statements | Direct approach | Indirect approach |
|---|-----------------|-------------------|
| 1 | 2 | 3 |
| The operating cash flows section typically begins with net income | | |
| Separate disclosure is provided for noncash investing/financing activities | | |
| Requires supplemental disclosure reconciling net income to operating cash flows | | |
| Conceptually, the preferred approach | | |

Table 7.2 (the ending)

| 1 | 2 | 3 |
|--|---|---|
| Includes three separate sections: operating, investing, and financing | | |
| Requires supplemental disclosure of cash paid for interest and cash paid for taxes | | |
| A loss on the sale of plant assets would be added back in operating cash flows | | |

Task 7.6

The following is an incorrectly prepared statement of cash flows of Herman Corporation.

HERMAN CORPORATION
Statement of Cash Flows
For the year ending December 31, 2013

| | |
|--|-------------|
| Cash balance on January 1, 2013 | 175,000 |
| Cash receipts during 2013 | |
| Sale of building | 800,000 |
| Dividend received on investments | 10,000 |
| Cash received from customers | 2,350,000 |
| Proceeds from issuing stock | 1,400,000 |
| Total cash receipts | 4,560,000 |
| Cash payments during 2013 | |
| Purchase of inventory | 760,000 |
| Interest on loans | 56,000 |
| Income taxes | 124,000 |
| Repayment of long-term note payable | 2,000,000 |
| Purchase of equipment | 435,000 |
| Selling and administrative expenses | 696,000 |
| Dividends on common | 175,000 |
| Total cash payments | (4,246,000) |
| Cash balance on December 31, 2013 | 489,000 |
| Noncash investing/financing activities | |
| Bought land by issuing promissory note payable | 450,000 |

Review and correct this presentation, using a direct approach.

Task 7.7

The accountant of Rimmerex Corporation used a spreadsheet to provide information needed to prepare the statement of cash flows for the year ending December 31, 2013. However, the data were accidentally sorted alphabetically into the following listing of items. To compound the problem, the "add" and "subtract" notations for each line item were also deleted. Review the information, and prepare a correct presentation, using the indirect approach. The beginning cash balance was 63,800 UAH, and the ending cash balance was 415,000 UAH.

| | |
|---|---------|
| Bought building by issuing common stock | 850,000 |
| Decrease in accounts payable | 34,000 |
| Decrease in accounts receivable | 21,000 |
| Depreciation expense | 68,000 |
| Dividends on common | 50,000 |
| Gain on sale of land | 20,000 |
| Increase in income taxes payable | 7000, |
| Increase in inventory | 27,800 |
| Increase in prepaid insurance | 3,000 |
| Net income | 215,000 |
| Purchase of equipment | 75,000 |
| Repayment of long-term note payable | 180,000 |
| Sale of land | 430,000 |

Task 7.8

Ozark Corporation reported sales of 1,000,000 UAH for 2013. The income statement revealed cost of goods sold of 480,000 UAH; selling and administrative costs of 340,000 UAH; interest expense of 20,000 UAH; and income taxes of 60,000 UAH. The selling and administrative expenses included 25,000 UAH for depreciation.

Comparative balance sheet information for Ozark follows (Table 7.3).

Ozark Corporation Balance Sheet items

| Item | The amount, UAH | |
|--------------------------|----------------------|----------------------|
| | on December 31, 2012 | on December 31, 2013 |
| Cash | \$458,700 | \$471,450 |
| Accounts receivable | 199,250 | 171,500 |
| Inventories | 248,600 | 278,800 |
| Prepaid insurance | 13,000 | 11,000 |
| Land | 250,000 | 250,000 |
| Building and equipment | 1,500,000 | 1,300,000 |
| Accumulated depreciation | 205,000 | 180,000 |
| Accounts payable | \$85,700 | \$93,400 |
| Interest payable | 10,500 | 15,000 |
| Income taxes payable | 22,000 | 8,000 |
| Common stock | 710,000 | 700,000 |
| Additional capital | 990,000 | 900,000 |
| Retained earnings | 646,350 | 586,350 |

No equipment was sold during the year. Equipment purchases were made by cash. Prepaid insurance included in the balance sheet is related to the administrative costs. All accounts payable included in the balance sheet relate to inventory purchases. The change in retained earnings is attributable to net income and dividends. The increase in common stock and additional paid-in capital is due to issuing additional shares for cash.

