ADVANCED AUDITING AND ASSURANCE

STUDY TEXT

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INTRODUCTION TO AUDITING


CHAPTER ONE

INTRODUCTION TO AUDITING

▶ OBJECTIVES

When you have studied this chapter you should be able to:

- Explain and discuss the nature of auditing
- Describe and discuss the regulatory framework for auditing and related services internationally and in Kenya
- Describe the provisions of the Accountants Act, Cap 531 in relation to professional misconduct.

▶ INTRODUCTION

The chapter covers the basic concepts and regulation that affects the auditing profession. Auditing is a key part of good corporate governance but the directors are responsible for maintaining a system of control that will safeguard the companies assert thus it gives guidelines of the facts that auditors must be aware of as part of their planning for carrying out a true and fair report

▶ DEFINITION OF KEY TERMS

1. **Auditing** the independent examination of and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation:
2. **An engagement letter** defines clearly the extent of the auditor's responsibilities and so minimise the possibility of any misunderstanding between the client and the auditor.
   Non-statutory audits performed by independent auditors because the owners, proprietors, members, trustees, professional and governing bodies or other interested parties desire them, not because the law requires them.

▶ EXAM CONTEXT

A complete understanding of the introduction to audit and assurance is essential as it helps the examinee tackle technical terms and have a deeper understanding of the questions. Nearly all questions will have something on the introduction to auditing and assurance

▶ INDUSTRIAL CONTEXT

Auditing as a profession plays an important role in ensuring that companies present a true and fair view of the financial statements to the different shareholders. Public Companies are required to publish audited financial statements at the end of the financial year.

1.0 DEFINITION OF AUDITING

According to the International Standard on Auditing (ISA) No. 200 *Objective and General Principles Governing an Audit of Financial Statements*, the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

The phrases used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms. A similar objective applies to the audit of financial or other information prepared in accordance with appropriate criteria.

The Institute of Certified Public Accountants of Kenya (ICPAK) defines auditing as **the independent examination of and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation:**

1.1 RELATED SERVICES

In addition to audit services, auditors provide other services. These can be classified as:

Assurance engagements

- Audits
- Reviews

Non-assurance Engagements (related services)

- Agreed upon Procedures
- Compilations

1.1.1 Reviews

The objective of a review of financial statements is to enable **an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared,** in all material respects, in accordance with an identified financial reporting framework. A similar objective applies to the review of financial or other

Information prepared in accordance with appropriate criteria.


A review comprises inquiry and analytical procedures, which are designed to review the reliability of an assertion that is the responsibility of one party for use by another party. While a review involves the application of audit skills and techniques and the gathering of evidence, it does not ordinarily involve an assessment of accounting and internal control systems, tests of records and of responses to inquiries by obtaining corroborating evidence through inspection, observation, confirmation and computation, which are procedures ordinarily performed during an audit.

Although the auditor attempts to become aware of all significant matters, the procedures of a review make the achievement of this objective less likely than in an audit engagement, thus the **level of assurance** provided in a review report is correspondingly **less** than that given in an audit report.

1.1.2 Agreed-upon Procedures (ISRS4400)

The objective of these procedures is to report on the factual findings of procedures as agreed with the client

In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third **parties have** agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

1.1.3 Compilations (ISRS 4410)

The objective of compilations is to collect, summarize and classify financial information i.e. using accounting rather than auditing expertise into understandable form e.g. financial statements

In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarize financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with due professional skill and care.

1.1.4 Prospective Financial Information

This is financial information based on assumptions about events that may occur in the future and possible actions by an entity. They can be in the form of a forecast, projection or both.

A forecast is prepared on the basis of assumptions as to future events, that is best estimates.

A projection is prepared on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place.

1.1.5 Audit and assurance reports

The need for assurance reports is increasing because for example,

- The need quicker and better information for decision making in increasingly competitive business environment.
- The complexity of systems and the anonymity of the internet present potential barriers to growth.
- The need for independent assurance that decisions are made based on reliable information.

An assurance engagement is an engagement in which the practitioner expresses a conclusion designed to enhance the degree of confidence of intended users, other than the responsible party, about the outcome of the evaluation or measurement of subject matter against criteria.

The practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. He or she also considers othe reporting responsibilities including communicating with those charged with governance.

ISAs, ISREsand ISAE s establish basic elements of assurance reports.

The form of assurance given maybe reasonable assurance or limited assurance.

A reasonable assurance engagement expresses an opinion in a positive form while a limited assurance engagement expresses a conclusion in a negative form.

1.2 THE NEED FOR AN AUDIT

If you take an example of a modern large liability company, we can clearly distinguish between the providers of funds and those who control those funds. The providers of funds are the shareholders, creditors, and other third parties who have given loans to the company. Those charged with the responsibility of controlling those funds are usually called directors and management. We can also clearly see that the company has resources, (assets), and claims against those resources, (Liabilities and capital.)

Since the providers of funds are divorced from the control of those funds it would seem logical that the controllers should on a regular basis give a report to the providers of the funds on changes in the resources and claims. This report of the controllers or directors according to the Kenya Companies Act should be in the form of annual accounts which consist of the balance sheet and the profit and loss account. The accounting profession has extended the accounts by requiring that a Cash Flow Statement be also appended to the accounts as part of the accounts.

The report of the directors in the form of accounts lacks credibility, in that:

a) It may contain errors;
b) It may fail to disclose frauds;
c) It could be misleading inadvertently;
d) It could be misleading deliberately;
e) It may fail to disclose all relevant information.

A further point to note is that modern companies can be very large with multi-national activities. Preparing accounts for such a group becomes a very complex operation that could involve bringing together and summarising the accounts of subsidiaries with differing accounting systems. All accounts are required to conform to very detailed and complex requirements of the Companies Act (CAP 486) and also to the requirements of the many International Financial Reporting Standards (IFRSs). Taking these points into consideration therefore, it becomes necessary that to give credibility to the accounts an independent qualified expert be appointed to objectively investigate the accounts and then report his findings to all interested parties, primarily the shareholders as required by the Companies Act, but also to other providers of funds and relevant regulatory authorities.

This independent expert is called the auditor. His investigations constitute an audit and the report of his investigations an audit report. Apart from resolving the problems of credibility an audit is essential to ensure that the requirements of the Companies Act and the International Financial Reporting Standards have been complied with. The accounts are referred to as financial statements. To summarise, we can identify the following parties as being interested in the financial statements.

a) The directors who produce them;
b) The shareholders to whom traditionally they are addressed;
c) Lenders and debenture holders;
d) Potential investors;
e) Employees;
f) Customers;
g) Suppliers;
h) Accountants;
i) Stock-brokers;
j) Credit rating agencies;
k) Financial Journalists;
l) Trade Unions;
m) Statisticians;
n) Competitors;
o) The Government, including the Tax Authorities and the;
p) Ministry of Finance for Economic Policy Decisions;
q) The general public.

All these people must be sure that the financial statements can be relied upon.

It should be noted that:

1. The auditor himself must be independent to have credibility.
2. He must have the primary objective of producing a report of his opinion on the truth and fairness of the accounts, so that any person reading and using them can believe in them.
3. Subsidiary objectives can be seen to be the detection of errors and fraud, the prevention of errors and fraud by the deterrent and moral effect of the audit and the ability to provide other benefits to his clients such as:
   - Assistance with accounting;
   - Systems;
   - Taxation;
   - Financial and other problems.

The Companies Act was designed to protect shareholders from directors hence the need for an audit as contained in the Companies Act mainly relates to limited liability companies, but as we shall see any organization can benefit from an audit.

1.3 TYPES OF AUDITS

1.3.1 Introduction

So far we have tended to think in terms of the audit of limited companies, and indeed, the emphasis throughout this text will be on such companies incorporated under the Companies Act 1962, not least because this type of audit situation is at the heart of the vast majority of auditing examination questions. However, it might be convenient at this stage to briefly indicate the main classes of audit which are undertaken in practice.

Statutory Audits and Non-Statutory Audits

1.3.2 Statutory Audits

Audits are compulsory under statute in the case of a large number of undertakings including the following:

Undertaking	Principal Act
Limited Companies	Companies Act 1962
Building Societies	Building Society Act 1962
Banking and Financial Institutions	Banking Act 1989
Insurance Companies	Insurance Act 1984
Co-operative Societies	Co-operative Societies Act


1.3.3 Non-statutory Audits

Non-statutory audits are performed by independent auditors because the owners, proprietors, members, trustees, professional and governing bodies or other interested parties desire them, not because the law requires them.

In consequence, auditing may and will extend to every type of undertaking which produces accounts, and will include therefore:

a) Clubs;
b) Charities (assuming an audit is not in any event statutory);
c) Sole traders; and
d) Partnerships

It may also extend to forms of financial statement other than the annual reported figures where those responsible for the statement, or those to whom the statement is made, wish an independent opinion to be expressed as to whether it gives a true and fair view. Examples would include:

a) Summaries of sales in support of a statement of royalties' payable where goods are sold under licence;
b) Statements of expenditure in support of applications for regional development or other governments grants; and
c) The circulation figures of a newspaper or magazine, used when soliciting advertising.

In all such audits the auditor must have regard to any regulations concerning financial statements which are contained in the internal rules or constitution of the undertaking. Examples of the regulations which would be essential reference material for the auditor in such assignments would include:

a) The Rules of Clubs, Societies and Charities
b) Partnership agreements.

1.3.4 Audit of Partnerships

Advantages of an audit to a partnership

The audit of a partnership is not normally required by statute and so the auditor must agree with the client what his rights and duties are going to be. The auditor must obtain written confirmation of his terms of engagement and must take care to clearly distinguish between audit and accountancy work and ensure that the client appreciates such distinction.

In addition to the advantages common to all forms of audit, namely, the verification of accounts and the possible detection of errors and fraud, the audit of the accounts of a partnership may also be seen to have the following advantages:

a) It will provide a convenient means of settling accounts between the partners, thus avoiding the possibility of future disputes.

b) The auditor may be able to make useful comments on the firm's accounting and control systems, where necessary making recommendations as to how areas of weakness could be eliminated.
c) The settlement or adjustment of accounts between partners on the occasion of any change in the partnership structure will be facilitated where audited accounts are available.
d) Where audited accounts are available this will perhaps make them more readily acceptable to the income tax authorities' Inland Revenue when it comes to agreeing an individual's partner's liability to tax. The partners may well wish to take advantage of the auditor's services in the additional role of tax advisor.
e) The sale of the business or the negotiation of loan or overdraft facilities may well be facilitated if the firm is able to produce properly prepared and audited accounts.
f) An audit on behalf of a 'sleeping partner' is highly advisable since generally such a person will have little other means of checking the accounts of the business, or confirming the scale of profits due to them.

Apart from the advantages discussed above, which would be peculiar to a partnership, similar advantages may be found in the audit of the accounts of a sole trader, club or charity. Whatever the nature of the business, the auditor will find himself concerned with compliance with Auditing Standards.

1.3.5 Interim and Final Audits

Whereas the split between the systems and balance sheet audits is concerned with the type of work covered, that between the interim and final audits is concerned with **timing.** The interim audit will normally take place approximately three-quarters of the way throughout the financial year.

There is an element of similarity between systems/balance sheet work and interim/final audits in as much as the majority of the systems work will be carried out during the interim audit and the majority of the balance-sheet work during the final audit. However, it will be necessary to complete some systems work during the final audit so that transactions between the time of the interim and final audits do not escape the auditor's attention. Similarly, some substantive testing is very likely to be carried out during the interim (e.g. verifying fixed assets additions to date).

With very small audits, it is sometimes considered unnecessary to carry out an interim audit. This means that, as a matter of convenience, all the audit work will be carried out in a single phase commencing typically, a short time before the year-end and continuing into the post balance sheet period.

At the other extreme, with large companies it is sometimes necessary to carry out more than one interim audit or, alternatively adopt a continuous auditing approach. In the case of a continuous audit the auditor's staff will either make several visits to the client spread throughout the year or, as in the case of very large companies, some of the audit staff will be present at the client's premises virtually all the time.

Advantages and Disadvantages of a Continuous Audit

(a) **Advantages**

i. The continual or regular attendance of the auditor may act as a deterrent to fraud;
ii. Weaknesses in the client's systems are noticed earlier and, if they exist, errors and fraud may be discovered more quickly;
iii. It is sometimes possible to start the balance sheet work before the year end. This will lead to swifter financial reporting;
iv. The auditor's work is spread more evenly throughout the year. This will help to relieve the pressures on staff that arise for many audit firms during the first few months of each year.

(b) **Disadvantages**

i. Audit staff who spend much of their time working on one client may find their independence adversely affected;
ii. The auditor's frequent (and sometimes unexpected) visits may cause inconvenience to the client;
iii. It is possible that figures may be altered (innocently or fraudulently) after they have been checked;
iv. It may be found that outstanding points and queries raised at one visit are forgotten and not followed up at a later stage. Strict control is needed to ensure that this does not happen particularly where the staff assigned to the audit has changed.

1.4 THE AUDITOR AND THE KENYA COMPANIES ACT, 1962, CAP 486

1.4.1 Duties

Make a report to the members on all accounts laid before the members in general meeting during his tenure of office:

- The report must contain matters mentioned in the 7th Schedule to the Act. Section 162 (1).
- This therefore means the auditor has to include in the report statements on the accounts i.e.

i. Compliance with the Companies Act;
ii. Truth and fairness of the balance sheet and profit and loss account.

The auditor also has to investigate and report whether or not:

i. Proper books of account have been kept;
ii. Proper returns have been received from branches not visited by the auditor.
iii. The accounts are in agreement with the books of accounts.

The auditor has also to report whether or not he has obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

1.4.2 Rights

1. Right to have his report read before the Company. (Section 162(2).
2. Right of access at all times to the books, accounts and vouchers of the company.
3. Right to require from offices of the company such information and explanation as he thinks necessary for the performance of the duties of the auditor. (Section 162(3).
4. Right to receive notice of and attend meetings and report on any matters that concern him as auditor. (Section 162(4).
5. Right to report to the members on his findings including failure by the directors and employees of the company to supply him with all the information and explanations which he deemed necessary. (Section 162(1) and 7th Schedule of the Companies Act. (Sections 161(3).

1.4.3 Powers

The rights may be considered to be powers but the Companies Act does not give the auditor any legal powers to assist him in his work.

The directors can refuse to give any information he wants and they can refuse to publish his report and can deny him access to the records and also fail to serve him with notice of meetings and there is NOTHING THE AUDITOR CAN DO!

The Companies Act does not give the auditor any legal powers.

1.4.4 Qualifications for Appointment as Auditor

- Must be a holder of a practising certificate issued pursuant to Section 21 of the Accountants Act. (Section 161(1).
- Should not be an officer or servant of the company. (Section 161(2a)(i).
- Shall not be a partner of or in the employment of an officer or servant of the company. (Section 161 (2a)(ii).
- Should not be a body corporate. (Section 161 (2a)(iii).
- If an auditor is disqualified from appointment as an auditor of the company's subsidiary company or holding company or any other venture which if it were a company would be a subsidiary or holding.

Please note that references to officer or servant should not be construed to mean auditor (although the auditor HOLDS OFFICE). (Section 161(2)(b).

1.5 THE AUDITORS AND THE KENYA COMPANIES ACT, 1962, CAP 486

1.5.1 Appointment

Every company must appoint an auditor/auditors at each annual general meeting to hold office from the conclusion of that, until the conclusion of the next annual general meeting.

Retiring auditor is deemed to be reappointed without passing a resolution at an AGM unless:

- He is not qualified for reappointment;
- Resolution is passed at the AGM appointing somebody instead of him or providing expressly that he should not be reappointed.
- He has given notice in writing of his unwillingness to be reappointed Section 159(2)a, b, c.

If at the AGM no auditor/(s) is/are appointed or deemed reappointed, the registrar may appoint a person to fill the vacancy. Section 159(3). The directors can appoint the first auditors at any time before the first AGM to hold office till that AGM. The directors can fill a casual vacancy in the office of auditor. Section 159(6).

1.5.2 Remuneration

Fixed by whoever appoints the auditor/s. Section 159 (7) (a). Remuneration includes any expenses of the auditor/s paid by the company. Section 159 (7) (b).

1.5.3 Dismissal/Removal

An auditor can be dismissed at any time before the end of his tenure of office. This is despite any agreement between him and the company. This removal is by ordinary resolution at a meeting with special notice (28 clear days) having been served. Only the members in a properly constituted meeting can remove an auditor from office.

When an auditor is removed before expiry of his tenure of office, then the company must within fourteen days give notice of this fact to the Registrar. The auditor must be informed of all attempts to dismiss or remove him, from office. He is allowed to make representations to the members if he feels the directors want to remove him unfairly. The directors have to circulate the representations to the members.

1.5.4 Resignation

Auditors in Kenya cannot under the Companies Act resign before the end of their tenure of office. The closest they can come to resigning is giving notice in writing to the company that they are unwilling to be reappointed. Section 159(2)(c).

1.6 THE NEW ENGAGEMENT

1.6.1 Background

Reiteration of the ICPAK definition of an audit highlights the problems of the new audit.

An audit is the independent examination of, and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation: If we take the example of a limited company audit, then we can immediately appreciate that (before a new audit client is accepted, the auditor concerned must ensure that there are no independence or other ethical problems likely to cause conflict with the ethical code. Furthermore, it is important for the new auditor to ensure that he has been appointed in a proper and legal manner - it will be appreciated that one auditor's appointment is normally another auditor's removal or resignation). Essentially, the initial procedures to be observed can be considered in 2 stages:

a) Procedures before accepting nomination; and
b) Procedures after accepting nomination.

1.6.2 Procedures before accepting nomination

The nominee auditor must take the following steps:

a) Ensure that he is professionally qualified to act i.e. is not disqualified on any legal or ethical grounds.
b) Ensure that the firm's existing resources are adequate to service the needs of the new client. This will raise questions of staff and time availability and the firm's technical expertise.
c) Seek references in respect of the new client company, it may be, as is often the case, that the directors of the company are already personally known to the firm, if not, independent enquiries should be made concerning the status of the company and its directors.
d) Communicate with the retiring auditor:

1.6.2 Procedures after accepting nomination

(a) Ensure that the outgoing auditor's removal or resignation has been properly conducted in accordance with the Companies Act 1962.
The new auditor should see a valid notice of the outgoing auditor's resignation, or confirm that the outgoing auditor was properly removed at a general meeting of the company.

(b) Ensure that the new auditor's appointment is valid. The new auditor should obtain a copy of the resolution passed at the general meeting appointing him as the company's auditor.

(c) Set up and submit a letter of engagement to the directors of the company.
This important procedure is considered immediately below.

1.6.3 The engagement letter

Purpose

We have established that the directors and auditors of a limited company have very precise legal duties, we are also aware that modern accountancy firms thrive on their ability to provide a wide range of professional services in addition to audit.

It is the purpose of an **engagement letter** to define clearly the extent of the auditor's responsibilities and so minimise the possibility of any misunderstanding between the client and the auditor. Further, the engagement letter provides written confirmation of the auditor's acceptance of the appointment, the scope of the audit, the form of his report and scope of any non audit services. If an engagement letter is not sent to clients - both new and existing - there is scope for argument about the precise extent of the respective obligations of the client and its directors and the auditor. The contents of an engagement letter should be discussed and agreed with management before it is sent and preferably prior to the audit appointment).

The engagement letter is a well established audit technique and ISA 210 **Terms of Audit Engagements** provides guidance in this area.

1.7 REGULATION OF THE ACCOUNTING PROFESSION IN KENYA

The broad regulations that govern the Accounting profession in Kenya are set out in the Accountants Act, Chapter 531 of the Laws of Kenya.

The act establishes various bodies to regulate the profession in Kenya. These are detailed below with their major respective functions summarised.

1. **Kenya Accountants and Secretaries National Examination Board (KASNEB) (Section 17).**

   Functions:
   - Prepare syllabuses for accounting examinations;
   - Make rules with respect to examinations;
   - Arrange and conduct examinations;
   - Issue certificates to candidates who have satisfied examination requirements;
   - Promote recognition of its examinations in foreign countries.

2. **Registration of Accountants Board (RAB)**

   Functions:
   - Register accountants who are effectively graduates of IAS / IFRSNEB examinations or hold qualifications recognised by RAB (Section 23 & 24).
   - Issue of Practising Certificates (Section 21).

3. **Institute of Certified Public Accountants of Kenya (ICPAK)**

   Functions:
   - To promote standards of professional competence and practice amongst members;
   - Promote research into the subjects of accountancy and finance and related matters, publication of books, periodicals, journals and articles;
   - Promote the international recognition of the institute;
   - Advise the KASNEB on matters relating to examination standards and policies.

4. **Disciplinary Committee**

   Membership to be determined by Council of ICPAK. Where the Institute Council has reason to believe that a member may be guilty of professional misconduct it shall refer the matter to the Disciplinary Committee which will inquire into the matter.

After its inquiry the Committee can recommend:-

a) No further action be taken against the member;

b) The member be reprimanded;

c) The member be reprimanded with publication of the reprimand in the Gazette;

d) Registration be cancelled;

e) Practising certificate be suspended.

Section 28 of the Accountants Act details what constitutes professional misconduct.


