



МІНІСТЕРСТВО ОСВІТИ І НАУКИ, МОЛОДІ ТА СПОРТУ УКРАЇНИ  
ХАРКІВСЬКИЙ НАЦІОНАЛЬНИЙ ЕКОНОМІЧНИЙ УНІВЕРСИТЕТ

Методичні рекомендації до виконання практичних завдань  
з навчальної дисципліни  
«ОБЛІК І АУДИТ»  
для студентів напряму підготовки 6.030601 «Менеджмент»  
спеціалізації «Бізнес-адміністрування»  
денної форми навчання

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Харків, ХНЕУ, 2013



**МІНІСТЕРСТВО ОСВІТИ І НАУКИ,  
МОЛОДІ ТА СПОРТУ УКРАЇНИ**

**ХАРКІВСЬКИЙ НАЦІОНАЛЬНИЙ ЕКОНОМІЧНИЙ УНІВЕРСИТЕТ**

**Guidelines for Practical Training  
in Academic Discipline  
"ACCOUNTING AND AUDITING"  
for full-time students  
of the direction 6.030601 "Management"  
specializing in "Business Administration"**

**Харків. Вид. ХНЕУ, 2013**



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Tasks aimed at acquiring knowledge and mastering practical skills according to the syllabus of the academic discipline are given to be performed during practical studies.

The issue is recommended for students of the Bachelor programme "Business Administration".

Методичні рекомендації до виконання практичних завдань з навчальної дисципліни «Облік та аудит» для студентів напряму підготовки «Менеджмент» спеціалізації «Бізнес-адміністрування» денної форми навчання

Подано завдання для виконання на практичних заняттях з метою набуття та закріплення практичних знань та навичок за тематичним планом згідно робочої програми навчальної дисципліни.

Рекомендовано для фахівців освітньо-кваліфікаційного рівня "бакалавр" спеціалізації «бізнес-адміністрування».

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## 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 Auditing". 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 auditing" 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 auditing" in themes of Module 2. "Fundamentals of Auditing "

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.



## Theme 5. Auditing as a Form of Control on Business Activities

Audit is 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. 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 change in 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.

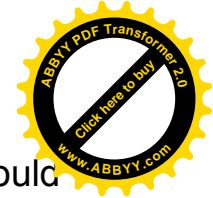
Audit has the following limitations:

- 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 skill and care and the 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 the financial statements.

Procedures in case of an indication of a fraud or an error:

- a. If 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 the fraud to those charged with governance and management.

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

f. An auditor should consider the effect of the fraud or error on the financial information and if material, he may consider qualifying his report.

Information is material, if its misstatement influences the economic decisions of financial statements 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 procedures 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 Tab. 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 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 Tab. 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 independent examination of operations conducted by management		
3. Auditor's opinion is on True & 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 & 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 for consolidating the accounts of separate legal entities.



## Task 5.5

Assign the content with the distinct accounting assumption in Tab. 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 Tab. 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 the form of the transaction. Substance over Form should be considered while accounting for transactions and in presentation of financial statements.			
Provide for known losses and recognise 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 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 controls drive the organization forward and also tackle 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 the 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 the 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 the 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 the 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 systems of risk management and internal control, 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 systems of risk management and internal control, 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 the 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 the 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 the 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 the financial accounts.

### Task 5.15

Name types of audit risks, which you know. Ascertain differences between them in Tab. 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 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 an 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 the 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 the organization or the 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 the 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 Tab. 5.10

Table 5.10

### Grading of auditor opinions on Internal Control System

The essence of auditor opinion	grading of auditor 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 a 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 the results of consulting engagements 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 control self-assessment 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 control self-assessment essence and organization

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

## Theme 6. Organization of Auditing of Financial Statements

An important step in planning process is an 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 – 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 – 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 risk and control risk arise even if an audit is not performed whereas the detection risk arises only at audit performance. Inherent risk and Control risk 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, assessment of inherent risk and control risk 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 lives 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 only; 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 in 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 report based on his 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. Planning		Preparing detailed audit programs for every aspect to be covered in audit
		Formulating overall plan based on knowledge of client's business
Stage 2. Performing procedures and obtaining evidences		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 there are 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 Tab. 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 an auditor to the management indicating the internal control weaknesses, irregularities and deficiencies observed by an auditor during the audit

Table 6.2 (the ending)

1	2	3	4
2	Check list	B	a list of questions prepared by an 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 an auditor and 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 an 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 an 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.

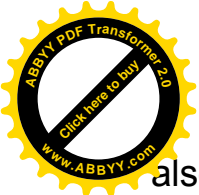
### Task 6.3

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.

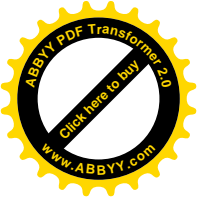
The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper 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 audit of financial statements.



## 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 an 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 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 Tab. 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. 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 for 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 if 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 the analyses made,
  - C. is the basis for an external auditor conclusion



D. document the information obtained

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

- A. an auditor
- B. an auditee.