Prepare Balance Sheet and a statement of cash flows for the year ending December 31, 2013.

Task 7.9

A company has a practice of selling goods based on the orders procured by the agents. The company raises the invoice of customers and sends the goods directly to them. But the documents for sale are sent through the bank and the buyer has to effect payment to the bank and obtain the documents for taking possession of goods from the carrier. On March, 31 2012, goods worth of 10,000,000 UAH were sold and the documents are in the bank, which were not cleared on the due date. The company has included the sales in the turnover for the year ending 2012. Decide whether and when the sales can be accounted.

Task 7.10

Fred Corporation presented the following balance sheet information (Table 7.4).

Table 7.4

Fred Corporation's Balance Sheet items

| Item | The amount, UAH | |
|--------------------------|----------------------|----------------------|
| | on December 31, 2012 | on December 31, 2013 |
| Cash | 664,000 | 9,000 |
| Accounts receivable | 375,000 | 345,000 |
| Inventories | 150,000 | 160,000 |
| Prepaid expenses | 35,000 | 25,000 |
| Land | \$300,000 | \$400,000 |
| Building | 700,000 | 700,000 |
| Equipment | 530,000 | 450,000 |
| Accumulated depreciation | (300,000) | (270,000) |
| Accounts payable | 112,000 | 119,000 |
| Interest payable | 2,000 | – |
| Common stock | 700,000 | 700,000 |
| Long-term note payable | 80,000 | – |
| Additional capital | 850,000 | 400,000 |
| Withdrawals | 50,000 | 100,000 |
| Retained earnings | 760,000 | 700,000 |

Additional information about transactions and events occurring in 2013 is as follows:

1. Accounts payable and accounts receivable relate solely to purchases and sales of inventory.
2. Prepaid items related only to advertising expenses.
3. The decrease in land resulted from the sale of a parcel at a 45,000 loss. No land was purchased during the year.
4. Equipment was purchased during the year in exchange for a promissory note payable. No equipment was sold.
5. Dividends of 55,000 were declared and paid.
6. The increase in paid-in capital resulted from issuing additional shares for cash.

The income statement for the year ending December 31, 2013, included the following key amounts (Table 7.5).

Fred Corporation's sales and expenses

| Item | The amount, UAH |
|--|-----------------|
| Sales | 2,000,000 |
| Cost of goods sold | 1,200,000 |
| Administrative personnel salaries expenses | 400,000 |
| Advertising expenses | 150,000 |
| Office depreciation expenses | 30,000 |
| Administrative utilities expenses | 15,000 |
| Interest expenses | 5,000 |
| Loss on sale of land | 45,000 |
| Income tax expenses | 40,000 |

Prepare Fred's Balance Sheet, statement of financial results and statement of cash flows (include required supplemental information about cash paid for interest and taxes) for the year ending 2013.

Task 7.11

A foreign currency loan was borrowed by a company for import of machinery. The imported machinery was installed and used for production during the financial year. On the Balance Sheet date, the valuation of the foreign currency loan has resulted in an exchange fluctuation loss, and the loss has been charged to the machinery account instead of charging the same to the profit and loss account. Decide, whether the treatment of the company is correct. Give full explanations and proper accounting entries.

Task 7.12

Examine separately each case dealing with a company's equity and liabilities accounting and reporting. Decide, whether an auditor is required to express an adverse comment in this regard. State an auditor decision/opinion for each case, give explanations and apply the provision with reasoning.

1. The Directors of a company propose to transfer to the Profit and Loss Account a large sum lying in unclaimed dividends account. The dividends remained unclaimed over the last seven years.