Organisation in an Auditing Firm

The organisation adopted by most of the large firms in Kenya involves a pyramid structure that is usually made up as follows:

Partner

Manager

Accountant in Charge

Audit Assistants, Trainees, juniors

The partner would be responsible for the overall audit and he would sign the final accounts although most firms have a second partner with whom the first partner will consult particularly on matters of qualification in reports. In addition, the partner has to approve the detailed plan of work and give his authority before work can begin. He will carry out a final review of the work once it has been done before signing the accounts. It is his duty to ensure that up-to-date services and advice on all professional matters are provided to the client. He has to ensure continuity in the relationship which can be absent lower down the pyramid. With difficult clients he is also charged with negotiating the audit fees. He can be sued on behalf of the firm.

The manager is appointed for every job and he is responsible to a partner for satisfactory completion of that assignment. His initial responsibility usually involves preparing provisional timings and costing for the audit and to agree the timings with the client. He has to ensure that there are sufficient staffs at the right grade to cover the client's requirements. From the appropriate staff, he has to select the proper accountant in charge and to brief him on what needs to be done. He will also review the audit plan and the related budget which may be prepared by the accountant in charge and he will monitor the progress of the job constantly to ensure that targets are achieved. He has to review the working papers in detail before they are submitted to the partner for his final review. The manager is a crucial person in the audit assignment. He has to ensure that the proposed report is properly drawn up. He has to ensure that the deadlines are met; he has to ensure that the accounts comply with all regulations in every way.

The accountant in charge is sometimes referred to as a supervisor or audit senior. His job is to control the day to day operation of the audit. However, his degree of autonomy depends very much on a particular firm's policy, the personalities of the managers and the accountant's own experience and ability. His typical responsibilities include:

a) The collection of detailed information for the preparation of the audit plan.
b) The delegation of specific areas of work to the audit assistants or trainees.
c) The planning and supervision of the day to day running of the audit.
d) The constant review of progress by comparison of actual time spent against budget.
e) Ensuring that the working papers have been thoroughly prepared and are presented in an orderly manner to the manager and the partner for review.

If we look at his position, we find that of the whole audit team he is best placed to discover errors and irregularities. Also if the client is not a client of integrity, the accountant in charge is the easiest person to influence. He is also the easiest person to lose to clients who are looking for young energetic accountants to join their organisations.

Audit Assistants or trainees are responsible to the accountant in charge for the detailed work of the audit. They are expected to produce working papers set out in accordance with the firm's quality control procedures.

Typical Set-Up in a Professional Firm: Only Professional Staff

Grading/Department: Senior Partner - Qualified Accountant: Overall in charge of the practice and co-ordinates the functions and relationships of all departments, and is usually the primary liaison with the international firm (if any).

Audit Department: Audit Partners - constitute a major part of the partnership as auditing is usually the core of securing business for the practice.

Tax Department: Tax Partner - usually one partner, at the same level as the audit partners, concentrates on running the tax department for both corporate and personal taxation.

Company Secretarial Department: Usually a company registered under the Companies Act with all the partners as directors. One partner may be assigned the responsibility of overseeing the activities of this department usually run by a qualified Company Secretary who is a manager level employee but not a partner. Changes brought about by the new act on Company Secretaries will require that this employee be made a director as corporate bodies can no longer be Company Secretaries.

Special Service: Providing book-keeping and accountancy services this department is usually headed by a person of junior manager grade with several clerks as support staff.

Insolvency Department: One audit partner can double up as insolvency partner when volume of business is small otherwise a full partner will be in charge of this department with several key support staff, that would include managers.

Management Consultancy: Usually headed by a Director who is same level as a partner but is not necessarily a qualified accountant. Most in-fact possesses other skills in consultancy. Information Technology is a major MCS involvement, Recruitment services, Management Training, Management Consultancy are the other areas of involvement.

Support staffs are called consultants and have grading such as:

Senior Consultant	—	Audit Equivalent	—	Senior Manager
Consultant	—	Audit Equivalent	—	Manager
Junior Consultant	—	Audit Equivalent	—	Supervisor

The Qualities of an Auditor or Professional Accountant

Quality Explained

1. Competence

1.1 The professional accountant must be fully conversant with

- Accounting and Book-Keeping;
- Auditing;
- Taxation Law and Practice;
- Internal Control and Accounting Systems;
- Company Law;
- Information Technology;
- Management and Financial Consultancy;
- Valuation;
- Liquidation, Receiverships and Bankruptcy proceedings;
- Economic environment, policies and trends.

1.2 Ability to communicate both orally and in writing

- To his staff in giving instructions and directions;
- To the management and employees in obtaining evidence;
- To shareholders in reporting his findings;
- To other third parties in reporting his findings and obtaining evidence.

1.3 Judgement

The accountant must be able to make sound judgements, not only in professional matters but also of people.
He must therefore not only possess the skill and have the experience but he must also have imagination and the ability to differentiate between material and non-material items and to recognise apparent inconsistencies and abnormalities.

2. Integrity

The accountant must be and be seen to be honest, a follower of the ethical code of the institute, a person of discretion and tact and a person aware of his or her wider responsibility to the community at large. The synonyms for integrity include honesty, uprightness, probity, rectitude, moral soundness.
When an accountant has ethical difficulties or is unsure of what course of conduct to follow, he must consult the institute or seek legal advice.

3. Independence

The accountant's "reason to be" is independence. A dependant accountant is a contradiction in terms. The rule is that the accountant must approach every assignment with objectivity. He must approach his work in a spirit of independence of mind. Again not only must he be independent, he must be seen to be independent. Any interest which might diminish an accountants' objectivity of approach or which might appear to do so must be avoided.

QUALITY CONTROL AND REVIEW

Quality controls refer to the procedures adopted by a firm to provide reasonable assurance that all audits done by a firm are being carried out in accordance with ISQC 1 i.e "Quality control for a firmthat perform audit and reviews of Historical financial information and other assurance related services engagements and ISA 220 "Quality controls for audits of historical financial information"

Importance of high quality audit work

- To achieve audit objectives
- To operate effectively, efficiently and economically
- To avoid disputes with clients and minimise risk of litigation
- To provide professional service to clients.
- To ensure regulatory visits proceed smoothly.
- To ensure staff are monitored and controlled.
- To help identify training needs at all levels.
- To ensure staff appraisal systems operate effectively at all levels.
- To provide assurance of the audit .process to stakeholders.


Quality controls procedures should be implemented at the audit firm level and on individual audits. Audit firm level procedures are designed to provide with reasonable assurance that the firm and it's personnel comply with professional standards and regulatory and legal requirements .Also that audit reports issued by the firm or engagement partners are appropriate in circumstances

Individual audits are designed to provide standards and guidance on specific responsibilities of employees regarding quality control procedures on individual audits

QUALITY CONTROL REVIEW PROCEDURES

- Audit review panel is a small number of partners within the firm that acts as a source of reference to ensure a consistent approach is adopted. Before issuing an audit report the panel considers; conflicts of interest or other matters which might detract from objectivity, proposed modifications, and contentious matters.

- Second partner review is an independent as possible but having knowledge of client. The review is more in-depth than in panel review .Second opinion is compared with first and any conflict is resolved before issuance of the audit report .It is time consuming and very expensive.

- "Hot "review is done by a review department within the firm before auditor's report is issued. It is applied to all audits. It is also in greater depth than panel review .It concentrates on conformity with firm's standards, all significant points being cleared, compliance with statutes and IASs, quality of the report to management, adherence to terms of engagement letter and content of representation letter. Its advantage is that the review department becomes an expert and the disadvantage is that there are difficulties in issuance of the audit report

- Post audit review are "cold" reviews performed after auditor's report is issued .It si conducted by senior staff/partners from other offices.recommendations must followed up to ensure implementation. It is time-consuming therefore it is applied to selected audits covering all partners and managers on a rotational basis.

PROFESSIONAL ETHICS

The purpose of professional code of ethics is:

- To provide members with guidelines for maintaining a professional attitude and enhancing the accountancy profession.

- To give accountability to the public

- To codify behaviour beyond that which is incorporated in legislation.

CODE OF ETHICS AND CONDUCT

The codes provide five fundamental principles and a conceptual framework to assist members in applying the principles effectively..

Fundamental principles

- Integrity-implies honesty, fair dealing an truthfulness.
- Objectivity-bias, conflict of interest or undue interest must not override members' professional and business judgements.
- Professional competence and due care –reflecting current developments, sound judgements continuing professional development (CPD) requirements, etc.
- Confidentiality of information.
- Professional behaviour.

INTEGRITY, OBJECTIVITY AND INDEPENDENCE

A member's objectivity must be beyond question. This can only be assured if members are seen to be as independent as possible. Regardless of the type of assignment. Members who provide assurance services to a client may none the less under specific circumstances find their perceived objectivity under threat because of the nature of their work and and of their relationshipwith the client. Consideration must also be given to the impact of "associate" firms as they may be separate legal entities but they may not be sufficiently independent of each other.

CONFIDENTIALITY

It has two aspects;

- Improper disclosure-Information obtained in the course of professional work should not be disclosed to a third party without the client's permission. Information obtained from one assurance assignment cannot be used in another without obtaining the permission of the client

Exceptions

- There is a statutory right or duty to disclose
- There is a requirement made by the law
- To comply with quality control reviews of regulatory bodies
- To respond to an inquiry or investigation of regulatory bodies

Confidentiality is an implied term of contract between the auditor and the client. Auditors are normally under no obligation to disclose the defaults or unlawful acts to anyone other than the client's management unless required by law. Where there is a right as opposed to a duty disclosure should only be made in pursuit of public duty or professional obligation. Information obtained from a client cannot be used after the ceases to act for the client


- ➢ Improper use of information-A member acquiring information in the course of his or her professional work should neither use nor appear to use that information for his personal advantage or that of a third party

☐ ADVERTISING, PUBLICITY & OBTAINING PROFESSIONAL WORK

Advertising

Promotional materials and advertisements must not;

- Discredit ACCA members, firms or the accountancy profession..
- claim superiority
- mislead
- fall short of standards regarding legality decency, clarity honesty and truthfulness

Publicity

This is communication to the public of facts which are not designed for deliberate promotion. Acceptable publicity includes

- Appointments and approval.
- Seeking employment or professional business\in professional directories but entry must not to be a promotional advertisement
- Books articles, interviews, lectures, media appearances.
- Training courses and seminars but must not have undue prominence in materials issued.

☐ AUDIT FEES

General basis on which fees are computed should be set out in the letter of engagement. Members can charge whatever they consider appropriate. The following factors should be considered;

- Seniority and professional expertise of persons engaged in work
- Time taken
- Risk and responsibility entailed in work.
- Urgency and importance of work to client.
- Overhead expenses

A firm may obtain assurance engagement for a fee level that is significantly lower than that charged by the predecessor firm or quoted by another firm. This creates a self interest threat that will not be reduced to an acceptable level unless the firm can demonstrate that appropriate time and qualified staff are assigned to the task and that all applicable assurance standards, guidelines and quality control procedures are complied with

Contingency fee means that no fee is charged unless a specified finding or result is obtained. Fess should not be charged on a %’ contingency or similar basis except where it is generally accepted

In assurance engagements fees must not be calculated on a percentage or contingency basis. In non-assurance engagements contingent fees are not acceptable. The threat of contingent fee arrangement for non-assurance clientswill depend on the possible range and degree of variability of the fee The threat maybe reduced by prior approval by an audit committee or an independent third party

Fee quotations - If a fee quotation is not economical, there maybe a self-interest threat. The firm must be able to demonstrate that appropriate time and qualified staff are assigned to the task and that all applicable assurance standards guidelines and quality control procedures are being complied with.

Fee disputes maybe dealt with as follows;

- Variations between the notes should be explained e.g. reasons for extra work.
- If a client pays a smaller amount, it must be stated, in writing. That is accepted as part payment and not full discharge of the amount owed.
- Both parties to a fee dispute may make a written application to ha an arbitrator appointed.
- A particular lien maybe exercised over certain books and papers which have been worked on.

What the profession does to secure the qualities in the accountant	Board responsible for development/action
Requirement to pass comprehensive examinations for entry into the profession	KASNEB
Requirements of a good general education before registration as student	KASNEB
Requirement of a minimum period of practical experience in a firm of Certified Public Accountants of Kenya before a practising certificate is given (an accountant cannot be an auditor without a practising certificate)	RAB
Requirement of registration with the Registration of Accountants Board of Kenya on qualification as an accountant	RAB
Determination of the financial reporting framework	ICPAK
Holding of seminars, Issue of magazines and other technical literature	ICPAK
Existence of the disciplinary committee	The Council of ICPAK


1.8 INTERNATIONAL, ASSURANCE AUDITING, STANDARDS BOARD (IAASB)

The preface to the International Standards on Quality Control, Auditing, Assurance and Related Services (International Standards or IAASB's Standards) is issued to facilitate understanding of the objectives and operating procedures of the International Auditing and Assurance Standards Board (IAASB) and the scope and authority of the pronouncements it issues, as set forth in the IAASB's Interim Terms of Reference.

The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest."

In pursuing this mission, the IFAC Board has established the IAASB to develop and issue, under its own authority, high quality standards on auditing, assurance and related services engagements (IAASB's Engagement Standards, as defined in paragraph 14), related Practice Statements and quality control standards for use around the world.

The IAASB's pronouncements govern audit, assurance and related services engagements that are conducted in accordance with International Standards.

They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with them. A professional accountant should not represent compliance with the IAASB's Engagement Standards unless the professional accountant has complied fully with all of those relevant to the engagement.

The IAASB is committed to the goal of developing a set of International Standards generally accepted worldwide. To further this goal, the IAASB works cooperatively with national standard setters, and takes a lead role in joint projects with them, to promote convergence between national and international standards and achieve acceptance of IAASB's Standards.

The International Auditing and Assurance Standards Board

The IAASB is a Board established by IFAC. The members of the IAASB are appointed by the IFAC Board to serve on the IAASB.

STUDY TEXT

IAASB members act in the common interest of the public at large and the worldwide accountancy profession. This could result in their taking a position on a matter that is not in accordance with current practice in their country or firm or not in accordance with the position taken by those who put them forward for membership of the IAASB. Each IAASB member has the right to appoint one technical advisor who may participate in the discussions at IAASB meetings.

IAASB meetings to discuss the development and to approve the issuance of International Standards, Practice Statements or other papers are open to the public. Agenda papers, including minutes of the meetings of the IAASB, are published on the IAASB's website.

The Authority Attaching to International Standards Issued by the International Auditing and Assurance Standards Board

International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.

International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.

International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than historical financial information.

International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.

ISAs, ISREs, ISAEs and ISRSs are collectively referred to as the **IAASB's Engagement Standards.**

International Standards on Quality Control (ISQCs) are to be applied for all services falling under the IAASB's Engagement Standards.

The IAASB's Standards contain basic principles and essential procedures (identified in bold type lettering) together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the whole text of a Standard to understand and apply the basic principles and essential procedures.

The nature of the IAASB's Standards requires professional accountants to exercise professional judgment in applying them. In exceptional circumstances, a professional accountant may judge it necessary to depart from a basic principle or essential procedure of an Engagement Standard to achieve more effectively the objective of the engagement. When such a situation arises, the professional accountant should be prepared to justify the departure.


Any limitation of the applicability of a specific International Standard is made clear in the standard.

The Authority Attaching to Practice Statements Issued by the International Auditing and Assurance Standards Board

International Auditing Practice Statements (IAPSs) are issued to provide interpretive guidance and practical assistance to professional accountants in implementing ISAs and to promote good practice.

International Review Engagement Practice Statements (IREPSs), International Assurance

Engagement Practice Statements (IAEPSs) and International Related Services

Practice Statements (IRSPSs) are issued to serve the same purpose for implementation of ISREs, ISAEs and ISRSs respectively.

Professional accountants should be aware of and consider Practice Statements applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Practice Statement should be prepared to explain how the basic principles and essential procedures in the IAASB's Engagement Standard(s) addressed by the Practice Statement have been complied with.

Current ISAs and IAPS:

ISA No	Title
	Glossary of terms Preface to ISAs and RSs.
200	Objective and General Principles Governing an Audit of Financial Statements
210	Terms of Audit Engagement
220	Quality control for Audits of historical financial information
230	Audit Documentation (Redrafted)
240	The Auditor's responsibilities relating to Fraud and Error in the Audit of Financial Statements (Redrafted)
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication of Audit Matters with those charged with Governance (Revised and redrafted)
300	Planning an audit of financial statements
315	Identifying and assessing the risks of material misstatement through understanding the entity and its environment (Redrafted)
320	Audit materiality
330	The auditor's responses to assessed risk (redrafted)
402	Audit Considerations Relating to Entities Using Service Organizations
500	Audit Evidence
501	Audit evidence – Additional Consideration for Specific Items
505	External Confirmations
510	Initial Engagements – Opening Balances
520	Analytical procedures

530	Audit Sampling and Other Selective Testing Procedures
540	Audit of Accounting Estimates, including fair value accounting estimates and related disclosure (Revised and Redrafted)
550	Related Parties
560	Subsequent Events (Redrafted)
570	Going Concern
580	Written representations (Revised and Redrafted)
600	Special consideration- audit group financial statement (including the work of component auditors) (Revised and Redrafted)
610	Considering the Work of Internal Auditing
620	Using the Work of an Expert
700	The independent auditors report on a complete set of general purpose financial statements.
710	Comparatives
720	Other Information in Documents Contain Audited Financial Statements
800	The Auditor's report on Special Purpose Audit Engagements

No	**Title**
IAPS 1005	The Special Considerations in the Audit of Small Entities
IAPS 1010	The Consideration of Environmental Matters in the Audit of Financial Statements
IAPS 1013	Electronic Commerce Effect on the Audit of Financial Statements

One of the requirements of IAS 700 the auditor must specifically mention in his report that the audit has been carried out in accordance with approved auditing standards. This is also required by IAPS. The auditing standards and guidelines prescribe best practice in auditing but in no way inhibit the auditor from exercising his judgment in particular situations.

Professional judgement is still required in interpreting the standards in particular areas, determining the sufficiency and type of evidence needed, areas where no standard or guideline has yet been pronounced on. Auditing standards therefore raise the requirements for professional judgement and an effective and economical audit can only be achieved with a great deal of thought at all stages. Therefore though mandatory, they are not designed to inhibit professional judgement.

1.9 THE INTERNATIONAL FINANCIAL REPORTING STANDARDS

International Financial Reporting Standards are of great importance to an auditor. A detailed review of those so far issued belongs to an accounting text and for this reason it is assumed that the students have knowledge of their requirements. However, elsewhere in this text the major auditing points with regard to each current IAS / IFRS are reviewed under the accounting standards checklist. The IAS / IFRS issued to date are as follows:

Examinable Authoritative documents

International Financial Reporting Standards (IASs/IFRS)

http://www.iasplus.com/standard/preface.htm Preface to International Financial Reporting Standards
http://www.iasplus.com/standard/ifrs01.htm IFRS 1 First-time Adoption of International Financial Reporting Standards
http://www.iasplus.com/standard/ifrs02.htm IFRS 2 Share-based Payment
http://www.iasplus.com/standard/ifrs03.htm IFRS 3 Business Combinations
http://www.iasplus.com/standard/ifrs04.htm IFRS 4 Insurance Contracts
http://www.iasplus.com/standard/ifrs05.htm IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
http://www.iasplus.com/standard/ifrs06.htm IFRS 6 Exploration for and Evaluation of Mineral Assets
http://www.iasplus.com/standard/ifrs07.htm IFRS 7 Financial Instruments: Disclosures
http://www.iasplus.com/standard/ifrs08.htm IFRS 8 Operating Segments
Framework for the Preparation and Presentation of Financial Statements
http://www.iasplus.com/standard/framewk.htm Framework for the Preparation and Presentation of Financial Statements
International Accounting Standards
http://www.iasplus.com/standard/ias01.htm IAS 1 Presentation of Financial Statements
http://www.iasplus.com/standard/ias02.htm IAS 2 Inventories
IAS 3 Consolidated Financial Statements Originally issued 1976, effective 1 Jan 1977. Superseded in 1989 by IAS 27 and IAS 28.
IAS 4 Depreciation Accounting Withdrawn in 1999, replaced by IAS 16, 22, and 38, all of which were issued or revised in 1998.