8. 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

9. 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

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

A. conformance of 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 internal audit system to the organization's governance, risk management, and control processes;

E. compliance of 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.

11. 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
12. 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;
13. 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 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 Auditing of Financial Statements

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 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:

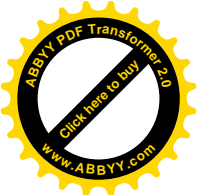
a) Whether physical verification of inventory has been conducted at reasonable intervals by management;

b) Are the procedures of physical verification of inventory followed by 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) Does the company have 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: Is there 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,. 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 UAH 10 000. The credit period allowed to an auditor was the same, which is allowed to other customers of a company.

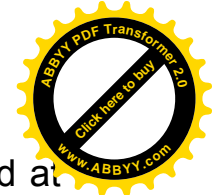
10. An auditor of a company, in addition to audit of accounts, accepted an engagement for consultancy services regarding tax matters of a company and the fees for such consultancy services was high in comparison with the fees charged for an audit.

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 of 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 UAH 50,000 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.

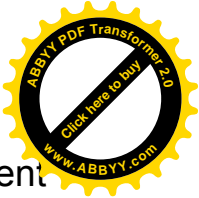
1. The amount payable to suppliers for machinery under deferred payment arrangements has been shown as current liabilities. Fixed assets of a company were offered as collateral security.

2. A company changed its accounting policy on valuation of inventories in 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 UAH 700,000; gross profit of UAH 300,000; selling and administrative costs of UAH 140,000; and income taxes of UAH 45,000. The selling and administrative expenses included UAH 10,000 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 Period Balance	End of Period Balance
Account 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 UAH 129,000. 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.		

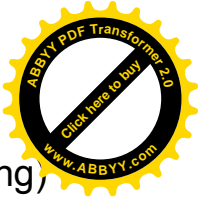


Table 7.2 (the ending)

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 a plant assets would be added back in operating cash flows.		

### Task 7.6

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 UAH 63,800, and the ending cash balance was UAH 415,000.

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

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



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 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 a customer and sends the goods directly to the customers. 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 UAH 10,000,000 have been sold and the documents are in the bank, which have not been declared 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 (tabl.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 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).



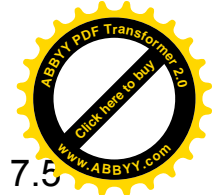


Table 7.5

**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.

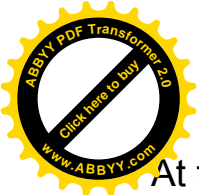
### **Task 7.13**

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 there are any.

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

2) The company incurs substantial costs for electricity to run its servers and air conditioning systems. On December 31, 2012, it is estimated that UAH 55,000 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 UAH 25 per month. However, it requires its customers to prepay in 6-month increments.



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

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

5) The company has total bank loans of UAH 1,500,000. This debt bears interest at 6%, payable monthly. On 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 (UAH 1,500,000) are all due on June 30, 2012. However, Server Planet has a firm lending agreement with the bank to renew and extend UAH 1,000,000 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)**

No	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. 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 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 was significantly poisoned by food 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 UAH 1,000,000 and such additional amounts as 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,

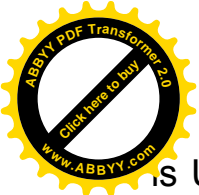
Robert Bean, Attorney

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 UAH 80 per unit. Riseva began the year with an accrued warranty liability of UAH 250,000. During the year, 50,000 lighting systems were sold. UAH 310,000 was 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 UAH 80,000. 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 UAH 10,000 of damages
June, 30	At the end of the month, it was estimated that employees are owed UAH 13,000 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 UAH 90,000, 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 UAH 75,000 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 UAH 100,000 in cash and executing a UAH 400,000 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 UAH 100,000 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 was 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 UAH 2,500,000;
- 2) before considering the effects of dividends, if there are any, Krull's net income for 2013 was UAH 3,000,000;
- 3) Krull declared UAH 750,000 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 UAH 5,000,000. No transactions impacted stockholders' equity during 2012 and 2013, other than the impact of earnings and dividends on retained earnings.

As the independent auditor:

- 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 UAH 1 par value common stock at UAH 3 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 UAH 5 per share;

4) declared and paid cash dividends of UAH 100,000;

5) reported net income for the full year of UAH 1,500,000.

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

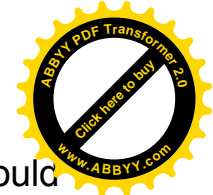
2. Financial reports are fraudulent in case:

- 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 UAH 1,670,000. However, this value was transposed and entered into the accounting system as UAH 1,760,000. As a result, ending inventory was overstated and cost of goods sold was understated by UAH 90,000. 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 UAH 90,000. Net income for 2013 was UAH 900,000, 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 UAH 1,760,000.



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 Auditing in a Commercial Company Management**

Technology exists to meet 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 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 auditing

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.

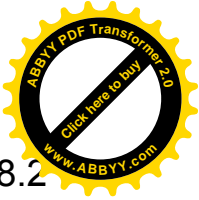
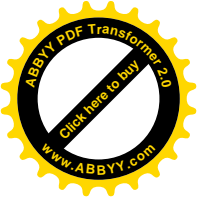


Table 8.2

### 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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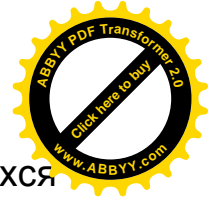
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