2. A company is following cash basis for recognising dividend income.

3. A company did not make provision for proposed dividend since proposed dividend does not represent a liability on the Balance Sheet date.

4. The Directors of a company have decided not to make provision for tax on the contention that sufficient reserves are available for meeting the tax liability.

5. Share application money pending allotment has been disclosed in the Balance Sheet of a company as current liability.

6. A company has not written off discount on issue of shares disclosed under "Miscellaneous Expenditures" in the Balance Sheet.

7. Interest paid on arrears of income tax account was charged to income tax account.

8. Interest on notes is being accounted on cash basis by a company.

9. For the purpose of declaring interim dividend, the directors of the company have made all provisions up to the date of declaration of the interim dividend out of the profits earned to that date. Subsequently the company incurred a loss for the financial year.

10. Subscription towards shares of a company from non-resident shareholders was deposited in a bank account outside Ukraine. On remittance, the proceeds realised were less than the nominal value of the shares. The difference was charged to the profit and loss account as exchange loss.

Task 7.13

Server Planet operates a web hosting company. Examine the current liability section of the company's, balance sheet prepared by accountant on December 31, 2012 (Table 7.6). Correct mistakes if are any.

1. In the beginning of year the balance of accounts payable was 100,000 UAH. Purchases on trade accounts during the year were 650,000 UAH, and payments on account were 610,000 UAH.

2. The company incurs substantial costs for electricity to run its servers and air conditioning systems. On December 31, 2012, it is estimated that 55,000 UAH of electricity has been used, although the monthly bill for December has not yet been received.

3. Server Planet sells web hosting plans for as low as 25 UAH per month. However, it requires its customers to prepay in 6-month increments.

By the year end, 375,000 UAH had been collected for 2013 web hosting plans.

4. Web hosting services are subject to sales taxes, and Server Planet collected 65,000 UAH during the year. All of these amounts have been remitted to taxing authorities, with the exception of 5,000 UAH that is due to be paid in January, 2013.

5. The company has total bank loans of 1,500,000 UAH. This debt bears interest at 6 %, payable monthly. By December 31, 2012, all interest had been paid, with the exception of accrued interest for the last half of December.

6. The company's bank loans (1,500,000 UAH) are all due on June 30, 2012. However, Server Planet has a firm lending agreement with the bank to renew and extend 1,000,000 UAH of this amount on a 5-year basis. The company intends to exercise this renewal option, but is not yet sure about the final disposition of the remainder.

Table 7.6

**Server Planet Balance Sheet on December 31, 2012
(the current liability section)**

| № | IV Current liabilities | The amount, thousand UAH |
|---|-----------------------------------|--------------------------|
| | Current portion of long-term debt | 500 |
| | Accrued liabilities: | |
| | unearned revenue | 375 |
| | accrued taxes payable | 60 |
| | accrued interest payable | 45 |
| | Miscellaneous playabilities | – |
| | Accounts payable | 750 |
| | Total | 1,730 |

Task 7.14

The auditing firm of Rosellini and Rossellini was auditing the year-end financial statements of its client, City Center Foods. In the course of the audit, it was discovered that City Center was the defendant in a law suit involving a "food poisoning" case. City Center denies that it sold any tainted food products. City Center's attorney provided a representation letter regarding the ongoing litigation. The following is a portion of the reply received from the attorney:

Dear Ms. Rossellini,

You requested us to provide you certain information connected to your examination of the accounts of City Center Foods, as of December 31, 2012.

While this firm represents City Center Foods, our engagement has been limited to specific matters involving the ongoing litigation between City Center Foods and Randal Ransom. This response is necessarily limited to those matters. The Company has advised us that it does not intend to waive the attorney-client privilege with respect to any information which the Company has provided to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files concerning the Company.

In the case of Randal Ransom v. City Center Foods: On June 30, 2012, Randal Ransom filed a civil action in District Court alleging that he had suffered acute food poisoning owing to products sold by City Center Foods. He further alleges that City Center Foods knowingly sold such food and failed to maintain appropriate refrigeration equipment. Mr. Ransom is requesting specific damages of 1,000,000 UAH and such additional amounts may be awarded by a jury.