STUDY TEXT

IAS 5 Information to Be Disclosed in Financial Statements Originally issued October 1976, effective 1 January 1997. Superseded by IAS 1 in 1997.
IAS 6 Accounting Responses to Changing Prices Superseded by IAS 15, which was withdrawn December 2003
http://www.iasplus.com/standard/ias07.htm IAS 7 Statement of Cash Flows
http://www.iasplus.com/standard/ias08.htm IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
IAS 9 Accounting for Research and Development Activities Superseded by IAS 38 effective 1.7.99
http://www.iasplus.com/standard/ias10.htm IAS 10 Events After the Reporting Period
http://www.iasplus.com/standard/ias11.htm IAS 11 Construction Contracts
http://www.iasplus.com/standard/ias12.htm IAS 12 Income Taxes
IAS 13 Presentation of Current Assets and Current Liabilities Superseded by IAS 1.
http://www.iasplus.com/standard/ias14.htm IAS 14 Segment Reporting
http://www.iasplus.com/standard/ias15.htm IAS 15 Information Reflecting the Effects of Changing Prices Withdrawn December 2003
http://www.iasplus.com/standard/ias16.htm IAS 16 Property, Plant and Equipment
http://www.iasplus.com/standard/ias17.htm IAS 17 Leases
http://www.iasplus.com/standard/ias18.htm IAS 18 Revenue
http://www.iasplus.com/standard/ias19.htm IAS 19 Employee Benefits
http://www.iasplus.com/standard/ias20.htm IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
http://www.iasplus.com/standard/ias21.htm IAS 21 The Effects of Changes in Foreign Exchange Rates
http://www.iasplus.com/standard/ias22.htm IAS 22 Business Combinations Superseded by IFRS 3 effective 31 March 2004.
http://www.iasplus.com/standard/ias23.htm IAS 23 Borrowing Costs
http://www.iasplus.com/standard/ias24.htm IAS 24 Related Party Disclosures
IAS 25 Accounting for Investments Superseded by IAS 39 and IAS 40 effective 2001.
http://www.iasplus.com/standard/ias26.htm IAS 26 Accounting and Reporting by Retirement Benefit Plans
http://www.iasplus.com/standard/ias27.htm IAS 27 Consolidated and Separate Financial Statements
http://www.iasplus.com/standard/ias28.htm IAS 28 Investments in Associates

http://www.iasplus.com/standard/ias29.htm IAS 29 Financial Reporting in Hyperinflationary Economies
http://www.iasplus.com/standard/ias30.htm IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions Superseded by IFRS 7 effective 2007.
http://www.iasplus.com/standard/ias31.htm IAS 31 Interests In Joint Ventures
http://www.iasplus.com/standard/ias32.htm IAS 32 Financial Instruments: Presentation Disclosure provisions superseded by IFRS 7 effective 2007.
http://www.iasplus.com/standard/ias33.htm IAS 33 Earnings Per Share
http://www.iasplus.com/standard/ias34.htm IAS 34 Interim Financial Reporting
http://www.iasplus.com/standard/ias35.htm IAS 35 Discontinuing Operations Superseded by IFRS 5 effective 2005.
http://www.iasplus.com/standard/ias36.htm IAS 36 Impairment of Assets
http://www.iasplus.com/standard/ias37.htm IAS 37 Provisions, Contingent Liabilities and Contingent Assets
http://www.iasplus.com/standard/ias38.htm IAS 38 Intangible Assets
http://www.iasplus.com/standard/ias39.htm IAS 39 Financial Instruments: Recognition and Measurement
http://www.iasplus.com/standard/ias40.htm IAS 40 Investment Property
http://www.iasplus.com/standard/ias41.htmS 41 Agriculture

RELEVANCE OF IAS / IFRS TO AUDITING

Auditors must include in their report their opinion on whether the financial statements they report on give a true and fair view. It is generally felt that in order for accounts to show a true and fair view there must be compliance with the IAS / IFRS. There may be situations where compliance with IAS / IFRS may result in a true and fair view not being given but this is rare. So effectively, the auditor is being asked to give an opinion on whether all IAS / IFRS have been complied with in the preparation of the accounts he is auditing. The auditor therefore must know and understand the IAS / IFRS in detail. Auditing students are also expected to know the IAS / IFRS in detail because invariably, there will be an examination question that requires this knowledge and students are advised to quote from the IAS / IFRS and state which of the IAS / IFRS is relevant to their answer.

International Financial Reporting Standards are intended to be applied to all financial statements which show a true and fair view. They set out the main assumptions underlying statements and they prescribe which accounting policy should be used when more than one are possible. They also specify disclosure requirements in many areas including the disclosure of accounting policies. Again they are not intended to be a comprehensive code of rigid rules. It is recognised that such a code sufficiently elaborate to cater for all business situation and circumstances and for every exceptional and marginal case is impossible.

The benefits of IAS / IFRS are:

1. They lead to a degree of uniformity and comparability among accounts.
2. They assist understanding by providing readers of the accounts greater information about the preparations of the accounts.
3. They assist accountants and auditors by aiding in the process of determining what a true and fair view is. They therefore help refine the meaning of true and fair view.
4. They describe a method of accounting and or disclosure requirement approved by the institute.
5. Members of the institute are obliged to secure adherence to IAS / IFRS whenever they are concerned with financial statements be they directors, accountants, company secretaries, auditors or in any other role.

Negligence in General

There is no recorded case in Kenya against auditors and this makes it difficult to be precise as to where the auditor's legal liability falls. We need therefore to refer to decided cased in other countries. But even in those countries there are in fact very few decided cases against auditors. In those countries, the vast majority of actions against auditors are settled out of court. This saves what could otherwise be very expensive court costs. It is also significant to note that this saves dragging the professional firm's name through the courts and most likely through the newspapers. Firms are of course anxious to avoid such bad publicity.

It is however generally known that the auditor's liability falls under three specific headings:

(a) To his clients under contract law;
(b) To third parties under the law of tort;
(c) Civil and criminal liability under statute law

And we will deal with each in turn:

To his clients: The auditor is under duty to report to the members in general meetings on all accounts examined by him and laid before them. His contract is therefore with the company as a whole and not with individual shareholders. The auditor can therefore be accused of negligence if:

(a) He fails to detect fraud or error which he should reasonably have detected;
(b) If he fails to comply with generally accepted auditing standards and practices.

However, it is also generally held that for an auditor to suffer actual financial loss, the following conditions must be met.

i. He must be proved to have been negligent;
ii. The complainant must have suffered a loss;
iii. The loss must be as a direct consequence of his reliance on the auditor's report and the auditor's negligence.

Therefore if the auditor fails to detect a fraud which is immaterial to the accounts and unless there are suspicious circumstances which he had noticed or should reasonably have noticed, it is unlikely that he will be held negligent.

Even if the fraud was material to the accounts, he may still escape liability if detection could not reasonably have been achieved using normal audit procedures. It must be admitted however this is a very dubious area of law.

The auditor has no duty to individual shareholders. A shareholder who makes an investment decision by relying on the auditor's report and suffers loss cannot claim under the law of contract. Only if the company as a whole has suffered, can the whole body of shareholders claim from the auditor.

In a number of cases it appears that claims have arisen as a result of some misunderstanding as to the degree of responsibility which the accountant was expected to take in giving advice or expressing an opinion. It is therefore important, to distinguish between disputes arising from misunderstanding regarding the duties assumed, and negligence in carrying out agreed terms.

The Use of Engagement Letters

There is a contractual relationship between an accountant and his client. The accountant should therefore ensure that at the time he agreed to perform certain work for the client, the scope of his responsibilities is made clear preferably in writing, in that the terms of his contract with his client are properly defined. Where possible a letter of engagement should be prepared setting out in detail the actual services to be performed, and the terms of engagement should be accepted by the client so as to minimise the risk of disputes regarding the duties assumed.

Liability to third parties

For a long time liability to third parties existed only in respect to physical injury. Liability for financial loss is a recent development. Examples of occasions when an accountant may run the risk of insuring a liability to third parties may include the following:

(a) Preparing financial statements or reports for a client when it is known or ought to be known that they are intended to be shown to and relied upon by a third party even if the identity of the third party is not disclosed.

(b) Giving references regarding a client's credit worthiness or an assurance as to his capacity to carry out the terms of a contract or giving any other reference on behalf of the client.

Again, it must be shown that the accountant was negligent, third parties suffered a financial loss, the financial loss occurred as a result of the accountant's negligence and that the accountant knew the purpose for which his report or accounts were to be used.

Liability under statute

Civil liability: Section 206 of the Companies Act provides that officers of the company and for these purposes auditors are considered as officers may be liable for financial damages in respect of the civil offences of misfeasance and breach of trust. This section which is only relevant to winding up refers to a situation where officers have misused their position of authority for the purposes of personal gain.

Criminal liability: Section 46 of the Companies Act states that an auditor shall be criminally liable if he wilfully makes a materially false statement in any report, certificate, financial statement etc. Wilfully implies fraudulently and can be difficult to prove. Whereby, it is held that where an officer of a body corporate with intent to deceive members or creditors, publishes or concurs in publishing a written statement of account which to his knowledge is or may be misleading, false or deceptive in a material particular he shall on conviction be liable to imprisonment for a term not exceeding 7 years.

Other relevant issues to be considered under this section include:

- The auditor with errors and irregularities;
- The auditor with illegal acts by client or client's staff;
- Questionable payments;

ILLEGAL ACTS

Auditors may uncover criminal offences committed by a client or an employee of the client. This puts them in a difficult position, but the auditor should act carefully and correctly and if necessary, take legal advice. The auditor must not commit a criminal offence himself. It is felt that he would have committed a criminal offence if:

(a) He advises his client to commit a criminal offence;
(b) Aids the client in devising or examining a crime;
(c) If he agrees with a client to conceal or destroy evidence or mislead the police with false statements;
(d) If he knows that his client has committed an arrest able offence and tries to impede his arrest and prosecution. Impede does not include refusing to answer questions or refusing to produce documents without the client's consent;
(e) If he knows that his client has committed an offence and agreed to accept consideration to withhold information;
(f) If he knows that the client has committed treason and fails to report the offence to the proper authority.

Discovery of unlawful acts

When an auditor discovers unlawful acts, usually he is not expected to disclose to the police or other authorities unless:

i. The client authorises disclosure;
ii. That disclosure is compelled by process of law for example, a court order;
iii. That disclosure is required in the auditor's own defence;
iv. The circumstances are such that the auditor has a public duty to disclose, for example, when the client has committed a serious crime or his act is treasonable.

Therefore to summarise, the auditor on discovery of an unlawful act should do nothing positively to assist in the offence or to prevent its disclosure. He must bring all offences of employees to the notice of his clients. If the offence is such that its non-disclosure means that the accounts are not showing a true and fair view, then the auditor must insist on disclosure or qualify his audit report. Discovery of material defects in previous accounts should be pointed out to the client with recommendation for disclosure.

MINIMISING AUDITOR'S LEGAL LIABILITIES

1) Limited liability to involve a contractual and contributory negligence limit.
2) Joint and several liability to be removed in favour of proportional liability according to name not ability to pay.
3) Lawyer of losing party to pay legal costs of winning party ("fee shifting") to prevent ready acceptance of litigation cases.
4) Refrain from out of court settlements.
5) Prevent incorporation of audit firms. Discourage avoidance of high risk clients by following professional ethics.
6) Use engagement letters to define tasks and responsibilities undertaken by client and auditor
7) Use clauses disclaiming liability to third parties.
8) Attempt to limit the use of documents to the purposes for which they are prepared for: identifying authorised recipients, stating the purposes of the report and stating that it may not otherwise be relied on.
9) Obtain expert advice where appropriate.
10) Obtain indemnity from the client or third party e.g. obligate the client or third party to indemnify the author from third party claims but do not limit the third party's liability to assert their claims.
11) Take steps to restrict use or citing of firm's name.
12) Liability to assert their claims.
13) Take steps to restrict use or citing of firm's name.

LEGAL PRECEDENCE

Liability to third parties

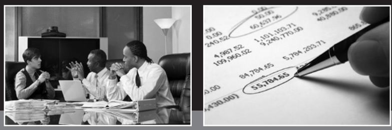
>>> Illustration: Caparo industries took over fidelity plc in1984 and alleged that it increased its shareholding on the basis of fidelity's accounts audited by touché Ross. Caparo used Touche Ross for alleged negligence in the audit, claiming that the stated 1.3million pounds pre-tax profit for the year to 31st march 1984 should have been reported as a 400,000 pounds loss.

Court of appeal ruled that the auditors owed a duty of care to Caparo as a shareholder in Fidelity when it made the final purchase and the bid.

The House of Lords ruled that;

- Auditors of a public company's accounts owe no duty of care to the members of the public at large who rely on accounts in deciding to buy shares in the company.
- As a purchaser of additional shares in reliance on the auditors ' report the shareholder stands no different from any other investing member of the public to whom the auditor owes no duty.
- The question of negligence was not addressed since it was held that the auditors owed no duty of care
- For duty of care to exist there must be a "special relationship" between the professional and the third party .This was not present between the auditor and the potential investor. special relationship was essential given that many statements are effectively put into general circulation and may be relied upon by strangers for different purposes.

Conclusion: The House of lords looked at the purpose of statutory accounts, on which an auditor must report, must be published with the principle purpose of providing shareholders as a class with information relevant to exercising their proprietary interests in a company .They are not published to assist individuals whether existing shareholders or not to speculate with a view of profits.



Questionable Payments

In some countries, business is often gained by bribing ministers or public officials or officers of companies or firms with whom one wishes to do business. Indeed bribery and corruption are a way of life in some business communities. This is the general area of questionable payments, which may include "commissions, usually based on the amount of business placed". When an auditor discovers such payments, he has to consider what course of action to take. In general, the following conduct by the auditor is acceptable.

(a) He should satisfy himself that the payment is as stated and that he has been told the whole story;

(b) He should satisfy himself that the payments were genuinely made in furtherance of the client's business;

(c) He has to satisfy himself that all directors of the company were aware of the payment and its purposes;

(d) He has to obtain a letter of representation, signed by all the directors to confirm (c);

(e) If the client is a subsidiary, then he has to ensure that the holding company and the primary auditors are aware of the payment and;

(f) He has to consider whether disclosure is required. Generally disclosure is not necessary because such payments are rarely material in the context of the company' accounts as a whole and usually a true and fair view is given without disclosure.

CHAPTER SUMMARY

- **The importance of an audit are**

1) The providers of funds are the shareholders, creditors, and other third parties who have given loans to the company are different from those charged with the responsibility of controlling those funds.
2) Since the providers of funds are divorced from the control of those funds it would seem logical that the controllers should on a regular basis give a report to the providers of the funds on changes in the resources and claims.
3) It's the requirement of the companies act that all public companies should be audit.

- **Retiring auditor is deemed to be reappointed without passing a resolution at an AGM unless:**

i) He is not qualified for reappointment;
ii) Resolution is passed at the AGM appointing somebody instead of him or providing expressly that he should not be reappointed.
iii) He has given notice in writing of his unwillingness to be reappointed Section 159(2) a, b, c.

- The Qualities of an Auditor or Professional Accountant are

  - Competence
  - Integrity
  - Independence

- **The auditor's liability falls under three specific headings:**

  (a) To his clients under contract law;
  (b) To third parties under the law of tort;
  (c) Civil and criminal liability under statute law

- International Financial Reporting Standards are intended to be applied to all financial statements which show a true and fair view. Their main benefits are

1. They lead to a degree of uniformity and comparability among accounts.
2. They assist understanding by providing readers of the accounts greater information about the preparations of the accounts.
3. They assist accountants and auditors by aiding in the process of determining what a true and fair view is. They therefore help refine the meaning of true and fair view.
4. They describe a method of accounting and or disclosure requirement approved by the institute.
5. Members of the institute are obliged to secure adherence to IAS / IFRS whenever they are concerned with financial statements be they directors, accountants, company secretaries, auditors or in any other role.

STUDY TEXT


CHAPTER QUIZ

1) What is the objective of auditing According to the International Standard on Auditing (ISA) No. 200

2) An auditor is felt to have committed a criminal offence if:

3) What are the Qualities of an Auditor or Professional Accountant

4) Name two types of auditing.

5) It is the purpose of an **...............** to define clearly the extent of the auditor's responsibilities and so minimise the possibility of any misunderstanding between the client and the auditor.

ANSWERS TO CHAPTER QUIZ

1. To enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

2.

(a) He advises his client to commit a criminal offence;
(b) Aids the client in devising or examining a crime;
(c) If he agrees with a client to conceal or destroy evidence or mislead the police with false statements;
(d) If he knows that his client has committed an arrest able offence and tries to impede his arrest and prosecution. Impede does not include refusing to answer questions or refusing to produce documents without the client's consent;
(e) If he knows that his client has committed an offence and agreed to accept consideration to withhold information;
(f) If he knows that the client has committed treason and fails to report the offence to the proper authority.

3. Competence, integrity, independence

4. Statutory and non statutory

5. Engagement letter

PAST PAPER ANALYSIS

Introduction to audit and investigation gives the student a general understanding of the concepts covered under this paper. Although it's rarely tested alone, it's incorporated in questions from other chapters, but the following sittings have tested more of this: 6/00 Question 1 and Question 4, 12/00 Question 2

EXAM QUESTIONS

Question one

You are the auditor of a listed (quoted) company with diversified interests mainly of an industrial nature. One subsidiary, however, acquired on the first day of the financial year, is engaged in banking. The finance director has asked you to advise him as to the manner in which the banking subsidiary should be treated in the group accounts.

Required:

Write a formal letter to the finance director setting out the legal and accounting standards requirements appropriate to these circumstances **(Total: 20 marks)**

Question two

You are the auditor of City Premises Kenya Ltd., a company which manages premises including letting and rent collections on behalf of landlords. Your firm has recently acquired an audit retrieval software package with the following capabilities:

1. General:
   - Mathematical (Multiply, divide, add, deduct and summarize).
   - Direct data access.
2. Specific:
   - Sorting out records.
   - Stratification of population
   - Frequency of analysis.
   - Statistical sampling
   - Greater then/less than selection
   - Comparison with a norm.
   - Identifying duplications
   - Matching.
   - Comparison of two files.
   - Reporting (including graphics).

The company utilizes a computerized system to record and process all transactions relating to its lease portfolio. The system incorporates a database in which all the lease agreement details and rentals received are recorded. The system contains the following fields:

- Current monthly rental.
- Lease agreement number.
- Description of premises.
- Names of landlords.
- Names of tenants.
- Lease commencement date.

- Lease period.
- Initial rent.
- Escalation percentages.
- Total outstanding rent receivable.
- Rent arrears: Month 1
  Month 2
  Month 3 and later.
- Collection commission percentage.
- Termination date.
- Renewal date.
- Journal entry adjustments.

Required:

(a) List the audit objectives that you would wish to achieve when auditing the accuracy of the information in the database. (5 marks)

(b) Describe how the audit retrieval software package could be used to achieve the objectives detailed in (a) above. (15 marks)

(Total: 20 marks)

Question three

For many years the law had adopted an approach whereby no action for negligence could be brought if the parties concerned had no contractual relationship with each other, unless the negligent act caused physical injury or was fraudulent misrepresentation. Thus, the auditor had a contractual relationship with his client or clients' shareholders only and owed a duty of care to them alone. However, the courts have increasingly sought to extend the liability of the auditor to other (even potential) users of financial statements. The view of the judiciary appears to be that the time is ripe for the auditing profession to assume a greater responsibility for its actions. The risk attached to users of audited financial statements has been reduced and, at the same time, there has been an increase in the risk carried by the auditing profession.

You are required to

(a) Describe the judicial decisions, which have altered the range of the auditors' duty of care to third parties.

(b) Explain how the auditor can ensure that the risk attaching to an audit is reduced to a minimum.

(c) Comment on the view that much of the litigation and allegations of negligence directed against the auditors may be more appropriately aimed at the directors of a company.

CASE STUDY

(Courtesy of www.nyscpa.org)

Sarbanes-Oxley, Accounting Scandals, and State Accountancy Boards
Red versus Blue State Reactions

By Karen Gantt, George Generas, and Barbara Lamberton

SEPTEMBER 2007 - The accounting scandals of the last several years seriously eroded confidence in the capital markets and led to unprecedented losses affecting both large and small investors. These losses led to sweeping federal legislative action; the reaction at the state level has, however, been more mixed, as shown by a review of both “red” and “blue” states affected by scandal.

The accounting scandals had a devastating effect on pensions and on trust in the capital market system. For example, in testimony in May 2002 before the U.S. Senate Commerce Subcommittee, the American Federation of State, County and Municipal Employees (AFSCME) stated that its members “lost more than Ksh1.5 billion of their retirement assets as a result of the Enron scandal through their participation in 150 public pension systems.” The U.S. Congress determined that federal legislation was needed to stem the tide of investor apprehension and reduce the chances of future accounting irregularities. On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act (SOX), creating sweeping changes affecting the practice and regulation of accounting and auditing.

SOX require public accounting firms to register with the newly established Public Company Accounting Oversight Board (PCAOB). More important, it also significantly narrows the scope of no audit services that can be provided to an audit client. Under SOX, certain consulting services, internal audit outsourcing, and other activities routinely provided to clients in the past are deemed illegal when performed by the audit firm. By imposing new restrictions on the practice of accounting, SOX sought to strengthen auditor independence in both fact and appearance. According to a white paper issued by the AICPA in October 2003, the prohibited services are “largely predicated by the SEC’s basic principles that the auditor cannot (1) audit his or her own work, (2) function in the role of management and (3) serve in an advocacy role for his or her client.”

Although SOX is a federal law, the practice of accounting is regulated on a state-by-state basis. Consequently, it is incumbent upon regulators in each state to carefully compare the provisions of SOX to their laws dealing with the practice and licensing of accounting. Under constitutional supremacy clause principles, conflicting federal and state laws are resolved in favor of the federal law. While states cannot ignore provisions of federal law, any given state may choose to enact stricter rules than those prescribed by SOX.

In order to restore public confidence, certain states have passed legislation in response to Sarbanes-Oxley. In fact, individual state accounting reform legislation provides evidence that some states have been active in quickly fine-tuning their regulation of the accounting profession. This article examines the actions of selected state accountancy boards in response to SOX to determine whether the perceived need for stricter regulation of the accounting profession varies by state.