This litigation is in its earliest stages, and discovery is not yet complete. At this stage of litigation, it is impracticable to render an opinion about whether the likelihood of an unfavorable outcome is either "probable" or "remote;" however, the Company believes it has meritorious defenses and is vigorously defending this litigation,

Robert Bean, Attorney

Based on this information answer the following questions:

1. What is a contingent liability?
2. What criteria drive the determination of when/how a contingency should be reported?
3. How do you believe the litigation described in the attorney's letter should be reported?

Task 7.15

Riseva Corporation manufactures and sells energy efficient lighting systems. These systems include a complex dimmer module, and about 10 % of all units sold require subsequent warranty repair. The average repair cost

is 80 UAH per unit. Riseva began the year with an accrued warranty liability of 250,000 UAH. During the year, 50,000 lighting systems were sold. 310,000 UAH were expended on warranty services performed during the year.

While auditing it was revealed that no journal entries were prepared to accrue additional warranty costs relating to current year sales and to account for monies expended on actual warranty work performed during the year.

Determine how much should appear as warranty expense in the current year Riseva Corporation income statement, and how much should appear as the warranty liability on the closing balance sheet?

Task 7.16

Wild Man Wilson hosts a television show where he gives investment opinions about companies to call-in-viewers. Below is the transcript of a portion of one of his shows that focused on employee benefits. Evaluate Wilson's Responses to the callers' questions, and identify the errors.

Caller 1: "Wilson, tell me about Xyloclick!"

Wilson: "The company is a fraud! It has a defined contribution plan for its employees and does not list the pension assets and liabilities on its books! Sell, sell, sell!"

Caller 2: "Wilson, tell me about Fling Media!"

Wilson: "You have to love this company. They are very conservative. They even accrue a liability for health insurance coverage relating to future retirees. Nobody does that! This company's real earnings are much higher than they are letting on. Buy, buy, buy!"

Caller 3: "Wilson, tell me about Big Foot Shoe!"

Wilson: "Well, it's true that peoples' feet are growing larger, so maybe this is a good play. But, beware because the company is not accruing costs related to employees' sick leave certificates. They offer some lame excuse about not meeting all four criteria of an applicable accounting rule. Wrong, you only need to meet one of the criteria! Sell, sell, sell!"

Caller 4: "Wilson, tell me about Optic Sky!"

Wilson: "Buy! The company offers employees a defined benefit pension plan. The pension trust is loaded with loot, yet the company continues to show a pension liability on its books. It's a hidden asset."

Task 7.17

While auditing it was revealed that the following information (Table 7.7) about Amazon Company business in June was omitted. June is the first month of Amazon Company operation and the current liability section of the company's balance sheet was not filled by an accountant.

Table 7.7

Transactions of Amazon Company in June

| Date | Transaction |
|----------|---|
| June,1 | Amazon borrowed \$100,000 via a note payable bearing interest at 1% per month. This note and all accrued interest are due at the end of July. |
| June,10 | Purchased \$25,000 of inventory, terms 2/10,n/30. The purchase was initially recorded at the net amount. The obligation was not paid in June. |
| June, 20 | Received prepayment in amount of 80,000 UAH. Goods were not delivered in June |
| June, 25 | Amazon was involved in an accident that resulted in damage to another person's property. Amazon expects to be held responsible for an estimated 10,000 UAH of damages |
| June, 30 | At the end of the month, it was estimated that employees are owed 13,000 UAH of accrued wages. |

Prepare any journal entries necessary to record the above transactions or events and compose the current liability section of the company's balance sheet as of the end of the month.

Task 7.18

An accountant of Campus Housing Corporation on the basis of its borrowing transactions listed in Table 7.8 prepared journal entries (Table 7.9) but has not managed to reflect any liabilities in financial statements.

Table 7.8

Borrowing transactions by Campus Housing Corporation

| Date | Transaction |
|---------|--|
| 1 | 2 |
| June, 1 | Campus purchased new furniture in exchange for a UAH 500,000 promissory note. The note was due in 6 months and bears monthly |

Table 7.8 (the ending)

| 1 | 2 |
|-------------|--|
| | interest at 9 % per annum to be paid next month. Interest liabilities were cut off in time |
| July, 1 | Borrowed cash of 90,000 UAH, giving one-year note. Note bears interest at 12 % per annum. Interest is to be accrued monthly and paid off in three days next to the accrual date. In fact payment for September was delayed to November |
| October, 1 | Campus was experiencing a temporary cash flow crunch. The company issued a UAH 40,000 one-year note in settlement of an outstanding account payable. The note bears interest at 10% per annum. Interest is to be accrued quarterly and paid off in three days next to the accrual date |
| October, 31 | Campus paid the note and accrued interest resulting from the transaction on June, 1 |
| November, 1 | Borrowed 75,000 UAH cash from a local bank, loan matures within 2-year and bears 6 % interest. Interest is to be accrued monthly and paid off in 10 days next to the accrual date |
| January, 2 | Campus paid the note and accrued interest resulting from the transaction on July 1 |

Examine following journal entries, detect and correct mistakes and omissions if there are any. Prepare liabilities sections in necessary statements and compute expenses assigned with borrowings.

Table 7.9

Campus Housing Corporation General Journal

| Date | The transaction | Debit | Credit | The amount, UAH |
|-------|--|-----------|-----------|--------------------|
| 1 | 2 | 3 | 4 | 5 |
| 01/06 | Purchased new furniture on note | 10 631 | 631 51 | 500,000 500,000 |
| 30/06 | Accrued interest expenses for June | 95 | 684 | 3,750 |
| 01/07 | Borrowed cash giving one-year note | 31 | 62 | 9,000 |
| 03/07 | Paid off interest expenses for June | 864 | 31 | 3,750 |
| 01/07 | Accrued interest expenses for July | 95 | 684 | 3,750 |
| 03/09 | Paid off interest expenses for August | 684 | 31 | 4,650 |
| 30/09 | Accrued interest expenses for September | 684 | 95 | 4,650 |
| 3/10 | Paid off interest expenses for September | 684 | 31 | 4,650 |

Table 7.9 (the ending)

| 1 | 2 | 3 | 4 | 5 |
|-------|--|-----|-----|---------|
| 31/10 | Accrued interest expenses for October | 95 | 684 | 4,650 |
| 1/11 | Borrowed cash on bank loan | 31 | 60 | 750,000 |
| 3/11 | Paid off interest expenses | 684 | 32 | 1,800 |
| 30/11 | Accrued interest expenses for November | 95 | 684 | 375 |
| 10/12 | Paid off interest expenses | 684 | 31 | 375 |
| 02/01 | Paid off short-term loan | 52 | 31 | 75,000 |
| 02/01 | Paid off interest expenses | 684 | 31 | 900 |

Task 7.19

On March 31, 2010, Rojas Corporation purchased land by giving 100,000 UAH in cash and executing a 400,000 UAH note payable to the former owner. The note bears interest at 10 % per annum, with interest being payable annually on April, 1. Rojas is also required to make a 100,000 UAH payment toward the note's principal on April, 1 each year.

Examine following journal entries for 2010 – 2012, detect and correct mistakes and omissions if there are any. Prepare liabilities sections in necessary statements and compute expenses assigned with borrowings.