Although SOX applies to public companies, some observers are concerned that various states could apply stricter standards to those public companies. Despite the perceived value of uniformity, there is concern that some states may react to SOX by aggressively expanding its scope to private entities.

A future Andersen-style collapse or near collapse of one of the Big Four firms could lead to it being placed into protective administration, under plans being actively considered by the International Forum of Independent Audit Regulators (IFIAR).

This month's two-day meeting of IFIAR will give detailed consideration to contingency plans in case of a crisis – such as a serious regulatory failure, or major litigation – at one of the Big Four. Paul Boyle, the vice chairman of IFIAR and chief executive of the UK's Financial Reporting Council (FRC), told *accounting & business*: 'IFIAR doesn't yet have any settled or formal position on this topic. One of the possibilities to be discussed at this meeting will be some form of administrative protection.' But he conceded: 'It is the most promising option at this stage.'

Legal and multi-jurisdictional challenges would have to be considered, said Boyle. 'Is it desirable? Is it legally possible? It may already be legally possible in some jurisdictions and not in others. It may be possible to change the law in some jurisdictions and not in others. But you have to consider this in the context of what would be a major crisis if one of the big firms did get into trouble – so you might have to consider something that is not perfect.'

IFIAR was established in September last year by 19 of the world's leading audit regulatory bodies, with others, such as those of the US and the European Commission, having observer status. It shares regulatory experiences and knowledge, promotes regulatory collaboration and provides a single global contact for international organisations that have an interest in audit. Australia and the UK are influential in the work of IFIAR – with Jeffrey Lucy, chairman of the Australian Securities and Investments Commission (ASIC), being the first chair of IFIAR and the FRC actively involved in it.

The FRC has been keen to develop theoretical responses to any possible collapse or lack of confidence in one of the Big Four. It was recently revealed that one option considered by the FRC has been the enforced sale of the firms' audit arms.

CHAPTER TWO

STUDY TEXT

ACCOUNTING AND INTERNAL CONTROL SYSTEMS: THEORY AND PRACTICE

CHAPTER TWO

ACCOUNTING AND INTERNAL CONTROL SYSTEMS: THEORY AND PRACTICE

▶ OBJECTIVES

When you have studied this chapter, you should be able to:

- Define and describe the objectives of internal control systems and the responsibility for internal control systems in the context of organisational objectives
- Describe the importance of internal controls to auditors
- Describe and illustrate the limitations of internal control systems in the context of fraud and error
- State the types of controls
- Summarise the methods used to ascertain and to record systems
- Discuss whether reliance should be placed on the systems to reduce the total amount of testing
- Design appropriate accounting and internal control systems
- Explain and discuss the impact of development in IT.

▶ INTRODUCTION

This capture covers the internal control systems that are put in place to safeguard the company's assets and the risk assessment procedures used by the auditor in the exercise of his responsibility. It also covers fraud and error that may exist in the financial statements and procedures that the auditors may use to use to detect them.

▶ DEFINITION OF KEY TERMS

1. ***Risk Assessment and Internal Control*** this is the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

2. **Internal control system** this are all the policies and procedures (internal controls) 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, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information

3. **Control environment** the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity

4. **Control procedures** this means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives

5. **Compliance tests** this are those tests which seek to provide audit evidence that internal control procedures are being applied as prescribed

6. **Substantive test**. These are those tests of transactions and balances and other procedures such as an analytical review which to seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or in the financial statements.

7. **Fraud** refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

▶ EXAM CONTEXT

This is a highly examinable area as it covers the procedures that the auditor uses to verify that the financial statements present a true and Fairview. The examiner usually requests the examinee to discuss the various internal control that the auditor can rely on and suggestion to the improvements of the internal control system.

▶ INDUSTRIAL CONTEXT

All businesses either medium or large have an internal control system. Internal control systems are used to safeguard the companies asserts and to ensure hat procedures set are followed as specified. The management is responsible for maintaining an effective control system which the auditor can rely on.

2.0 THE ACCOUNTING SYSTEM

Definition

ISA 315 Understanding the entity and its assessing the risk of material misstatement **accounting system is the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.**

ISA 315 Risk Assessments and Internal Controls states that the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

The Companies Act Cap 486 places a duty upon the auditor in preparing his report to carry out investigations that will enable him form an opinion on the financial statements in accordance with the seventh schedule to the Companies Act Cap 486

The objective of the accounting system is to ensure that all transactions are completely and accurately processed and recorded and that the resulting accounting entries are valid.

Managements interest in the accounting system

Management needs complete and accurate books of accounts because:

i. There is no other way the business can be controlled;
ii. Records of debtors and creditors are indispensable;
iii. The best way to safeguard assets is to have a proper record of them;
iv. Accounts can only be prepared if proper primary books exist;
v. The Companies Act has specific requirements on keeping of proper books of accounts;
vi. The various acts covering NSSF, NHIF, PAYE, VAT, and LEVY require proper books.

What constitutes an adequate system of accounting depends on the circumstances. The important thing is that the system should provide for the orderly assembly of accounting information to enable accounts to be prepared. A system of accounting cannot succeed in completely and accurately processing and recording all transactions, unless internal arrangements set up by the management known as **Internal Controls** are built into the system.

2.1 INTERNAL CONTROL SYSTEMS

ISA 315: "**Internal control system**" means **all the policies and procedures (internal controls) 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, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information**. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:

a) "The control environment"

This means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- The function of the board of directors and its committees.
- Management's philosophy and operating style.
- The entity's organizational structure and methods of assigning authority and responsibility.
- Management's control system including the internal audit function, personnel policies and procedures and segregation of duties.

(b) "Control procedures"

"Control procedures" means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:

- Reporting, reviewing and approving reconciliations.
- Checking the arithmetical accuracy of the records.
- Controlling applications and environment of computer information systems, for example, by establishing controls over changes to computer programs
- Access to data files.
- Maintaining and reviewing control accounts and trial balances.
- Approving and controlling of documents.
- Comparing internal data with external sources of information.
- Comparing the results of cash, security and inventory counts with accounting records.
- Limiting direct physical access to assets and records.
- Comparing and analyzing the financial results with budgeted amounts.

AUDITING

Exam Focus

This is a fertile area for examiners. Invariably in every examination paper set on auditing there will always be a question on internal controls.

We will consider the definition, the theory, the practice and its impact on the accountant being audited and the accountant who is doing the auditing.

The management is concerned that errors and irregularities should not occur because if they did occur they would result either in the loss of assets or the production of accounting records that are unreliable in that they will fail to disclose a true and fair view of the financial position and the results from operations of the entity concerned.

Meaning of the definition

a) **Orderly and efficient manner:** An organization that is run in an orderly and efficient manner is able to satisfy the needs of its managers, shareholders, auditors, customers, suppliers and anybody else interested in the operations of the entity. It will be able to satisfy the needs of its production facilities. The results of orderliness include the timely production of information that is reliable; they also include the cooperation of all parties concerned. An organization that is run in a disorderly and inefficient manner will soon degenerate into chaos and would probably have to close down sooner or later. This is important to the auditor in that where the organization is well run he will expect reliable information timely received or provided and he will receive the cooperation of the management, the staff and other third parties from whom he may seek representations. This reduces the amount of detailed work the auditor has to do.

b) Ensure **adherence to management policy**: Every organization must have aims or objectives. For a company these are usually to be found in its Memorandum and Articles of Association. The management is charged with the responsibility of designing policies that will enable the organization's objectives to be achieved. So the management must set policies that have to be followed or adhered to, to achieve the objectives of the organization. To do this, management identifies broad policies such as: the industry in which to operate, the products to produce, where the factory is to be located and which market its products are aimed at. Management also sets detailed policies such as the number of accounts clerks to be employed and their remuneration. For the auditor adherence to management policy places the whole organization in perspective. Only if the auditor understands the organization's objectives and the policies adopted by the management to achieve those objectives will he be able to determine whether measured against those objectives, the accounts give a true and fair view. The policies adopted particularly in determining the values attached to assets and liabilities and the amounts to be charged as revenue or expenditure in the profit and loss account must be in accordance with generally accepted accounting principles.

c) **Safeguard the assets:** The assets are the resources of the organizations. They must therefore be protected from loss. This protection can be done directly i.e. physically locking the assets under lock and key and trying to prevent their deterioration or safeguarding can be done indirectly through records and documentation. Safeguarding the assets means restricting access to the assets. Indirect restriction means that access to the assets should be through authorised documentation. For the auditor, the accounts cannot give a true and fair view if he cannot confirm that the assets concerned actually exist and have the value attributed to them.

d) **Secure as far as possible the completeness and accuracy of the records**. It is difficult to control any business unless you have got reliable and accurate records. Business decisions cannot be made unless all the transactions have been completely and accurately processed and recorded. The Companies Act requires proper records being kept for all the company's transactions and activities. It further requires that these records should be such that accounts that give a true and fair view can be extracted from them. Therefore, the organization must keep reliable records and therefore the management must take the appropriate steps to ensure that it secures as far as possible the completeness and accuracy of the records. For an auditor, his interests in this element of internal control arises out of his statutory responsibility to investigate and report whether proper books of accounts have been kept, whether the accounts he is examining are in agreement with those books, and whether the Companies Act requirements have been complied with in all material respects. He therefore has a direct interest in complete and accurate records.

2.2 FRAUD AND ERROR

ISA 240: The Auditor's Responsibility to Consider Fraud And Error states that when planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of Material misstatements in the financial statements resulting from fraud or error.

Misstatements in the financial statements can arise from fraud or error.

The term "**error**" refers to an **unintentional misstatement in financial statements, including the omission of an amount or a disclosure**, such as the following:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

The term "**fraud**" refers to **an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.**

Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as **management fraud**;" fraud involving only employees of the entity is referred to as **"employee fraud**." In either case, there may be collusion with third parties outside the entity.

Two types of intentional misstatements are relevant to the auditor's consideration of fraud – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve the following:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. **While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.**

Responsibility of Those Charged With Governance and of Management

The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary by entity and from country to country. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity. This responsibility arise out of the contractual relationship between the directors, managers and the company

Recent Pronouncements on corporate governance have reinforced this responsibility

Responsibilities of the Auditor

The Auditor has no responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent.

As described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. An audit conducted in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only **reasonable assurance** that material misstatements in the financial statements will be detected.

In planning the audit, the auditor should discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error. The auditor should make inquiries of management:

(a) To obtain an understanding of:
  (i) Management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
  (ii) The accounting and internal control systems management has put in place to address such risk;
(b) To obtain knowledge of management's understanding regarding the accounting and internal control systems in place to prevent and detect error;
(c) To determine whether management is aware of any known fraud that has affected the entity or suspected fraud that the entity is investigating; and
(d) To determine whether management has discovered any material errors.

Procedures when Fraud is suspected

When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.

When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.

Evaluation and Disposition of Misstatements, and the Effect on the Auditor's Report

When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud or error, the auditor should consider the implications for the audit.

Documentation

The auditor should document fraud risk factors identified as being present during the auditor's assessment process and document the auditor's response to any such factors. If

during the performance of the audit, fraud risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor should document the presence of such risk factors and the auditor's response to them.

Communication

When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor's responsibility to communicate that information to management, those charged with governance and, in some circumstances, to regulatory and enforcement authorities.

Communication of Misstatements Resulting From Error to Management and to Those Charged With Governance

If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260,

Communication of Audit Matters With Those Charged With Governance

The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Communication of Misstatements Resulting From Fraud to Management and to Those Charged With Governance

If the auditor has:

(a) Identified a fraud, whether or not it results in a material misstatement in the financial statements; or

(b) Obtained evidence that indicates that fraud may exist (even if the potential effect on the financial statements would not be material); the auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance in accordance with **ISA 260.**

Communications to Regulatory and Enforcement Authorities

The auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. The auditor considers seeking legal advice in such circumstances.

Errors can be described as an intentional mistake and they can occur at any stage in a business transaction and they can be of any type. Auditors would primarily be interested in the prevention, detection and disclosure of errors for the following reasons:

(a) Existence of errors may indicate that accounting records are unreliable and are therefore not a satisfactory basis from which to prepare financial statements. The auditor could therefore conclude that proper books of accounts have not been kept where there are too many material errors. This is a ground for qualification of an auditor's report.

(b) Too many errors may also indicate that the system of internal control is not reliable, and therefore the auditor wishing to place any reliance on a system of internal control may not be able to do so.

(c) If errors are of sufficient magnitude, they may be sufficient to affect the true and fair view given by the accounts.

Irregularities

Irregularities can be described as intentional distortions of financial statements for whatever purpose and also as misappropriation of assets whether or not a company by distortions of financial statements. The auditor's responsibility towards fraud and other irregularities is exactly the same as that of errors.

Materiality

If the auditor knows or suspects that an error or irregularity has occurred or exists, then he cannot apply materiality consideration until he has sufficient evidence of the extent of the error or irregularity

Indication of irregularities

Possible indications of irregularities include:

(a) Missing documents or vouchers, these could have been deliberately destroyed to conceal an irregularity;
(b) Evidence of altered documents: alterations can take place after the transaction has been approved;

(c) Unsatisfactory explanation: these are explanations that are vague and are unsupported;
(d) Evidence of disputes;
(e) Existence of suspense accounts or unexplained differences on reconciliations;
(f) Evidence that internal control is not operating as it is intended to;
(g) Unduly lavish life styles of employees and officers;
(h) Figures not agreeing with expectations.

Reporting

To the members: unless the errors and irregularities result in the accounts not giving a true and fair view, or do not conform to statute, or proper books have not been kept, then there is no need to report. To the top management: if the auditor suspects that management are involved in irregularities, then he should report to the main board or to the audit committee. To management: all actual or potential irregularities should be reported with recommendations for changes. To third parties: the auditor should take legal advice or advice from his professional body to ensure the accounts give a true and fair view, but only disclose those matters where he has a clear public duty to disclose for example, if a serious crime has been committed.

TYPES OF INTERNAL CONTROL

1. **Organization:** Enterprises should have a plan of their organization defining and allocating responsibilities and identifies lines of reporting for all aspects of the enterprises' operation, including the controls. The delegation of authority and responsibility should be clearly specified.

2. **Segregation of duties:** One of the prime means of control is the separation of those responsibilities or duties which would if combined enable one individual to record and process a complete transaction. Segregation reduces the risk of intentional manipulation and error and increases the element of checking. Functions which should be separated include those of authorization, execution, custody, recording and in the case of a computer based accounting system, systems development and daily operations.

3. **Physical:** These are concerned mainly with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to authorised personnel. This includes both direct access and indirect access through documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.

4. **Authorization and approval:** All transactions should require authorization or approval by an appropriate responsible person. The limits for this authorization should be specified.

5. **Arithmetical and accounting:** These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised, that they are all included and that they are correctly recorded and accurately processed. Such controls include: the checking of the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliations, control accounts and trial balances and accounting for documents.

6. **Personnel:** There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. Inevitably, the proper functioning of any system depends on the competence and integrity of those operating it. The qualifications, selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

7. **Supervision:** Any system of internal control should include the supervision by responsible officials of day to day transactions and the recording thereof.

8. **Management controls:** These are the controls exercised by the management outside the day to day routine of the system. They include: the overall supervisory controls, exercised by management, the review of management accounts, and comparison thereof with budgets, the internal audit functions and any special review procedures.

   You should remember the key internal control objectives in relation to recording and processing; (validity, completeness, accuracy, independence).

Types of controls explained:

To explain the above types of controls we will constantly refer to purchase of raw materials.

Organization: The enterprise should create proper departments that will achieve an efficient and orderly working environment. In the areas of purchases one would expect the organization to have a stores department which is charged with the responsibility of monitoring stock levels so that when the stock of raw materials reaches the reorder level they will raise a requisition for new supplies. We would expect that a clerk in the stores department has been charged with this responsibility and that he does his job. He knows what is expected of him, he knows whom he reports to, he knows whom he can delegate his work to and he knows the limits of his authority. We would also expect a purchasing department charged with the responsibility of receiving the requisition from the stores. Their function is once they received the requisition they will examine it for necessity and they will select the most appropriate supplier who has been approved by the entity. They will raise the LPO, check the details on the LPO, get it approved, and despatch it to the supplier. You should note that organization relates to having proper departments within the company and within those departments to have individuals with clearly specified job descriptions.

Segregation of duties: For every transaction, we can identify the following stages: initiation, authorization, execution, custody of the resultant assets and the recording of the whole process. As much as possible, these stages should be separated as far as the individuals who carry them out are concerned. In the case of raw materials, the initiation began in the stores department when the goods were requested. Part of the execution is carried out by the purchasing department when they examine the requisition and raise the LPO. Authorization of the LPO will have to be done by an independent person. We can already see that two departments have been involved, the stores and the purchasing department. These controls cover what used to be originally called internal check. This archaic term used to refer to a situation whereby the work of one person was subject to independent review by another person or was complimentary to the work of another person. It also covers rotation of duties whereby no one person is kept in the same position for an indefinitely long period of time. It includes the requirement that people should take regular leave so that other people can have the opportunity to carry out their functions.

Physical: The store-man should know the condition under which the raw materials should be stored to ensure that they do not deteriorate. He has also to ensure that the raw materials are securely kept in a warehouse that is well protected so that no one can just walk in and steal the raw materials. We will also expect the organization to have raw materials requisition notes so that they have to be properly authorised for raw materials to be moved from the warehouse to the production section.

Authorization and approval: As we saw under organization the purchasing department will raise the LPO; the LPO commits the organization to use its resources. These commitments require to be approved at the appropriate levels hence you will find that before the LPO becomes a valid contract, it must be approved in accordance with the approved delegation of authority. The reason for this is that as it forms a basis of a contract between the organization and the supplier it needs to be checked for grammatical mistakes and the commitment of funds.

Arithmetical and accounting: Transactions have to be recorded in monetary terms, or where necessary in physical quantities. The entity must therefore have adequate records to record all transactions and adequate documents to provide evidence and an audit trail of the transactions from authorization up to recording. In the case of our raw materials, we would therefore expect that when the raw material arrives at the warehouse, somebody should check it for quantity and quality to ensure that what we are receiving is what we ordered, these would mean comparing with the orders. A document must be raised to acknowledge receipt of the goods and the checking of their quality and quantity with the orders. A copy of the document acknowledging receipt should be sent to the accounts department for them to be able to match it with the suppliers invoice when it is received to ensure that we are being charged for goods that we ordered and received. The suppliers invoice will have to be entered into the purchases day book, the purchases ledger and into the creditors control account.

Personnel: Personnel controls are neglected in many organizations much to the regret of the organization concerned. Personnel involve allocating the human resources in the most efficient and cost effective manner. Every individual should be given a job that he is competent of doing, he should be properly remunerated for that job, he should be motivated to do the job, and he should see a clear career path. Also the integrity of the staff involved has to be established. This involves obtaining references of key staff before the organization engages them and constant counselling to ensure that they have not lost their integrity. When the raw material reaches the warehouse, we would expect that the store man knows exactly what kind of material it is, how it should be stored to protect it from deterioration and how it should be used. We would expect that he could see potential for development within the organization and that his salary or remuneration is commensurate with his responsibilities.

Supervision: Everybody's work should be subject to supervision. So the clerk who raises the requisition in the stores has his superior supervising his activities to ensure that he does not just raise requisitions without confirming that in fact the reorder level has been reached.

Management controls: These are exercised by management by ensuring compliance with the broad policy's of the organization. In the case we are looking at, we can envisage the managing director being given a schedule of purchases for the whole month, he then reviews this schedule and tries to determine whether the material we bought was in the quantity and amount that the organization should be using, whether we are within budget and whether we are being profitable or not.

The aim of a system of internal control we said was to minimise the incidents of errors and irregularities. So as we move on to the practice of internal control we will be considering the potential errors and irregularities that can occur and the measures the organization takes to ensure that they do not occur and if they occur they are detected within reasonable time so that future occurrences are prevented.

THE PRACTICE OF INTERNAL CONTROL

The traditional classification of operation for internal control purposes was:

a) Cash and cheques received including cash and bank balances;
b) Cash and cheque payments;
c) Salaries and wages;
d) Purchases and trade creditors;
e) Sales and trade debtors;
f) Stocks including work-in-progress;
g) Fixed assets and investments.

However, it is more usual now to classify transactions in accordance with their related cycles. These cycles are recognized in a typical manufacturing organization as: sales cycles, purchases cycle, wages cycle and conversion cycle.

The Sales Cycle

1. Potential error or irregularity:

Goods being despatched or leaving the premises without being invoiced, services being rendered without being invoiced, goods on consignment or in transit to other branches not being recognised in the books.

Implications

Understatement of sales, wrong management accounts, loss of assets of the company and accounts that will not give a true and fair view as sales and debtors are understated.

Preventive measures

The sales department should acknowledge orders received. This can be done by the organization ensuring that all customers' orders are transcribed their own internal sales orders which should be pre-numbered. The objective is to initiate the accounting trail and reduce the possibility of disputes with the customers. The sales department should also be responsible for fixing selling prices and delivery dates and any special discounts should be approved by a responsible official. Before the order is processed further, it is passed on to the credit control department, they check the credit worthiness of the customer and if he is an existing customer they have to check that the new order will not exceed the credit limit. If the customer has not dealt with the company previously, then bank and trade references should be obtained. The credit control department if it is satisfied that this is a customer who should be supplied with the goods will then check with the stores to confirm the availability of the stock items. They will then approve the sales order and pass it on to stores to despatch the goods. Stores should despatch the goods ensuring what they are despatching is in accordance with what the customer ordered and what has been approved by the credit control department.