Table 7.10

Rojas Corporation General Journal

| Date | The transaction | Debit | Credit | The amount, UAH |
|----------|--|-------|--------|-----------------|
| 31/03/10 | Purchased land | 10 | 15 | 400,000 |
| 31/03/10 | Accounts payable partly reduced | 31 | 631 | 400,000 |
| 31/03/10 | Issued long-term note payable | 631 | 62 | 100,000 |
| 31/03/11 | Accrued interest expenses for 2010 | 684 | 95 | 40,000 |
| 01/04/11 | Paid off interest expenses for 2010 | 95 | 31 | 40,000 |
| 01/04/11 | Paid off the current portion of the long-term debt | 51 | 31 | 100,000 |
| 30/06/11 | Accrued the current portion of the long-term debt | 51 | 611 | 100,000 |
| 31/03/12 | Accrued interest expenses for 2011 | 95 | 684 | 40,000 |
| 01/04/12 | Paid off interest expenses for 2011 | 684 | 31 | 40,000 |
| 01/04/12 | Paid off the current portion of the long-term debt | 31 | 51 | 100,000 |
| 30/06/12 | Accrued the current portion of the long-term debt | 611 | 51 | 40,000 |

Task 7.20

On January 1, 2012, Juan Silvia borrowed UAH 500,000 to purchase a new office building. The loan is to be repaid in 2 equal annual payments, beginning December 31, 2012. The annual interest rate on the loan is 9 %.

It is required:

- 1) to calculate the annual payment on the loan.
- 2) to prepare the appropriate journal entries to record the loan and subsequent payments at the end of 2012 and 2013.
- 3) If the loan were to be repaid in 24 equal monthly payments (0.75 % interest rate per month), how much would the monthly payment equal?

Task 7.21

Krull Corporation presented the following selected information:

- 1) before considering the effects of dividends, if there are any, Krull's net income for 2012 was 2,500,000 UAH;
- 2) before considering the effects of dividends, if there are any, Krull's net income for 2013 was 3,000,000 UAH;
- 3) Krull declared 750,000 UAH of dividends on November 15, 2012. The date of record was January 15, 2013. The dividends were paid on February 1, 2013;
- 4) Stockholders' equity, on January 1, 2012, was 5,000,000 UAH. No transactions impacted stockholders' equity during 2012 and 2013, other than the impact of earnings and dividends on retained earnings.

As the independent auditor should:

- a) determine the amount of net income for 2012 and 2013;
- b) determine the amount of total equity at the end of 2012 and 2013;
- c) prepare journal entries, if needed, to reflect the dividend declaration, the date of record, and the date of payment;
- d) decide whether total "working capital" is reduced on the date of declaration, date of record, and/or date of payment.

Task 7.22

Pasquali Corporation was incorporated on January 1, 2013. The following equity-related transactions occurred during 2013:

- 1) issued 4,000,000 shares of 1 UAH par value common stock at 3 UAH per share;

- 2) declared and issued a 5 % stock dividend (200,000 shares) at a time when the market value of the stock was UAH 6 per share;
- 3) reacquired 15,000 treasury shares at 5 UAH per share;
- 4) declared and paid cash dividends of 100,000 UAH;
- 5) reported net income for the full year of 1,500,000 UAH.

Evaluate these activities and prepare a statement of stockholders' equity for the year ending December 31, 2013.

Task 7.23

Select the appropriate response:

1. Omissions of information from financial reports that are intended to deceive users are considered fraudulent:
 - A. true;
 - B. false.
2. Financial reports are fraudulent in case:
 - A. altering accounting records or documents;
 - B. misrepresenting or omitting significant information;
 - C. changing of the accounting policy;
 - D. misapplying of accounting principles.

Task 7.24

Company's ending inventory on December 31, 2013 was 1,670,000 UAH. However, this value was transposed and entered into the accounting system as 1,760,000 UAH. As a result, ending inventory was overstated and cost of goods sold was understated by 90,000 UAH. This error was discovered on March of 2014, when the CFO was preparing a presentation for potential investors. The 2013 books had long-since been closed, and financial reports were already released. The CFO proposed to correct the error by debiting Cost of Goods Sold and crediting Inventory for 90,000 UAH. Net income for 2013 was 900,000 UAH, and for 2014 should be at about the same level.

1. What is the appropriate journal entry to correct the error? You may assume the balance of the Inventory account is shown as 1,760,000 UAH.

2. In the CFO presentation to the potential investors, how much should be reported as 2013 net income? How much should be reported as inventory on hand on December 31, 2013?