They should raise documentation to evidence the despatch of goods. This should be a pre-numbered document and is usually called a despatch note or a goods delivery note. They should be issued numerically in sequence. Copies of the despatch note should be sent with the goods. One copy as advice to the customer and a second copy to be signed by the customer and returned to the company as proof of delivery. To ensure that all goods leaving the premises are invoiced the delivery note sequence should be checked prior to raising invoices and each delivery note should be checked to ensure that an invoice is raised.

Detective measures

1. This involves an independent clerk matching all the delivery notes or despatch notes with the invoices and the investigation of any unmatched delivery notes.

2. **Potential error or irregularity**

   Goods being sent to bad credit risk:

   Implications: incidents of bad debts, loss of assets.

   Measures are: the establishment of a credit control department that examines all the orders received by the sales department and establishes the credit worthiness of the customer before authorising stores to despatch the goods. A review of long outstanding debts and investigations as to why payment is not being received.

3. **Potential error or irregularity**

   Overdue accounts escaping follow-up:

   Implications: increased incidents of bad debts.

   Measures: the production of an aged debtors list. The ageing must be checked for correctness. The credit control department should review this listing regularly and ensure that overdue accounts are constantly followed up. The company can institute a stop service list where all delinquents are placed and this list distributed within the organization to ensure that any transactions with the concerned parties are closely monitored.

4. **Potential errors or irregularities**

   Invoicing errors occurring: that is sales invoiced but not recorded, sales invoiced incorrectly.

   Implications: mis-statements in sales and debtors either up or down. Loss to the organization as money will not be received for sales made and increased disputes with customers due to errors in invoicing.

   Measures: the use of pre-numbered sales invoices and the requirements that they be issued in sequence. The existence of proper journals - that is the sales journal and the debtors' ledger. The checking of the invoices raised by an independent clerk of the arithmetical accuracy, the pricing, the discounts allowed, the coding and the cross referencing to the customer's order. Sending statements to customers on a regular basis, quantity reconciliations compared with actual documentation.

5. **Potential errors and irregularities**

   The receipt of cash or cheques not being banked including teeming and lading.

   Implications: misappropriation of cash and hence loss to the organization. Increased interest expense due to late banking. Exposure to theft by burglars.

   Measures: the requirement that mail should be opened by the managing director's secretary in the presence of some messenger. She should then prepare a pre-list of all cheques received by mail. Cross all cheques and pass them on to the cashier promptly for his banking. The organization should use pre-numbered receipts and have a requirement that for all money received, a receipt must be raised. The receipts should be promptly entered in the cash book and pay-in-slips prepared accordingly. There should be a requirement that all receipts be banked promptly and intact thus if we have received cash, cash should be banked and if cheques have been received, then cheques should be banked and no substitution should be allowed. Regular bank reconciliation should be prepared, checked and approved by a responsible official. An independent clerk should on a regular basis compare the pre-list prepared by the secretary to the pay-in-slip and on to the bank statement.

6. **Potential errors and irregularities**
   Cash sales being improperly dealt with by persons initially receiving cash and persons handling cash from initial receipt to final banking.

   Implications: misappropriation of assets as cash is the most readily realisable assets.

   Measures: use of pre-numbered cash sales receipts, restricting the number of people who can handle/receive cash, requiring that returns be filed on a daily basis, quantity reconciliation, close supervision of the cash handlers, encouraging customers to pay by either cheque or credit card, surprise cash counts and reconciliation with the supporting records.

7. **Potential errors and irregularities**
   Debtors accounts being improperly credited. A debtors accounts can be credited either by receipt of cash or by the issue of a credit note.

   Implications: unreliable records, increased incidents of bad debts, disputes with customers, loss for the organization.

   Measures: coding of customers. An independent clerk selecting credit entries in customers account and matching those to their initial receipts or credit notes.

Other matters to consider

Sales ledger department

The sales ledger department will be responsible for recording invoices against the appropriate debtor. To ensure that all the invoices are included the documentation should be serially numbered and the sequence should be checked prior to recording.

The accounts department

The ledgers should be balanced monthly and agreed with an independently held debtors control account. Once accounts are reconciled, then statements should be sent to customers as they provide an independent check on the overstatement of debts or the understatement of monies received. This would therefore require the statements being sent out by a senior official after he has checked the balances on the statement to the ledger. Any customers query should be dealt with by staff other than those who maintain the ledgers. The writing off of bad debts and the approval of credit notes should be done by a senior official. These will include the requirement of an appropriate supporting documentation and properly raised and approved documentation. We may therefore require seeing lawyers' correspondence as far as bad debts are concerned and goods returned notes as far as credit notes are concerned.

In the absence of the above controls, the following are examples of the types of fraud that may become possible:

1. Collusion between customers and sales invoicing department. If such collusion occurs, invoices may not be raised, or they may be raised only for reduced amounts. Such a fraud can involve substantial sums of money but can be prevented by proper sequential control over delivery notes and the subsequent independent check of despatch documentation to invoices.

2. Failure to raise despatch documentation. If goods are allowed out of the premises without delivery notes being raised the matter may never be discovered. So the best way to prevent these from happening is to have the minimum number of entrances to the premises with a guard at each entrance checking documentation in respect of all goods leaving.

3. Improperly raised credit notes. Fictitious credit notes can be used to cover up the misappropriation of cash or to reduce a customer's debt, particularly if the member of staff involved is in collusion with the customer. The false writing off of bad debts can be used in the same way.

4. Cashiers. The cashiers function must be kept strictly separate from any of the sales procedures in order to ensure that teeming and lading does not take place. The cashier should record all the monies received and should bank them daily to avoid having large amounts on the premises. The bank pay-in-slip should be prepared at least in duplicate. One copy for the bank and the other one to be stamped by the bank and returned as proof of deposit. The person who makes out the pay-in-slip should not take the money to the bank.

THE PURCHASES CYCLE

1. Potential errors and irregularities

Liabilities being set up for goods or services which are either not authorised or not received.

Implications: Unreliable records as they do not show the true position of liabilities, there may cause loss due to paying for goods or services never received.

Measures: If suppliers are in collusion with employees, fictitious charges can be approved for payment with a share subsequently going to the employee. This can most easily occur at the goods inwards stage and is particularly possible if the inspection procedures are inadequate. False invoices can be introduced at any stage in the processing and false supporting documentation can be produced as well and this type of fraud is difficult to prevent. Therefore, the purchases function should be such that only specified employees have the power to requisition goods and then only up to an authorised limit. Such limits increasing with the level of seniority. The requisitions should be serially numbered and should be sent to the buying department. The buying department will be charged with the responsibility of negotiating the best prices and delivery dates from suppliers and ensuring that quality goods are received. Central buying has some advantages such as: ability to buy in bulk and therefore reduce the volume of small orders, knowledge of the most reliable suppliers and being able to plan optimum reorder times and quantities. The existence of a separate purchasing department considerably strengthens internal control because it prevents user departments from ordering goods without the order being subjected to independent check. At the same time the user department checks on the buying department. When the order is raised, it should contain information about price and delivery dates requirement. A delivery address should be quoted. Several copies of the order are usually required. One for the supplier, one for the buying department, one for the accounts department, one for the requisitioned to advise him, that the matter is receiving attention and one to the stores to inform them of what to expect. These LPO's should be pre-numbered. When goods are received, they should be received in areas specially designed for receipt of goods. Goods received notes should be raised; they should be pre-numbered and issued sequentially. Numbering strengthens internal control and reduces the possibility of fake documents. For a goods received note this is very important because it is the prime supporting document for the supplier's invoice. A copy of the goods received note should therefore go straight to the accounts department for this purpose. A copy should be sent to the buying department for matching off in the order file. Any shortages should immediately be notified to the buying department so that appropriate credit can be claimed. The accounts department on receiving the invoices should stamp them, they should then collect all the relevant supporting documents such as goods received notes, copy orders etc. and on this basis should approve the invoice for payment. There should exist a purchases journal, purchases ledger, and a creditors control account.

Before invoices are authorised for payment, they should be checked and the system should require that they should all be presented with their supporting documentation for approval.

2. **Potential errors and irregularities**

Liabilities being incurred but not recorded:

Implications: Understatement of liabilities hence disputes with suppliers.

Measures: The use of pre-numbered goods received notes, the matching of the goods received notes with suppliers statements and invoices, the use of pre-numbered purchase orders and their subsequent matching with goods received notes, investigation of unmatched goods received notes, regular reconciliations between the creditors ledger and the suppliers statements, having a list of approved suppliers.

3. **Potential errors and irregularities**

Making payments without proper documentation and proper authorization e.g. incomplete documentation, forged or fraudulent documentation and duplicate payments.

Implications: Paying for services and goods not received. Overstatement of purchases and expenses.

Measures: A requirement that before any payment is made all invoices must be originals and they must be supported with proper and complete documentation. Once payment has been made on a set of documents, they should be clearly marked that they have been paid to prevent their representation.

4. **Potential errors and irregularities**

Misallocation of charges to the wrong general ledger accounts.

Implications: Mis-statement of various expenses and accounts not giving a true and fair view.

Measures: Coding of all expenses and creditors accounts. On receipt of an invoice, it should be coded and the coding should be checked by an independent clerk. Use of budgetary control measures.

5. **Potential errors and irregularities**

Goods being returned to suppliers without being recorded in their records. Credit notes not being raised or recorded for short deliveries.
Implications: Overstatement of purchases and loss of receipts due to the company.

Measures: All goods returned should have a despatch documentation raised for them. A copy of the despatch documentation concerned should be passed over to the accounts department and the purchasing department for them to liaise with the supplier and follow up the receipt of a credit note. All claims should be subject to numerical control.

Other matters to be considered

Unless documentation is cancelled at the time the cheque is signed, it is possible for a genuine invoice to be represented for a second payment. This usually involves collusion between an employee and the supplier and the company can lose substantial sums of money in this way. Cheque payments should be authorised on the basis of validly approved documentation. The cashier normally draws the cheque which should be crossed account payee. The cheque should then go to the first cheque signatory for signing. There should be a second cheque signatory to act as a check on the first signatory. Limits should be imposed on the signatory and all supporting documentation should be cancelled at the time of signing. When the cheques have been signed they should immediately be despatched to the payee. They should never be returned to anyone who has had anything to do with their preparation or authorization especially not to the cashier for in the right hands, signed cheques are as good as cash as it only takes little skill to be able to alter the name or amount on the cheque.

The cashier should record the payments in the cash book and regular bank reconciliations should be prepared. Where suppliers send statement, reconciliations should also be prepared. Suppliers' statements should never be used as the sole documentation supporting a cheque payment.

Cash payments

The best system to maintain for cash payments is the imprest system. In this system a fixed sum or imprest is assigned to the petty cashier and more cash is only obtainable on the production of vouchers that have been paid. The advantages of this system are:

a) The fixed balance prevents escalation of the amount held, so the amount at risk can be kept small.

b) The system is self checking because each time a reimbursement is required the petty cashier must present his records to the official responsible for examination.

c) Reconciliation of petty cash book is made easier. The amount of the imprest should be as low as possible and the number of floats in use should be kept to a minimum. IOU should not be allowed nor should staff cheques be cashed out of petty cash. No other receipts should go into the petty cash. At the time of the reimbursement, the responsible official should check the petty cash book with the supporting vouchers and should sign it accordingly. Regular surprise cash counts can usefully be made. The accountant has to be on the look out for use of falsified vouchers and the representation of used vouchers. A properly run imprest system is reasonably well protected from material fraud.

Bank and cash balances

Money in all forms is highly susceptible to misappropriation. For this reason regular bank reconciliations should be carried out by senior independent officials. Outstanding items should be investigated, particularly if they are long outstanding.

THE WAGES CYCLE

1. **Potential errors and irregularities**

Can persons other than genuine employees be paid through the payroll? This includes consideration of fraudulent double payment for leavers.

Implications: Overvaluation of stocks by using wrong labour costs, loss to the organization by paying for services never received.

Measures: The personnel department is responsible for hiring and firing personnel. They are also responsible for authorising alterations in rates of pay as a result of promotions or general pay increases. When we have a separate department in existence for personnel matters, then an independent record can be maintained of all personnel in employment and this can provide a very useful check on the work of the wages department. All changes should be notified to the wages department through the use of serially numbered change documents. On the time keeping side, clock card or time sheets are normally used to record the hours worked. In either case the amounts shown by the employee should be verified independently. The clocking in process should be observed by having a time keeper at the gate. This system can be abused and the organization should be alert to this possibility.

Time sheets should be approved by the employees' immediate superior and if possible reconciled to production records. The approved clock cards or time sheets are sent to the wages department for them to produce the payroll. Different clerks in the wages department should check the hours worked as calculated by the foreman. Calculate the gross pay by reference to the employee's personal card showing his wage rate, check the calculation of gross pay, calculate net pay by reference to tax tables and employee's personal records, check the net pay calculations, check the casts and cross casts of the payments. The payroll should be approved by a senior member of the management team. In most organizations this is done by the chief accountant, the personnel manager and the managing director. Before approval, the official can carry out a useful review by casting and cross casting the payroll, scanning the payroll for duplicated names or unusually high payments, check the number of employees on the payroll to personnel records, carry out a month to month reconciliation in both numbers and amounts taking into account leavers and joiners and when they actually left or joined.

Once the payroll is approved the cheque can then be drawn. There should be at least two cheque signatories. Preferably the person who approved the payroll should not be one of the signatories. The money can now be collected from the bank and distributed.

■ The following stages should be followed

1. **Drawing the cheque - the cashier**

Collecting the money from the bank - security firm

Filling the pay envelopes - independent employees

Distributing the cash to the employees - other independent employees and the foreman.

The employees who fill the envelopes should have had no previous dealings with the preparation of the payroll. They should count the money before beginning their work. The exact amount of the payroll should be withdrawn from the bank. Once the envelopes are filled, they should be counted and given to a second batch of independent employees who should check the number of packets handed over before distributing them to employees. The foreman should accompany the pay out in order to identify the correct employee. Where the employee is not present, their pay packet should not be given out to another employee.

2. Potential errors and irregularities

   Employees being paid for work not done or unclaimed wages being misappropriated.

   Implications: Overstatement of stock values due to using wrong labour rates. Pay to an employee whose salary may have been misappropriated by another employee or thief.

   Measures: These have been covered adequately under (1) above under clock cards and time sheets.

3. **Potential errors and irregularities**

   The occurrence of payroll errors: starters, leavers, rate changes.

   Implications: Mis-statements of various expense accounts, wrong stock valuations.

   Measures: Monthly reconciliations, agreement of payroll records with personnel records, independent clerk checking the calculations of the payroll, review of the payroll by department heads, and budgetary control matters.

4. **Potential errors and irregularities**
   Improper deductions being made or being misappropriated.

   Implications: Having to make double payments to the authorities where the deductions have been misappropriated, complaints by employees.

   Measures: Requirement that all deductions be documented and the documentation be approved. The documentation should be checked against the payroll to ensure agreement.

5. **Potential errors and irregularities**

   Inflation of the payroll in other ways.

   Implications: Unreliable records, mis-statements of expenses and stock costs.

   Measures: Monthly reconciliations, checking the payroll by an independent clerk and the review mentioned under (1) above done by the approver of the payroll.

■ Other matters to be considered

If a proper independent record of employees is not maintained, it becomes possible to insert dummy employees on the payroll. Fictitious names can be invented or employees who have retired or left employment may be retained on the payroll. This type of fraud is usually perpetrated by the wages officer. Overstatement of gross pay can also occur when there is collusion between an employee and the wages officer so that he is deliberately overpaid. Overstating the payroll can also occur but can easily be prevented by casting the payroll at the time of approval.

STUDY TEXT

Other Areas

1. General cash: the worry here is miscellaneous receipts being omitted, non-trading or petty cash payments being made and not authorised and the possibility of misappropriation and improper use of cash balances.

2. General ledger: the processing of unauthorised journal entries and the making of errors in subsidiary ledgers.

3. Stocks: the loss or pilferage of stocks, the consumption or wastage without proper recording of stocks, the overstatement or understatement of work-in-progress and

4. Fixed assets: the acquisition or disposal of fixed assets without proper authority or recording.

Other matters to be considered

In the area of stocks and fixed assets the control requirements are primarily concerned with custody procedures. Custody procedures are of great importance because all fraud involves misappropriation of assets. The things to note are:

1. Maintenance of stock records: this should be performed by a person who has not access to the physical stocks and has no responsibility for sales or purchase records.

2. Custody procedures: this can be achieved by using segregated lockable areas under the control of a store man who can be held accountable by means of stock records.

3. Reconciliation of physical quantities to stock records: these reconciliations are vital for the prevention/detection of fraud and to ensure that the stock figure in the accounts show a true and fair view. Internal auditors are the appropriate officials to control the stock count and a subsequent reconciliation. Discrepancies should be referred to the highest level of authority and should be investigated immediately.

4. Writing off damaged, obsolete and slow moving stocks: it is essential that authority for writing off these stocks should come from a senior independent official and only on the basis of appropriate documentary evidence. Such stocks are revealed by periodic stock checks or they come to light during the ordinary course of business.

5. Scrap and waste products: waste products and scraps can have considerable value in certain types of industry. But their control can be difficult. It becomes necessary therefore to have calculations of estimated scrap and waste and this should be compared regularly with actual amounts. Significant differences to be investigated immediately.

6. Concealment of theft by write off: if those who have access to stocks also have the authority to make write offs in the records for damage then theft can be very easily concealed. Similarly people who have access to stocks, if they are permitted to record

the stock records or the sales or purchases records then book quantities can be manipulated so that they correspond with the actual quantities of stock in hand.

FIXED ASSETS

Although most fixed assets are very large and very immovable (no one is likely to steal the whole building), some fixed assets can be small, highly portable and very stealable. Motor cars, bulldozers, power tools and even portable computers all spring to mind. Such items can be very valuable indeed. It is essential that they are adequately controlled.

Authorization and approval of capital expenditure

This should be performed by senior levels of management. Limits should be placed on the authority of each manager with major items of expenditure requiring approval by the board.

Accounting records

The accounting records should be maintained by a person who has no access to the fixed assets and has no responsibility for authorising purchases or sales thereof. There should be clear distinction between capital and revenue items.

Plant registers

Detailed records must be kept as to the location and value of fixed assets. Many companies do not maintain these records. However, if it is maintained, the clerk responsible for it should have no involvement with the assets themselves or with the general ledger or with sales or purchases of fixed assets. This way enables records to provide independent evidence but the value increases if the records are regularly checked to the assets themselves and reconciled to the general ledger. As this work should be done by independent employees, internal auditors are quite appropriate.

Scrapping, sale or transfer of assets

The responsibility for taking assets out of service should be reserved for the highest level of management and then only on the basis of documentation that is properly approved.

Other matters to be considered

Small portable items may simply be stolen from the premises. This can be prevented by ensuring that someone is fully accountable for all items of equipment. We should also have appropriate security measures at all points of access to the company. Regular reconciliations of the plant register to the physical assets should be prepared and explanations sought for any discrepancies from the persons accountable. If people who have responsibilities are also in positions to write up the accounting records or the plant register then by altering the books, they can cancel a misappropriation. An employee who has physical control as well as the responsibility for approving the scrapping of assets may scrap items prematurely. The auditor should also be on the lookout for sale of assets which are no longer required at below market values even though they have not reached their retirement age. Also the use of company assets for private purposes.

INVESTMENTS

By their very definition, investments are valuable. The issues to watch out here for are:

1. Authorization of purchases and sales: these should be performed by very senior level management and those responsible should have no connection with cash or the custody of documents of title.

2. Maintenance of investment register: this should be performed by a clerk who has no access to the documents of title and no responsibility for authorization of purchases or sales. The register requires reconciliation with the investment account in the general ledger. The documents of title should be vouched regularly. Again some work for internal auditors.

3. Maintenance of records: an independent clerk should be given the duty of comparing contract notes with purchase and sales authorization and for ensuring that charges have been correctly calculated. Additional arrangements should be made for dealing with share transfers for ensuring that share certificates are received or delivered and that bonuses, rights issues, capital repayments and dividends or interests are received and properly accounted for. The internal auditors may play an important role in ensuring that this work is well performed.

4. Documents of title: adequate custody procedures must be maintained for documents of title and two senior officials should have responsibility for them. Access to the documents should be by the two officials acting jointly.

THE AUDITOR AND SYSTEMS OF CONTROL AND ACCOUNTING

The accounting system operates within a system of internal control. The accounting system is designed to ensure that every transaction is complete and accurately processed and recorded and that it is valid. The system of internal control is a collection of internal arrangements designed by the management to ensure that the accounting system achieves its objectives.

Ascertainment

The auditor ascertains the system by asking questions of knowledgeable people within the organization. He can also ascertain a system by a study of the systems manual prepared by the client. He can also study the documents used in the organization and he can observe the procedures being performed.

Recording

The auditor must record the system that he has ascertained. This simply means putting it on paper. He can record the system in several ways:

1. Narrative notes: narrative notes are probably the most adaptable means of recording but they have the disadvantages that they can be cumbersome to use, they are difficult to interpret and review and they are awkward to change. It is also difficult to identify if any part of the system has been omitted plus of course the difficulty associated with reading other peoples illegible hand writing. This method is therefore appropriate to small businesses or to an overall record of systems in large companies.

2. Use of internal control questionnaires: In our review of the various cycles we identified measures that an organization can take to prevent and detect errors and irregularities. These measures represent desirable controls than can exist in a system. Now internal control questionnaires are pre-printed documents asking specific questions about the existence of desirable controls in the system. The way they are framed is such that the questions can be answered in a `yes' and `no' manner. A `no' answer implying a weakness in control or a lack of control. `Yes' answers indicate strength. Internal control questionnaires help to ensure that all basic control points are considered and in the context of control evaluation they can be extremely useful but they are not efficient as a means of recording an accounting system because just like narrative notes they can become very cluttered hence becoming difficult to interpret.

3. Flow-charts: a flow chart is a diagrammatic representation of the flow of documents through an accounting system with every check or control recorded on the lines of flow and segregation of duties highlighted. This method of recording ensures as far as possible the completeness of recording because a missed stage would result in a flow line simply stopping in the middle of a page. It eliminates the need for lengthy narrative, it is easy to understand and extract the salient points of control and any related weaknesses. In addition, if the format is standardised then assimilation is made easier. The method however does not facilitate the recording of physical, personnel, supervision or management controls which are usually best contained in narrative notes. A flow-chart is widely regarded as an important tool in the evaluation of systems. It is primarily designed to reveal the absence of essential accounting controls therefore time should not be spent on recording details which are irrelevant to this purpose. Preparing flow-charts is time consuming and for a professional firm expensive to prepare. Consideration must always therefore be given to their cost effectiveness. In most situations it is not appropriate to prepare flow-charts at all. All these techniques can be used at the same time and are therefore not mutually exclusive.

The information required

a) An overall organization chart. We need a chart that will show the principle departments of the company together with the description of their functions and the number of people employed therein. The titles and names of all responsible officials should be recorded along with their lines of responsibility within the organization.

b) A list of the principal books of accounts with a brief description of how each are kept. Records can be kept in many ways, ranging from hand written ledgers through accounting machines to the most sophisticated real time computerised data processing systems. It is essential to have precise details of the methods used.

c) Information as to accounting information flows and controls: this is usually in the form of flow-charts. Anyway whatever method is used it is important to record the person who is responsible at each stage for the authorising, the recording and the custody of relevant assets and records.

d) Narrative notes on appropriate accounting controls particularly with reference to the accountability of employees in each audit area. By this we mean for example authority limits for cheque signatories together with their specimen signatures and in addition a brief description would also be included on any other controls.

After recording the system in whichever way, the auditor needs to corroborate the records. Corroboration means confirming that what he has recorded is what actually takes place. Corroboration is done by use of a walk through test. This involves collecting samples on a judgemental basis of one or two transactions and following them through the system as recorded. The walk through test confirms the records and also confirms the auditors understanding of the system. After corroboration, if it is the system of accounting, the auditor will perform tests and from the results of those tests he will assess its adequacy as a basis for the preparation of the financial statement. To this end I refer you to the chapter on Accounting systems and implications. If it is a system of internal control, after corroboration, the auditor seeks to evaluate those controls. Evaluation of controls is carried out from three points of view with the sole aim of being able to establish whether the system constitutes a reliable basis for the preparation of annual accounts and to determine the required amounts of substantive testing. If internal control is weak it may not be possible to express any opinion at all on the accounts presented. On the other hand, a strong system of internal control can minimise the amount of substantive testing used in arriving at an opinion. The three points of view mentioned are:

1. To consider the possibility of fraud;

2. Possibility of undiscovered errors occurring and

3. Possibility of accounts being deliberately distorted

Evaluations

Evaluation can be approached from the ICQ point of view of trying to determine if desirable internal controls are present in a system and from the view of an ICEQ where we use key control questions to determine if specific errors or irregularities are possible. Let us look at both approaches:

ICQ: We have already met this document which is just a list of questions that typically ask whether certain controls are performed and if so, when, how and by whom. The ICQ is usually formulated such that there is one covering each of the areas discussed under accounting cycles. An example of an ICQ on the purchasing cycle is appended as an appendix to this chapter. ICQ facilitate the orderly valuation of the internal control. They eliminate the possibility of matters being overlooked and they provide a basis for the manager/partner reviews of the opinions reached by the staff in the field. They provide audit evidence of the basis of audit conclusions in the event that the auditor's judgement is subsequently challenged. Their major failings are: they concentrate on the controls themselves rather than the error or irregularity that the controls are designed to prevent or detect. It is also generally considered that these ICQ's can become too complex and cluttered for meaningful evaluation and that in large and complex organizations systems information is best recorded in the form of flow-charts or systems. It is essential that the audit is conducted in a searching and enquiring manner, always bearing in mind the types of problems that may arise. With ICQs it is very easy to forget the significance behind every question and for this reason much of their value is lost and most major firms now adopt the internal control evaluation questionnaire approach.

ICEQs: ICEQs are characterised by the use of the key control questions covering the accounting cycles dealt with earlier which are then backed up by backup questions. Where the system has been recorded by the use of narrative notes or flow-charts weaknesses are not easily apparent as was the case when the ICQ was used. The ICQ is a comprehensive, all inclusive method of ascertaining, recording and evaluating a system of control but where as we have seen the system is recorded in the other two methods then we have need for another document for us to be able to evaluate the strengths and weaknesses of the system. The likelihood of defalcation can be evaluated by determining whether the segregation of duties is satisfactory. The possibility of error can be considered by looking at the checks present in the system in the light of the various types of error possible. The possibility of distortion normally by senior officials cannot be readily determined by questionnaire but may be revealed during the course of evaluation procedures by looking out for signs that the management are under pressure.

STUDY TEXT

Limitations of the effectiveness of internal controls

The auditing guidelines stress that no internal control system however elaborate can by itself, guarantee efficient administration and the completeness and accuracy of the records nor can it be proof against fraudulent collusion, especially on the part of those holding positions of authority or trust. Internal controls depending on segregation of duties can be avoided by collusion. Authorization controls can be abused by the person in whom the authority is vested. Management is frequently in a position to override controls which it has set up itself. Whilst the competence and integrity of the personnel operating the controls may be ensured by selection and training, these qualities may alter due to pressure exerted both within and without the enterprise. Human error due to errors of judgement or interpretation to misunderstanding carelessness, fatigue or distraction may undermine the effective operation of internal control.

The auditor's use of internal control

The auditor's objective in evaluating and testing internal control is to determine the degree of reliance which he may place on the information contained in the accounting records. If he obtains reasonable assurance by means of completeness and accuracy of the accounting records and the validity of entries therein he may limit the extent of his substantive testing. Because of the inherent limitations in even the most effective internal control system, it will not be possible for the auditor to rely solely on its operation as a basis for his opinion on the financial statement. In some enterprises the auditor may be unable to determine whether all the transactions have been reflected in the accounting records unless they are effective internal controls. The types of internal control on which the auditor may seek to rely vary widely. Where the auditor's primary evaluation indicates that there are controls which meet the objective which the auditor has identified then he should design and carry out compliance tests if he wishes to rely on those controls. However, where his evaluation discloses weakness in or the absence of internal controls such that material error or omission could arise in the accounting records or financial statements the auditor will move directly to designing and carrying out substantive tests.

AUDIT TESTING

The auditor is not entitled to place any reliance on internal controls based solely on his preliminary evaluation. He should carry out compliance tests to obtain reasonable assurance that the controls on which he wishes to rely were functioning both properly and throughout the period.

Compliance Tests

Compliance tests are defined as those tests which seek to provide audit evidence that internal control procedures are being applied as prescribed. We have seen that the auditor first ascertains a system of internal control through various means, he then records that system again through various possible means, then through the use of walkthrough tests he seeks to corroborate the record. After corroboration he must carry out an evaluation of the system to determine whether conceptually it is reliable, or has certain key controls upon which he can place reliance.

If he evaluates the system and reaches the conclusion that the system has controls upon which he can place reliance, then the auditor has to make a further decision and this is whether he should carry out compliance tests or not. A point must be made here, it is the application of the system that is being tested not the transactions although the testing is through the medium of transactions. So in carrying out his compliance tests and as exceptions are noted where the system has not been complied with in any particular, then the auditor may need to revise his system description and re-evaluate its effectiveness. He also will need to determine if the failure of compliance was an isolated case or is symptomatic.

Controls and their exercise can leave a visible trail like a signature or a stamp on a document or they may leave no visible trail. Compliance tests therefore can be carried out through inspection of documents to determine whether appropriate signatures and evidence of approval and checking exists, or through observation whereby there is no evidence that a procedure was carried out as expected. The tests carried out by examination of documents can usually be extended and conclusions extrapolated to cover the whole population concerned. However, for those subject to observation we can only draw conclusions based on what was actually observed and we have no evidence that the procedure is performed that way throughout the period.

In compliance tests the issue of materiality does not arise. Every exception is material and should be investigated. If compliance tests disclose no exceptions the auditor may reasonably place reliance on the effective functioning of the internal controls tested. He can therefore limit his substantive tests on the relevant information in the accounting records.

The accountant is concerned as far as every transaction is concerned that it has been recorded and processed completely and accurately and that it is valid. Internal controls are arrangements established by the management to ensure that this is so, therefore compliance tests provide the auditor with indirect evidence that all transactions have been completely and accurately processed and recorded. Example: A key control that the auditor wishes to rely on may be that before the payroll is paid the chief accountant, the personnel manager, and the managing director must sign to approve it. The auditor would therefore select a sample of payrolls and going through them seek to confirm that the appropriate signatures have been appended. Now if he finds that the appropriate signatures are actually appended then it gives him some assurance that everything relating to the payrolls was completely and accurately processed and recorded and all the resultant entries are valid. This is so because we would not expect the chief accountant, the personnel manager and the managing director to approve a payroll that is wrong in some particular. You can see from this that the auditor has not referred to any information contained in any records or any financial statements and yet he has some assurance. Therefore as a result of this, he may limit his detailed tests on the payroll to a minimum.

If the compliance tests have disclosed exceptions which indicate that the control being tested was not operating properly in practice the auditor should determine the reason for this. He needs to assess whether each exception is only an isolated departure or is representative of others and whether it indicates the possible existence of errors in the accounting records. If the explanation he receives suggest that the exception is only an isolated departure then he must confirm the validity of the explanation for example by carrying out further tests. If the explanation or the further tests confirm that the control being tested was not operating properly throughout the period then he cannot rely on that control. In these circumstances, the auditor is unable to restrict his substantive testing unless he can identify an alternative control on which to rely. Before relying on the alternative control he must carry out suitable compliance tests on it. Example: In our payroll example above, suppose the auditor picks five payrolls and on further examination finds that one of them does not have the appropriate signatures. This may mean that maybe responsible officials were on leave in which case the control was not exercised. He could therefore select five more payrolls to confirm that the exception was an isolated one. If he finds out that the payroll is never approved by the three officials as required then he cannot limit his detailed substantive tests and he will have to look for evidence that all the employees on the payroll were genuine, they were paid for work done and the recording was correctly done.

Substantive tests

These are defined as **those tests of transactions and balances and other procedures such as an analytical review which to seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or in the financial statements.** You can see from this definition that all audit work comes within substantive tests; we however use the term to mean all tests other than compliance tests. A substantive test seeks to provide direct evidence of the correct treatment of a transaction, a balance, a liability or any item in the books or the accounts.

The emphasis here is on the information contained in the records or the financial statements and seeking evidence to prove its completeness, accuracy and validity and not a check on the procedures established by the management to ensure that it is so.

Some examples:

1. Transactions: you may find the sale of a fixed asset recorded in the accounting books. The auditor would need to examine the copy invoice, the authority for the transaction, the elimination of that item of fixed assets from the plant register and other books; the accounting treatment and he will also seek evidence that the price obtained was reasonable.

2. Balances: a bank balance recorded in the books. The auditor would need to obtain direct confirmation from the bank, and compare that confirmation with the bank reconciliation and the cash book.

3. Analytical review: the auditor seeks evidence that proper cut off has been achieved. He can do this by examining the gross profit ratio and the accounting treatment of receipts and issues of stock items.

4. Completeness of evidence: the auditor can obtain representation from the company's lawyers that there are no pending legal cases against the company that could result in significant losses.

ROTATIONAL TESTS

In practice the auditor will carry out only compliance tests and substantive tests. Compliance tests to provide him with indirect evidence and substantive tests - direct evidence.

Occasionally however there is reference to rotational tests and these are of two kinds:

1. Visit rotation: this is where the client has numerous branches, factories or locations. It may be impractical to visit all of them each year. In such cases the auditor visits them in rotation such that each will not be visited each year, but all will be visited over a period of time.

2. Emphasis: there are times the auditor rotates audit emphasis. The auditor performs a systems audit on all areas of the clients business every year but he would select one area for special in depth testing. There is opinion that every audit every year must cover all areas adequately, however, as auditors usually serve for several years rotational testing makes sense in terms of effectiveness and efficiency. It is vital that rotational tests are carried out at random so that client staff do not know which areas or locations will be selected in any one year.

TECHNIQUES OF AUDIT TESTING

Under our review of audit evidence we examined techniques of obtaining audit evidence and these are the techniques for audit testing.

Timing of audit testing

1. Walk through tests: their purpose is to conform the correct recording of an accounting system and the auditor's understanding of that system and the related controls. These are therefore best performed:

   a) After recording the system.
   b) The following year if you are the auditor because it is inefficient to ascertain and record the system every year. All the auditor needs to do is to ask the client whether there has been any changes in the system and if there has been no changes then a walk through test confirms that the record is still appropriate.
   c) After an interim audit visit when the auditor comes in for the final audit he can carry out walk through tests to confirm that the systems have not changed.
   d) When the auditor did not prepare the record of the system then he carries out walkthrough tests to confirm his understanding of the system.

2. Compliance tests: the sample should be representative of the whole years transactions. They are usually carried out at the interim audit visit and up-dated at the final visit to ensure that the whole period has been covered.

3. Substantive test: these tests are applied to:

   a) Transaction records where internal controls are weak or non-existent or where the system cannot be relied on.
   b) Unusual, extraordinary or one off transaction and transactions which are not covered by the system.
   c) All assets and liabilities at the balance sheet date.

STUDY TEXT

Therefore we can see that substantive tests are usually carried out at any time during the audit but mostly concentrated at the final visit.

To summarise audit testing

The stages in audit testing are:

1. Internal control evaluations which will be followed by.

2. Compliance testing which gives satisfaction to some extent on the reliability of the records and the controls. This will be followed by:-

3. An overall analytical review designed to expose apparent inconsistencies and abnormalities in the financial statements and the underlying records. These three help us determine the extent of substantive testing. Substantive testing consists of tests that are designed to substantiate the completeness, accuracy and validity of information contained in the accounting records and financial statements. They consist of:

a) Detailed analytical review which is designed to help locate material mis-statements in the accounts by comparing transactions and balances with related items both for the same period and for previous periods.

b) Tests of details which consists of transaction testing and balance testing and are designed to substantiate individual items in the accounts and so gain assurance either about the validity of similar transactions or about the details that underlie the various accounts balances. Test of details consist of transaction testing which is achieved by vouching whereby vouching is defined as proving the authenticity of a recorded transaction, the checking of casts and cross casts, checking of postings and reconciliations. Balance testing is achieved by direct confirmation and the physical inspection; all these give the necessary confidence for the auditor to express an opinion on the accounts.

The Relationship between External Auditing and Internal Auditing

Introduction

Very large organisations (and some small ones) have found a need for an internal audit in addition to an external audit. Internal auditors are employees of the organisation and work exclusively for the organisation. Their functions partly overlap those of the external auditors but in part are quite different.

The *precise* functions of external auditors are either laid down by statute or embodied in a letter of engagement. The functions (which are rarely *precisely* laid down) of internal auditors are determined by management and vary greatly from organisation to organisation.

Internal audit can be defined as:

"an independent appraisal function within an organisation for the review of systems of control and the quality of performance, as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources."

Internal auditing is thus:

a. Carried on by independent personnel. Internal auditors are employees of the firm and thus independence is not always easy to achieve. However it can be assisted by:

- having the scope to arrange its own priorities and activities
- having unrestricted access to records, assets and personnel
- freedom to report to higher management and where it exists to an audit committee
- Having internal audit personnel with an objective frame of mind

The ISA 610, deals with Reliance by External Auditors on the work of the Internal Auditor.

- IA personnel who have no conflicts of interests or any restrictions placed upon their work by management.
- IA personnel having no responsibility for line work or for new systems. A person cannot be objective about something he/she has taken responsibility for. On the other hand the IA should be consulted on new or revised systems
- IA personnel who have no non-audit work.

Since internal auditors are employees it is difficult to ensure that they are truly independent in mind and attitude.

b. an appraisal function. The internal auditor's job is to appraise the activity of others, not to perform a specific part of data processing. For example, a person who spent his time checking employee expense claims is not performing an internal audit function. But an employee who spent time reviewing the system for checking employee expense claims may well be performing an internal audit function.

c. as a service to the organisation.

The management requires that:

i. Its *policies* are fulfilled.
ii. The *information* it requires to manage effectively is reliable and complete.
iii. The organisation's assets are safeguarded.
iv. The internal control system is well designed.
v. The internal control system works in practice.

The internal auditor's activity will be directed to ensure that these requirements are met. The internal auditor can be seen as the eye of the board within the enterprise.

d. Other duties may include:
   i. Being concerned. An example of this is in energy saving.
   ii. Being concerned with the response to the internal control system to errors and required changes to prevent errors.
   iii. Acting as a training officer in internal control matters.
   iv. Auditing the information given to management particularly interim accounts and management accounting reports.
   v. Taking a share of the external auditor's responsibility in relation to the figures in the annual accounts.

2. ESSENTIAL ELEMENTS OF INTERNAL AUDIT

The essential elements of internal audit are:

a. Independence—see above

b. Staffing—the internal audit unit should be adequately staffed in terms of numbers, grades and experience.

c. Training—all internal auditors should be fully trained.

d. Relationships—internal auditors should foster constructive working relationships and mutual understanding with management, with external auditors with any review agencies (e.g. management consultants) and where appropriate with an audit committee. Mutual understanding is the goal.

e. Due care—an internal auditor should behave much as an external auditor in terms of skill, care and judgement. He should be up to date technically and have personal standards of knowledge, honesty, probity and integrity much as an external auditor. It is desirable that an internal auditor is qualified, because of ethical considerations as much as technical standards implied by membership of a professional body.

f. Planning, controlling and recording—fundamentally the internal auditors should behave much as external auditors in this respect. The plan should identify audit areas which may be:

   i. Activity (e.g. payroll, income, stores, purchasing etc.)
   ii. Nature of the audit (e.g. protective, systems audit, value for money)
   iii. Level of audit required (e.g. degree of risk, frequency and extent of audit).

   Internal auditors plan their work strategically (two to five years for all areas to be covered), periodically (typically one year when the strategic plan is translated into a schedule of work) and operationally (each piece of work, in detail).

   Controlling includes supervision and review of internal audit work.

   Working papers should be of a similar detail and standard as those of external auditors.

g. Systems control — the internal auditor must verify the operations of the system in much the same way as an external auditor i.e. by investigation, recording, identification of controls and compliance testing of the controls. However, the internal auditor is also concerned with:

- The organisation's business being conducted in an orderly and *efficient* manner
- Adherence to management policies and directives
- Promoting the most *economic, efficient* and *effective* use of resources and achieving the management's policies.
- Ensuring compliance with statutory requirements
- Securing as far as possible the completeness and accuracy of the records
- Safeguarding the assets

h. Evidence — the internal auditor has similar standards for evidence as an external auditor, he will evaluate audit evidence in terms of sufficiency, relevance and reliability.

i. Reporting — the internal auditor must produce timely, accurate and comprehensive reports to management on a regular basis. These should report on the matters outline in g. above and with the accuracy of information given to management and give recommendations for change.

3. EXTERNAL AND INTERNAL AUDITORS COMPARED AND CONTRASTED

Common interests

a. An effective system of internal control
b. Continuous effective operation of such system
c. Adequate management information flow
d. Asset safeguarding
e. Adequate accounting system (for example to comply with the Companies Act Cap 486)

Differences

a. **Scope**—the extent of the work undertaken. Internal audit work is determined by management but the external auditor's work is laid down statute.

b. **Approach**. The internal auditor may have a number of aims in his work including an appraisal of the efficiency of the internal control system and the management information system. The external auditor is interested primarily in the truth and fairness of the accounts.

c. **Responsibility**. The internal auditor is answerable only to management. The external auditor is responsible to shareholders and arguably to an even wider public. both are of course answerable to their conscience and the ethical concepts of their professional bodies.

Areas of work overlap

This can apply in the following areas:

a. Examination of the system of internal control.
b. *Examination of the accounting records* and supporting documents.
c. Verification of assets and liabilities.
d. Observation, enquiry and the making of statistical and accounting ratio measurements.

Reasons for Co-Operation between External and Internal Auditors

Internal audit is an element of the Internal Control system established by management. Thus as external auditors are accustomed to place reliance on internal controls they will consider if reliance can be placed on this element.