3. Is the amount of the error material? If you were an accountant for this company and instructed by the CFO to record the erroneous entry, what would you do?

Theme 8. Information Resources of Accounting and Audit in a Commercial Company Management

Technology exists to further business goals and objectives. The failure of technology to perform as intended (i.e., technology risk) may result in/or contribute to a business risk – the risk that business goals and objectives are not achieved effectively and efficiently.

While using a computer system of document flow, an auditing system of a company should be built around four principles. These are:

1) the failure of technology is only a risk that needs to be assessed, managed, and audited if it represents a risk to a business.

2) key controls should be identified as the result of a top-down assessment of business risks, risk tolerance, and controls, including automated controls required to manage or mitigate business risk.

3) business risks are mitigated by a combination of manual and automated key controls. To assess the system of internal control to manage or mitigate business risks, key automated controls need to be assessed.

4) system of auditing may be relied upon to provide assurance of the continued and proper operation of automated key controls.

To assess whether there are adequate controls to manage or mitigate a defined business risk, key controls should be identified. Key controls are those relied on to ensure failures in achieving business objectives that will be either prevented or detected on a timely basis.

The key controls that are identified include:

manual controls (e.g., the performance of a physical inventory).

fully automated controls (e.g., matching or updating accounts in the general ledger).

partly automated or hybrid controls where manual control relies on application functionality, if an error in that functionality is not detected, the entire control would be ineffective.

Key automated controls, including hybrid controls and collectively considered critical IT functionality, need to operate effectively and consistently.

Task 8.1

Decide whether statements listed in Table 8.1 are true or false according to the International Standards for the Professional Practice of Internal Auditing.

Table 8.1

Information resources impact on the quality of accounting and audit

| Statement | True | False |
|---|------|-------|
| 1. Internal auditors whose primary responsibility is information technology auditing need to have knowledge of key information technology risks and controls to perform their assigned work | | |
| 2. Technology-assisted audit tools are the only data analysis techniques that may be used when exercising due professional care. | | |
| The International Standards for the Professional Practice of Internal Auditing suppose that the adoption of electronic media for creation, transmission, and storage of audit working papers raises security concerns that do not arise in an environment in which these documents exist only in hard copy. | | |
| 4. The internal audit quality assurance and improvement program includes follow-up recommendations involving appropriate and timely modification of technology | | |
| 5. The more computerized is an accounting system, the more an auditor must use computer-assisted audit techniques to obtain evidence. | | |
| 6. Effective internal controls can ensure success. | | |

Task 8.2

The process of creating IT-based auditing system consists of eight steps, starting with understanding of the audit's review purpose or controls assessment and ending with a defined scope of work. Place the steps (Table 8.2) in the correct order.

Table 8.2

Steps of creating IT-based auditing system

| No | The content |
|----|--|
| | Identify the business objectives for which the controls are to be assessed |
| | Identify the key controls within business processes required to provide reasonable assurance that the business objectives will be achieved |
| | Identify the critical IT functionality relied upon among the key business controls |
| | Identify the significant applications where ITGCs need to be tested |
| | Identify IT process risks and related control objectives |
| | Identify the IT -based auditing system to test that it meets the control objectives |
| | Perform a reasonable person holistic review of all key controls |
| | Determine the scope of the review and build an appropriate design and effectiveness testing program |

Task 8.3

Distinguish errors and frauds in accounting process in cases listed in Table 8.3.

Table 8.3

Accounting errors and frauds

| Case | Error | Fraud |
|--|-------|-------|
| 1. Falsification of accounts | | |
| 2. Misappropriation of assets | | |
| 3. Mathematical mistakes | | |
| 4. Suppression of transactions | | |
| 5. Oversight of facts | | |
| 6. Omission of transactions effects | | |
| 7. Wrong accounting procedures | | |
| 8. Misapplication of accounting policies | | |

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з навчальної дисципліни
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для студентів напряму підготовки 6.030601 "Менеджмент"
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