Some of the objectives of internal audit are the same as those of the external auditor. For example, the internal auditor will perform work on the documentation and evaluation of accounting systems and internal controls and will carry out compliance and substantive tests. It makes economic sense to reduce the work of the external auditor by relying on work done by the internal auditor.

Basis of Co-Operation

The external auditor may utilize the work of the internal auditor in two ways:

a. By taking into account the work done by the internal auditor;
b. By agreeing with the management that internal audit will render direct assistance to the external auditor.

Nature of Internal Auditing

The scope and objectives of internal audit ate set by management and vary widely. The areas of activity may include:

a. Reviewing accounting systems and internal control;
b. Examining financial and operating information for management, including detailed testing of transactions and balances;
c. Reviewing the economy, efficiency and effectiveness of operations and of the functioning of non financial controls;
d. Review of the implementation of corporate policies, plans and procedures;
e. Special investigations.

Some of these functions are directly relevant to the objectives of the external auditor—seeking evidence of the truth and fairness etc., of items in the Accounts. Even special investigations may be relevant. For example, an investigation into the extent of slow moving stock is relevant to the value of stock or an investigation into the viability of a branch may be evidence as to the correctness of using going concern values for that branch's assets.

Some of the functions are clearly not relevant to the external auditor's objectives. For example, the cost of a control is not relevant, only its effectiveness.

Some internal audit work is not audit work at all but is part of internal control. For example internal audit in Local Authorities may scrutinize and approve expenses claims. Such work is an internal control but is not auditing.

Assessment

Before placing any reliance on the work of an internal auditor, the external auditor must assess the internal auditor and his work in the following areas:

a. **Independence.** The internal auditor may be an employee of the organisation, but he may be able to organise his own activities and report his findings to a high level in management. an internal auditor on whom the external auditor places reliance must be independent and be able to communicate freely with the external auditor.

b. The **scope** and **objectives** of the internal audit function areas such as 6a and b are likely to be useful to the external auditor. But c., d. and e. may also. For example, an investigation into a fraud may supply evidence to the external auditor that the extent of the fraud is not material.

c. **Due professional care.** To be useful to an external auditor the internal auditor's work must be done in a professional manner. That is, it must be properly planned, controlled, recorded and reviewed. The auditor who arrives in the morning and says to himself "what shall I do today" is not much use.

d. **Technical competence.** Membership of a professional body with its competence and ethical implications is desirable. Ongoing training in specialist areas, such as computers, is useful.

e. **Reporting standards.** A useful internal auditor will provide high standard reports which are acted upon by management.

f. **Resource available.** An internal audit department that is starved of resources will not be very useful to the external auditor.

The assessment should be thorough and fully documented and included in the working papers. If the conclusion is that the internal audit department is weak or unreliable, then this fact should be communicated in the external auditor's "report to management".

Extent of Reliance

The extent of reliance depends on many factors including:

a. The **materiality** of the areas or items to be tested. Petty cash expenditure may probably be left to the internal auditor.
b. The level of **audit** risk inherent in the areas or items. The value of work in progress in a Civil Engineering company or the provision for doubtful debts in a Hire Purchase company, are high risk areas which the external auditor must see to himself.
c. The level of **judgement** required. The level of delay repairs in a truck leasing company requires careful judgement.
d. The sufficiency of **complementary** audit evidence. The internal audit may be relied upon to audit debtors accounting procedures if the external auditor has evidence in the form of a debtor's circularisation.
e. **Specialist** skills possessed by internal audit staff. In a Bank, the internal audit department will have specialist knowledge and skills in the appraisal of the Bank's computer system.

Detailed Planning

Having decided that he *may* be able to place reliance on the work of the internal auditor, the external auditor should.

a. Agree with the chief of internal audit the timing, test levels, sample selection procedures and the form of documentation to be used;
b. Record the fact of his intended reliance, its extent and the reason for the fact and extent, in his working papers;
c. Confirm with top management that he is doing so.

Controlling

In order to be able ultimately to place reliance on the work of the internal auditor, the external auditor should:

a. Consider whether the work has been properly staffed, planned, supervised, reviewed and recorded;
b. Compare the results with other evidence (e.g. Debtors circularisation);
c. Satisfy himself that any unusual or "put upon enquiry" items have been fully resolved;
d. Examined the reports made and the management's response to the reports;
e. Ensure the work is to be done in time.

At the conclusion, the arrangements should be reviewed to make things even better next year.

Recording

The external auditor will have a high standard of recording in working papers. The internal auditor's work must be equally good if it is to be relied upon.

Evidence

The detailed material in this chapter is important for students, but you should not lose sight of the fact that an audit is about *audit evidence*. The work of the internal auditor is evidential material. Whether it is good evidence supplying a reasonable basis for conclusions to be reached, is a matter of judgement. It may be desirable for the external auditor to test the work of the internal auditor by supplementary procedures or by re-testing transactions or balances tested by the internal auditor.

Report to Management

Whether or not any work of the internal auditor is relied upon, the internal auditor may uncover and report on weaknesses in internal controls. If the internal auditor reports to management and management responds, then the matter may rest there. If, however, weaknesses are material and the response by the management inadequate, then it may be desirable to include the weaknesses in the external auditor's **own report to management.**

4.0 THE IMPACT OF DEVELOPMENTS IN INFORMATION TECHNOLOGY

Internal Control Considerations

For an accountant, we can look at problems of computerisation from two angles. Their impact on the system of internal control and their implications for the auditor.

The impact of computers in the system of internal control

There are special characteristics of an EDP system that the accountant must be aware of. Their basic differences from a manual system are:

(a) **EDP systems take much longer and are more difficult to install.** Inefficient installation can therefore result in major problems including accounting chaos that can lead to the accountant being unable to determine the truth and fairness of the accounts and at times can lead to the failure of the company.

(b) **EDP systems are much more complicated and therefore can create problem of understanding for the accountant be he the auditor or just the company's accountant**.

(c) **The natural division of data processing between various parts of an organization and its accounting department is usually lost together with the understanding of the interest in data processing which managers have.** This is because a large part of that data processing operations become centralised and there is concentration of power in the computer department. This may facilitate error and fraud and make its discovery difficult.

(d) **The steps of processing and storage of data on magnetic files leaves no visible trail unless they are printed out**. Most modern systems rely heavily on direct entry of data via key boards and the storage of data on discs. There is often no print out of outputs as information can be assessed as required on visual display units.

(e) **Generally speaking, if correct data is presented to the machine and faultless computer programmes are used the output should be error free**. These however reinforce the mistaken belief that machines do not make mistakes. But machines cannot be relied upon to recognize nonsense data. A machine will not think, it will do as it is told. Therefore if it has been instructed incorrectly it will always correctly make the same mistake, whereas a clerk in a manual system would be expected to notice and query this.

(f) **Speed.** A computer's potential for producing information in both terms of volume and speed is of course vast but its potential as vehicles of manipulation and fraud is equally great, and even if we were to leave aside the question of fraud, it is generally true that when production of vital data is dependent on a computer if things go wrong, they may go wrong on a truly big scale.

All these differences radically alter the way in which accounting data is recorded, the way in which such recording must be controlled and authenticated, the training needs and attitudes of the staff responsible at both management and technical levels and the way in which the process and its results must be audited. This may therefore mean the introduction of additional controls within the organization to deal with the additional problems.

The general controls that need to be incorporated into the data processing system are divided into two types of controls:

(a) **General controls** which are further divided into administrative controls and systems developments controls

(b) **Application controls**

General controls: Administrative controls:

These arise from the risks implicit in the concentration of power in the EDP department, the carrying of a large number of files of important data centrally stored and storing data in a form which is highly inflammable concentrated, sensitive to temperature and atmospheric conditions and dependant for processing on machinery which is susceptible to break down. The measures that will have to be taken to minimise the possibility of loss from these problems include:

i. Physical facilities such as a specially designed fire proof room whose temperature is properly controlled and entry is restricted to only authorised personnel.

ii. Maintaining back up copies of all important programmes and files. This includes the grand father and son configuration whereby three files are maintained at different levels and at different locations to enable reconstruction to take place should the need arise.

iii. Having standby arrangements like uninterrupted power supply units to deal with power blackouts and having arrangements with other users of similar machines to allow processing of urgent information should the machines breakdown. These procedures should be subjected to regular checks to confirm that they do work in practice.

iv. The maintenance of a library to ensure that access to programmes and files is properly controlled.

v. Adequate division of duties. The presence of computers does not dispense with the need to observe that fundamental aspect of internal control i.e. the division of responsibilities in such a way as to ensure that:

   (a) Those in a position of responsibility do not themselves become involved in executing the routine of the procedures they have authorised.

   (b) Those occupied with recording functions do not have control over or access to the assets whose movements they are controlling and recording.

   (c) That the work of one person is automatically checked for authority, accuracy, completeness and procedural adherence by another independent member of staff preferably in a different department. The clerical responsibilities that need to be taken into consideration in the user departments can be allocated in relation to collection and sorting of input data, creation of batches and batch totals, retention of control data for comparison with outputs, authorisation of inputs to be transmitted to the EDP department, collection and distribution of outputs, comparison of output received e.g. schedules, statistical summary, exception reports, error reports and reprocessing requirements.

Within the computer area itself, the principles of this aspect of internal control must be observed. Systems development staff and programmers should play no part in actual processing in fact, ideally they should have no access to the computer room. This is because having written the programs they will be aware of the controls that have been written into the programs and will therefore be capable of by-passing them. Development staff should not even be allowed to test their programs. The EDP manager and his supervisors who between them are responsible for all activity in the EDP area must maintain their independence of all detailed procedures and they should therefore have no active part in day to day routine processing. A suitable log for recording the movement of all files, their safe custody when not in use, their clear identification at all time should be maintained and this should be the responsibility of the librarian who should have no routine duties in the EDP section. In addition, a console log is needed as an important security function for making permanent records of every operator intervention.

Systems development controls

These are intended to ensure that we have a valid system of processing whenever new applications are devised, meeting the requirements of management and user department. These aims are achieved by:

(a) The use of standard documentation;
(b) The use of standard procedures whenever possible;
(c) Specifying rigid authorisation procedures whenever new applications are envisaged or existing programs amended or extended;
(d) The adoption of adequate testing routines prior to implementation and;
(e) Instituting a comprehensive system of program and document security.

The stages of systems development may be briefly summarised as follows:

i. **Feasibility:** A committee which would usually include the EDP manager and head of the user department concerned will consider the feasibility of each proposed application from the view points of financial viability and technical capability. The decision therefore rests on the familiar cost benefit equation. The benefits of the new application must be weighed against the cost. If the project is assumed feasible, then the next stage is commenced. It may be advisable to inform the auditor to obtain his input at this stage because the auditor is an expert on systems of internal controls; he is also very knowledgeable on the requirements of the Companies Acts as far as proper books of accounts are concerned. He may also have requirements that need to be taken into consideration and he may also know the best suppliers of the equipment that would be more suitable for the company's needs.

ii. **Systems Analysis:** The systems analysts are highly trained members of the development personnel. They will consider every new application from every relevant angle taking into account the needs of all those affected by the proposed changes. The external auditor should be consulted at this point on particular features which he requires to be included. This will save the problem of the loss of audit trail that frequently occurs. Once all the users including the auditor have been consulted as to their specific needs and the manner in which their work will be affected by the new procedures and documentation, the systems analyst then set out the program requirements in the form of flow charts known as block diagrams. These must be approved before programming can begin.

iii. **Programming:** Compared with systems analysis which requires a certain degree of creativity and imagination, programming is a mechanical exercise mainly requiring strict adherence to the logical steps which one by one make up the program.

iv. **Program testing:** Program testing is divided into desk checking which as the name suggests takes place at the desk rather than on the computer. Here each instructions is tested by the programmers for logic, consistency and accuracy with reference to created test data. As each logic error is discovered the necessary corrections are made. This is called debugging. The use of test packs. Created data designed to highlight as many problems and potential logic errors as possible are punched and run on the computer against the new program. The output will then be closely compared with pre-prepared hand written results and any further errors revealed will be corrected. **Pilot running:** In this case the new programs are tested against batches of live data covering the range of possible inputs as comprehensively as possible. Once again this is compared with manually prepared results. The chief programmer will then inform the EDP manager that the program has been thoroughly tested and debugged and is performing the task it was designed for.

v. **Parallel running:** This stage requires the new system and the existing system to operate side by side for a lengthy period during which results are compared. This is designed to ensure that the program responds correctly to the real processing requirement of the user department involved, that adequate computer time will be available, that any errors remaining can be eliminated and that the user department staff get used to the new routines and documentation. It may be useful to get the auditor in to carry out a few tests to enable him assess the adequacy of the controls incorporated in the systems design.

vi. **File conversion:** Assuming that all the previous five stages have been successful and have been duly approved, then all the files need to be converted into computer format. This is usually a troublesome and time consuming exercise and before the manual records are destroyed, it is important to ensure that the converted files are accurate, complete and up-to-date.

Application Controls

Application controls codify the operating routines to be followed by the EDP and the user departments in their relations with each other. Application controls cover:

(a) The preparation of inputs and its transfer to the computer;
(b) The processing of data within the computer;
(c) The preparation of outputs and its distribution;
(d) The maintenance of master files and the standing data contained therein.

We can therefore say that application controls are mainly concerned with completeness of inputs, completeness of processing, accuracy of input, accuracy of processing, validity of data processed and the maintenance of data files.

Application Controls

Completeness: Input

Purpose: All transactions are recorded, input and accepted by the computer (Control over the numbers of documents). Each document is processed only once.

Some control techniques which may be applied by the computer (programmed procedures) or by the user (Manual). All rejected data must be investigated and corrected. Control data, matching sequence, one for one.

Completeness: Processing

Purpose: All input and accepted data updates the master file. Output reports are complete.

Control techniques include Control totals, matching sequence, one for one, summary processing (all after updates).

Accuracy: Input

Purpose: Control over the data fields to ensure the accuracy of data transcribed from source to input-document (where applicable) and the data are accurately converted to machine-readable form.

Control techniques include Control totals matching, one for one, programmed checks (e.g. reasonableness).

Accuracy: Processing

Purpose: Accurate data are carried through processing to the master file. Computer generated data are accurate. Output reports are accurate.

Control techniques include Control (after update) one for one, summary processing, manual reconciliation of accepted items, totals with file totals.

Master Files and Standing Data: Validity

Purpose Only authorised data updates the master files. No changes to the data are made after authorisation.

Control techniques include Programmed checks (e.g. authority limits), manual authorization and review.

Master Files and Standing Data: Maintenance

Purpose: Data on master files cannot be changed without authority and there are no long outstanding or unusual items on file.

Control techniques include: Manual reconciliation of file totals with manual control account, exception reports.

Tests the auditor does and all these application controls are to be found in the Appendix.

Auditors are bound to investigate the system of internal control of their client's organization before the execution of detailed audit tests. The system produces the records; the records produce the final accounts on which the auditor has to report. In an EDP system the nature of internal controls is strikingly different and therefore it becomes necessary for the auditor to open his mind to changes which become necessary. In a conventional system, visual scrutiny of every function is possible at every stage of recording and the allocation of duties is relatively straightforward.

The Auditor's Approach

If we look at the basic differences between computerised and conventional systems we will be able to appreciate the impact they have on the auditor's approach. If we revisit these differences, we can classify them as follows:

(a) **The complexity of computerised systems**: Usually an auditor can fully understand a conventional system in a matter of hours at the most, whereas a computerised system cannot easily be comprehended without expert knowledge and a great deal of time.

(b) **A separation between the computer and the user department**: The natural checks on fraud and error normally provided by the interaction of user personnel and accounting personnel no longer applies in a computer environment. This leads to reluctance on the part of the auditor to rely on internal controls in a computerised system.

(c) **Lack of visible evidence**: Data in computer systems is stored primarily on magnetic discs. This information is not easy to examine. This creates problems for the auditor, it must however be appreciated that most computer installations in Kenya produce acres of print out and the auditor may be faced with too much record rather than too little. After all the management is also interested in running a business and needs these records.

(d) **Most data on computer files is retained for short periods**: Manual records can be retained for years. These records may be kept in a manner which makes access by the auditor difficult and time consuming.

(e) **Computers systems can have programmed or automatic controls:** Therefore their operation is often difficult to check by an auditor.

(f) Since programs operate automatically without personnel being aware of what the program is doing, any program with an error is likely to process erroneously for ever.

(g) **Use of outside agencies**: Sometimes the client uses a computer bureau to maintain their accounting records. The problems here for the auditor are in being able to examine controls and systems when access is not a legal right.

Changes in audit approach:

Systems design: In conventional systems the auditor finds out about the client's system. In a computerised system, it is advisable for the auditor to be there right from the design stage, when the systems are set out.

Timing of audit visits: More frequent visits may be required because there may be changes in systems and programs, print outs are often shredded and magnetic files overwritten. Frequent changes occur in filing order and the audit trail has to be followed while it still exists.

Systems review: This follows the normal way of using a questionnaire but is more difficult because EDP systems are more complex, technical language is used, too much documentation is available, many controls are program controls meaning that their evaluation may require detailed study of programs which are written in high level languages or in machine code, and frequent changes are made to systems and programs.

Audit tests: These will have to differ from those used in manual systems to reflect the new records being examined.

The Control File

When auditing EDP systems, it will be found that much reliance is placed within the system upon standard forms and documentation in general, as well as upon strict adherence to procedures laid down. This is no surprise, of course, since the ultimate constraining factor in the system is the computer's own capability, and all users are competitors for its time. It is therefore important that an audit control file be built up as part of the working papers, and the auditor should ensure that he is on the distribution list for notifications of all new procedures, documents and systems changes in general. The following should be included in the audit control file.

(a) Copies of all the forms which source documents might take, and details of the checks that have been carried out to ensure their accuracy.
(b) Details of physical control over source documents, as well as of the nature of any control totals of numbers, quantities or values, including the names of the persons keeping these controls.
(c) Full description of how the source documents are to be converted into input media, and the checking and control procedures.
(d) A detailed account of the clerical, procedural and systems development controls contained in the system (e.g. separation of programmers from operators; separation of control of assets from records relating thereto).
(e) The arrangements for retaining source documents and input media for suitable periods. This is of great importance, as they may be required for reconstructing stored files in the event of error or mishap.
(f) A detailed flow diagram of what takes place during each routine processing run.

(g) Details of all tapes and discs in use, including their layout, labelling, storage and retention arrangements.

(h) Copies of all the forms which output documents might take, and details of their subsequent sorting and checking.

- The auditor's own comments on the effectiveness of the controls.

Auditing Around the Computer

When it is possible to relate on a one to one basis, the original input to the final output or to put it another way, where the audit trail is always preserved than the presence of the computer has minimal effect on the auditor's work, and in that case it is possible to ignore what goes on in the computer and concentrate audit tests on the completeness, accuracy, validity on the input and the output, without paying any due concern to how that output has been processed. Where there is super abundance of documentation and the output is as detailed and complete as in any manual system and where the trail from beginning to end is complete so that all documents can be identified and vouched and totally cross referenced, then the execution of normal audit tests on records which are computer produced but which are nevertheless as complete as above then this type of auditing is called auditing around the machine. In this case, the machine is viewed as simply an instrument through which conventional records are produced. This approach is much criticised because:

i. It indicates a lack of knowledge on the part of the auditor;
ii. It is extremely risky to audit and give an opinion on records that have been produced by a system that the auditor does not understand fully, and;
iii. A computer has immense advantages for the auditor and it is inefficient to carry out an audit in this manner.

However, problems arise when it is discovered that management can use the computer more efficiently in running the business. This is usually done by the production of exception reports rather than the full records. For example, the management is interested in a list of delinquent debtors, therefore producing the whole list of debtors means the list has to be analyzed again to identify delinquent debtors and act upon them. This is inefficient and time consuming as the printer is the slowest piece of equipment in any computerised system. From the auditor's view, exception reports which provide him with the very material he requires for his verification work raises a serious problem because he cannot simple assume that the programs which produce the exception reports are:

i. Doing so accurately;
ii. Printing all the exception which exists;
iii. Are authorised programs as opposed to dummy programs specially created for a fraudulent purpose or out of date programs accidentally taken from the library and;
iv. That they contain programs control parameters which do in fact meet the company's genuine internal control requirements.

So although it may be reasonable for management to have faith in their systems and programs, such faith on the part of the auditor would be completely misplaced and may reflect very adversely on his duty of care. This is the first situation on the loss of audit trail.

The other situation where loss of audit trail is noted where the computer generates, totals, analyses and balances without printing out details. It therefore becomes necessary for the auditor to find a way to audit through the computer rather than around it. But before we go on to that, the loss of audit train can be overcome as follows:

(a) We can have special print outs for auditors, remember the need to be consulted at the design stage.

(b) Inclusive audit facility: This means putting in the programs special audit instructions that enable the computer to carry out some audit tests and produce print outs specially for the auditor.

(c) Clerical recreation: Given unlimited time and man power, maintain the possibility to recreate manually the audit trail. This would obviously be a very tedious exercise.

(d) Total testing and comparison: It is possible to compare results with other data, budgets, previous periods and industry averages.

(e) Alternative tests: We can perform stock takes, debtors' circularisation and examination of the condition of fixed assets.

(f) We can use test packs to verify program performance.

Auditing Through the Computer

There are basically two techniques available to the auditor for auditing through the computer. These are a use of test packs and the use of computer audit programs. These methods are ordinarily referred to as computer assisted audit techniques (CAATs).

Test packs: These are designed to test the performance of the clients' programs. What it involves is for the auditor either using dead data i.e. data he has created himself or live data i.e. the client's data that was due for processing to manually work out the expected output using the logic and steps of the program. This data is then run on the computer using the program and the results are compared. A satisfactory outcome gives the auditor a degree of assurance that if that programme is used continuously throughout the year, then it will perform as required. You can see that this technique of test packs falls under compliance testing work.

(a) Live testing has the following disadvantages:

i. If the data is included with normal data, separate test data totals cannot be obtained. This can sometimes be resolved by the use of dummy branches or separate codes to report the program's effects on the test data.

ii. Side effects can occur. It has been known for an auditor's dummy product to be included in a catalogue.

iii. Client's files and totals are corrupted although this is unlikely to be material.

iv. If the auditor is testing procedures such as debt follow up, then the testing has to be over a fairly long period of time. This can be difficult to organise.

(b) Dead testing has the following disadvantages:

i. Difficulties will be encountered in simulating a whole system or even a part of it.

ii. A more detailed knowledge of the system is required than with the use of live files.

iii. There is often uncertainty as to whether operational programs are really being used for the test.

iv. The time span problem is still difficult but more capable of resolution than with live testing.

Computer audit programs. These consist of computer programs used by an auditor to read magnetic files and to extract specified information from the files. They are also used to carry out audit work in the contents of the file. These programs are sometimes called enquiry or interrogation programs. They can be written by an audit firm themselves or they can be found from software houses. They have the advantage that unskilled staff can easily be taught to use them.

STUDY TEXT

Uses of computer audit programs

Selection of representations or randomly chosen transactions or items for audit tests, e.g. item number 36 and every 140th item thereafter. Scrutiny of files and selection of exceptional items for examination e.g. all wages payments over Kshs.120, or all stock lines worth more than Kshs.1,000 in total. Comparison of two files and printing out differences e.g. payrolls at two selected dates. Preparation of exception reports e.g. overdue debts. Stratification of data e.g. stock lines or debtors; with a view to examination only of material items. Carrying out detail tests and calculations. Verifying data such as stock or fixed assets at the interim stage and the comparing of the examined file with the year end file so that only changed items need be examined at the final audit (with a small sample of the other unchanged items). Comparison of files at succeeding year ends e.g. to identify changes in the composition of stock.

Advantages

1. Examination of data is more rapid;
2. Examination of data is more accurate;

3. The only practical method of examining large amounts of data;
4. Gives the auditor practical acquaintance with live files;
5. Provides new opportunities to the auditor;
6. Overcomes in some cases a loss of audit trail;
7. Relatively cheap to use once set up costs have been incurred;

Disadvantages

1. Can be expensive to set up or acquire.
2. Some technical knowledge is required.
3. A variety of programming languages is used in business. Standard computer audit programs may not be compatible.
4. Detailed knowledge of systems and programs is required. Some auditors would dispute the need for this detailed knowledge to be gained.
5. Difficulty in obtaining computer time especially for testing.

There can be no doubt that standard computer audit program packages will be in general use in the near future. Use of audit software raises the visibility of the auditor in the eyes of the company. It makes the audit more credible. Deficiencies in the system are often discovered and can be reported to management. This also makes the audit more credible. Packages are not however usually available for small machines.

ON-LINE AND REAL TIME SYSTEMS

Traditional batch processing has the advantages that the data can be subjected to checks for validity, accuracy and completeness before it is processed. But for organizations that need information on strict time scale, this type of processing is unacceptable. This has led to the development of on-line and real-time systems and the number is growing particularly in airline offices, banks, building societies and other financial institutions. The auditor's duties do not change but his techniques have to change. The key features of these systems are that they are based on the use of remote terminals which is just a VDU and keyboard typewriter. These terminals will be scattered within the user department and they have access to the central computer store. The problem for the auditor arises from the fact that master files held in the central computer store may be read and up-dated by remote terminal without an adequate audit trail or in some cases, any record remaining. Necessary precautions have to be made therefore to ensure that these terminals are used in a controlled way by authorised personnel only. And the security techniques include:

i. Hardware constraints e.g. necessitating the use of a key of magnetic-strip badge or card to engage the terminal, or placing the terminal in a location to which access is carefully restricted, and which is constantly monitored by closed-circuit television surveillance systems;

ii. The allocation of identification numbers to authorised terminal operators, with or without the use of passwords; these are checked by the mainframe computer against stored records of authorised numbers and passwords;

iii. Using operator characteristics such as voice prints, hand geometry (finger length ratios) and thumb prints, as a means of identification by the mainframe computer;

iv. Restricting the access to particular programs or master-files in the mainframe computer, to designated terminals; this arrangement may be combined with those indicated above;

v. In top-security systems, the authority to allocate authorities such as those indicated above (i.e. determination of passwords, nominating selected terminals), will itself be restricted to senior personnel, other than intended users;

vi. A special file may be maintained in the central processor which records every occasion on which access is made by particular terminals and operators to central programs and files; this log will be printed out at regular intervals e.g. the end of each day, or on request by personnel with appropriate authority.

What differentiates an on-line system from a real-time system is that the on-line system has a buffer store where input data is held by the central processor before accessing the master files. This enables the input from the remote terminals to be checked by a special scanning program before processing commences. With real time systems however, action at the terminal causes an immediate response in the central processing where the terminal is online. Security against unauthorised access and input is even more important in real-time systems because the effect of the input is that it instantaneously updates the file held in the central processor and any edit checks on the input are likely to be under the control of the terminal operators themselves. In view of these control problems, most real time systems incorporate additional controls over the scrutiny of the master file for example, logging the contents of the file before look and after look.

SYSTEMS AUDIT APPROACH

The systems audit is based on the following:

The volume of transactions in a modern company and the cost of auditing preclude the examination and verification of every transaction followed by the summarization of the transactions into the financial statements.

The verification of all transactions would not in itself be sufficient because it would not give any assurance as to the completeness of transactions.

The systems based audit depends on reliance on systems which prevent or detect any variation from correct processing of documents into entries in the financial records, and hence their inclusion in the financial statements. The auditor needs to understand the system and verify that controls are effective throughout the period under review.

The Internal Control System

ISA 315 *Risk Assessments and Internal Control* defines the internal control system as comprising the *control environment and control procedures*. It includes all the policies and procedures adopted by the management of an entity to assist in their objective of achieving, as far as practicable, the orderly and efficient conduct of the business, including adherence to management policies, the safeguarding of asses, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

Control environment means **the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance to the entity**. It encompasses management style, corporate culture, values, philosophy and operating style, the organizational structure, personnel policies and procedures.

Personnel policies and procedures, for example, would include those covering recruitment, retention and dismissal. The organizational structure should have clear lines of reporting responsibility and the maintenance of an internal audit function and audit committee demonstrates a commitment to high level controls. The use of management accounts for the purpose of variance analysis is also a high level control.

The control environment provides a background to detailed control procedures. It does not itself, of course, ensure the effectiveness of the internal control system as a whole.

Control procedures are those established to achieve the entity's specific objectives. These objectives in an accounting context include the proper authorization, timely and accurate recording of transactions in the correct period, the safeguarding of assets and ensuring he existence of assets recorded. They include particular procedures to prevent, detect and correct errors. They differ from entity to entity and are affected by the size of the entity.

In practice, the choice of controls may reflect a comparison of the cost of operating individual controls against the benefits expected to be derived from them.

Many of the internal controls which would be relevant to the larger enterprise are not practical, appropriate or necessary in the small enterprise. Management of small enterprises have less need to depend on formal internal controls for the reliability of the records and other information because of their personal contact with or involvement in the operation of the enterprise itself.

At its simplest, companies need internal controls to stop things going missing and to make some sense of how the business is doing. Documents get lost and assets go home with the staff even where there are controls in place to record everything. Managers have a gut feeling for how the business is doing, but when all they have to prove it is three large boxes stuffed full of invoices and two large boxes full of expenses (and neither of these are quite complete), they may find it difficult to prove their ideas to the taxation authorities and of course they may well be very wrong.

Documents are batched and pre-numbered so that one can check they are all there. If some sale invoices have gone missing we may not be collecting what is owed to us. This means that our cash flow suffers and we cannot pay our debts. It also means that our financial statements may be wrong. If our financial statements understate our income we will find it more difficult to obtain finance from the bank and if we are a listed company, we will appear less attractive to investors. If our purchase invoices go missing, or if we do not match goods received notes to invoices at the period end in order to arrive as goods received not invoiced figure, matters are even worse. We think we are making good profits but we are not. We spend money that is owing to payables and when they present their final demands we have no cash and they threaten to put us into liquidation. Business goodwill is damaged. We then have to adjust profits downwards and we are accused of misleading the bank about our profits in order to obtain finance.

But what if the amounts involved are small? Does one invoice really matter? Experience shows that if one invoice has gone missing it is highly likely that several more are also missing and the larger the organization gets, the bigger the numbers get and the tighter the controls have to be to prevent significant errors.

Why so many authorization controls? In order to allocate responsibility and deal with everyday problems. If fifteen people are involved in the processing of one invoice and something is badly wrong with it, there has to be a mechanism to show that the error occurred at a particular stage. If we do not do this, errors continue to happen, no-one takes responsibility and the organization gets a reputation for inadequate administration and inefficiency, and frauds become possible. Say for example, a clerk routinely authorizes a false purchase invoice raised by friend outside the company. The company pays the invoice and the clerk and his friend share the proceeds. This is a very common type of fraud. Controls to prevent this require payments to be authorized only with reference to purchase invoices that are attached to goods received notes, or authorizations for the receipt of services by mangers completely unconnected with the accounting function.

ISA 315 states that internal controls within an accounting system are need to ensure that:

1. Transactions are executed in accordance with general or specific authority

2. All transactions are recorded at the correct amount in the correct account in the proper period so as to permit the preparation of financial statements.

3. Access to assets and records is authorized

4. Recorded assets are compared with existing assets periodically and appropriate action is taken with regards to differences.

Why internal control interests the external auditor

At an early stage in his work the auditor will have to decide he extent to which he wishes to place reliance on the internal controls of the enterprise. As the audit proceeds, that decision will be kept under review and depending n the results of his examination he may decide to place more or less reliance on these controls.

The principal reason why internal control interests the auditor is that the reliance on internal control will reduce the amount of substantive testing of transactions and resultant balances in the ledger accounts required.

The operation of internal controls should ensure the completeness and accuracy of the accounting records. If the auditor is satisfied that the internal control system is functioning, there is therefore a reduced risk of error in the accounting records.

It is very important to the auditor therefore to establish what internal control system exists and then to test that system to ensure that it is working properly.

Another reason that the auditor needs to consider the adequacy of the accounting system is that the auditor usually has an additional responsibility under legislation to form an opinion as to whether proper accounting records have been kept. This implies the operation of a sound system of internal control.

By recording the accounting system and checking its operation by tests of control, the auditor can reduce the amount of substantive procedures. The total amount of work is reduced as a result.

Specific control procedures

These include:

1. Reporting, reviewing and approving reconciliations.
2. Checking the arithmetical accuracy of the records
   Such controls include checking the cash in a purchase invoice, and recalculating the sales tax on sales invoices
3. Controlling applications and the environment of computer information
   These are dealt with later in the text
4. Maintaining and reviewing control accounts and trial balances
   Control accounts include receivables and payables ledger control accounts, bank reconciliations and non-current asset registers.
5. Approval and control of documents.
   In a purchase system for example, there should be present authority limits. An order to the value of $1,000 could be approved by a department head, up to $5,000 by anyone director, and beyond this by the Board as a whole.
6. Comparing internal data with external sources of information.
   This might include supplier statement reconciliations.
7. Comparing the results of cash, security and inventory counts with the accounting records
8. Limiting direct physical access to assets and records
   An important general principle with respect to assets and records is that of segregation. In particular there should be a division of responsibilities for:

   (i) Authorizing or initiating the transaction
   (ii) The physical custody and control of assets involved

(iii) Recording the transaction
No one person should be in a position both to misappropriate an asset and to conceal his act by falsifying the records. For example, in a sales system the duties of receiving money from customers and writing up the sales ledger should be separated. If not, money could be misappropriated and the records falsified to cover this.

9. Comparing and analyzing the financial results with budgeted amounts.

The control environment

Auditors need to consider the control environment of the client as it provides the background against which the various other controls are operated. However a strong control environment does not, by itself, ensure the effectiveness of the overall internal control system. Factors reflected in the control environment include the following:

- The philosophy and operating style of the directors and management
- The entity's organizational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory controls)
- The directors' methods of imposing control, including the internal audit function, the functions of the board of directors and personnel policies and procedures.

Understanding the system

As we have seen before, ISA 315requires that auditors obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach, whether that be a systems based approach, or a substantive approach. It also helps with the assessment of inherent and control risk. If control risk is to be assessed as less than high, the justification for that assessment must be documented.

This understanding can be updated year on year and auditors often perform 'walk through' tests, to ensure that their understanding and documentation of the system are correct. This simply involves taking a transaction through the system from source to destination and can often 'double' as a test of control and as a substantive procedure, depending on which elements of the transactions are checked. Such tests are particularly useful where the auditor is relying on the client's documentation of the system.

Proper Accounting Records

Remember that most companies are under a legal obligation to keep proper accounting records and that auditors are required to form an opinion as to whether they have done so. Most national laws require that the accounting records must be sufficient to show and explain the company transactions and must be such as to:

(a) Disclose with reasonable accuracy, at any time, the financial position of the company at that time, and

(b) Enable the directors to ensure that any balance sheet and income statement comply with the requirements of the legislation as to their form, contents and otherwise.

National legislation often prescribes specific books and accounts that must be kept. In countries with a Civil Code legal tradition, it is common to have a 'Chart of Accounts' that all companies are required to maintain in some form. There is also detailed guidance on what type of transactions should be posted to the various accounts. Common Law tradition countries such as the UK, the US, Canada and Australia do not have charts of accounts. They are of course required to prepare accounts in accordance with specific formats laid down in legislation and accounting standards. IAS 1 Presentation of Financial Statements contains pro-formas for the balance sheet and income statement of financial statement prepared under IASs.

Adequacy of the accounting system

An accounting system should provide for the orderly assembly of accounting information and appropriate analyses to enable financial statements to be prepared. What constitutes an adequate accounting system will depend on the size, nature and complexity of the enterprise. In its simplest form for a small business dealing primarily with cash sales and with only a few suppliers the accounting system may only need to consist of an analyzed cash book and a list of unpaid invoices. In contrast, a company manufacturing several different products and operating through a number of dispersed locations may need a complex accounting system to enable information required for financial statements to be assembled.

Documenting the system

The various methods of ascertaining and recording the system may be summarized as follows:

Ascertaining

(a) Examining previous audit work

(b) Client's own documentation of the system

(c) Interviews with client's staff

(d) Tracing transactions

(e) Examining client's documents

(f) Observation of client's procedures

Recording

(a) Narrative notes

(b) Organization chart

(c) Internal control questionnaires (ICQs) or checklists

(d) Flowcharts

You should be familiar with these methods of ascertainment and recording from previous studies.

Reliance on Internal Controls

Limitations on the effectiveness of internal controls

As we have seen, it is possible to reduce the volume of substantive procedures required but not to eliminate the requirement altogether. This is because all systems have inherent limitations such as:

- The need to balance the cost of the control with its benefits
- The fact that internal controls are applied to systematic transactions, not one of year end adjustments, which are often large and subject to error.
- The potential for human error
- The possibility of circumvention of internal controls through the collusion of managers or employees with other parties inside or outside the entity.
  The supervisor responsible for checking and authorizing overtime claims could collude with employees, to enable excess overtime payments to be claimed for example.
- The abuse of authority and override of controls
  Abuse of authority might involve ordering personal goods through the firm. It is very easy for directors and managers of organizations of any size to instruct staff to bypass normal procedures such as the requirement for authorization for payments.
- The obsolescence of controls

Control objectives, procedures, and test of control

It is not practical to go into detail about the exact reason for every control that is commonly used. As you go through this section, try and think of reasons why the control is in operation, think about what might happen if the control were not there, what assets could be lost, what records would be incorrect and how the business would be damaged or made inefficient and unprofitable.

You must distinguish carefully between control objectives, control procedures (both of which are the responsibility of the client) and tests of control (which are the responsibility of the auditor). They are not the same thing!

Control Objectives

Remember that control objectives for all systems are, in outline, as follows

(a) That only authorized transactions are promptly recorded at the correct amount is the appropriate accounts in the proper accounting period,

(b) That access to assets is only in accordance with proper authorization and

(c) That recorded assets are compared with existing assets.

STUDY TEXT

Control Procedures

Detailed control procedures are often similar across sales, purchases and other areas and include, for example;

- Sequential numbering of documents with subsequent checking of the sequence for completeness
- The maintenance of batch and other control totals at the input stage with subsequent checking to output for completeness and accuracy
- The maintenance of control accounts which are checked to ensure that they reconcile to the ledgers
- Authorization, evidenced by the signature of responsible officials' for the raising, input and distribution of documents.

Tests of control

Tests of control (also known as compliance tests) by the auditor involve auditors ensuring that the procedures above have been applied, by looking for evidence of, for example, the checking of sequences, and creation of batch totals, control account reconciliations and authorization. Often the auditor is simply looking for a signature, to show that the control procedure has been performed. He will also sometimes re-perform the control by, for example, checking that the reconciliation has been performed correctly or checking that all of the documents within a sequence are actually there, with no omissions or duplications, in order to prove to himself that the control has actually been performed, rather than the document simply having been signed. Re-performance of a control procedure will often also serve as a substantive procedure.

The Revenue, expenditure and other cycles approach

A traditional approach to auditing is the division of transaction processing into cycles. Examples of cycles include sales and receivables cycle, purchases and payables cycle, wages and salaries cycle, petty cash cycle, the inventories recording cycle and the conversion cycle for a manufacturer. Each cycle received has its own section of the audit programme and the audit team would normally be divided into sub groups and allocated a particular cycle.

The rationale behind this method is that for each cycle the data capture, processing and output and the internal controls, will be specific. In turn the nature and level of testing for each cycle can be planned accordingly. The method effectively encompasses all the items in a set of financial statements except one-off transactions. For example the sales and receivables cycle incorporated turnover, its analysts into segments, receivables and related write offs and provisions.

Used in isolation this approach is now seen as unnecessarily detailed and hence top expensive.

As examples of the cycle approach we shall consider the sales and receivables and the purchases and payables cycles.

Sales and Receivables Cycle

Control Objectives

How do the control; objectives noted above translate into 'real life' objectives for sales?

For many businesses, sales are made on credit and thus the sales cycle includes control objectives for receivables. These control objectives include:

- Customers' orders should be authorized, controlled and recorded in order to execute them promptly and determine any allowance required for losses arising from unfulfilled commitments.
- Goods shipped and work completed should be controlled to ensure that invoices are issued and revenue recorded for all sales.
- Goods returned and claims by customers should be controlled in order to determine the liability for goods returned and claims received but not entered in the accounting records.
- Invoices and credits should be appropriately checked as being accurate and authorized before being entered in the accounting records
- Validated receivables transactions, and only those transactions, should be accurately entered in the accounting records.
- There should be procedures to ensure that sales invoices are subsequently paid and that doubtful amounts are identified in order to determine any allowances required.

Achievement of Objectives

In order to achieve these objectives there should be good segregation of duties. There are three distinct processes in the sales system which should be segregated and performed by different staff in order to establish effective internal controls. They are:

- *Accepting Customers' Orders*: Sequence-controlled documents should be used to acknowledge all orders received. Any uncompleted orders should be regularly reviewed.

  Credit limits should be checked by the credit control department. Selling prices, special discounts and delivery dates should be fixed by senior members of the department – never by the accounts staff.
- *Dispatch department*: Sequence-controlled documents should be used (goods outwards or dispatch notes) for all goods leaving the premises. These should be completed by the gatekeeper or the dispatch department –never by the accounts staff.

- *Invoicing the goods*: Sequence controlled invoices should be raised by the sales department and then passed to the accounts department for recording. Independent checks should be made to ensure that invoices have been raised for all goods outwards notes.

In addition strict control of credit notes is essential to ensure that they are raised by proper authority in the sales department against goods received notes. It is not uncommon for credit notes to be raised to 'hide' what are in fact bad debts or to conceal theft of cash receipts. Credit notes can also be used to cancel out fictitious sales invoices which have been raised in order to boost sales figures artificially.

Control procedures over sales and receivables

There are a large number of controls that may be required in the sales cycle due to the importance of this area in any business and the possible opportunities that exist for diverting sales away from the business and other persons benefiting.

(a) Orders

- The orders should be checked against the customer's account; this should be evidenced by initialing. Any new customer should be referred to the credit control department before the order is accepted.
- Existing customers should be allocated to a credit limit and it should be ascertained whether this limit is to be exceeded if the new order is accepted. If so the matter should be referred to credit control.
- All orders received should be recorded on pre-numbered sales order documents.
- All orders should be authorized before any goods are dispatched
- The sales order should be used to produce a dispatch note for the goods outwards department. No goods may be dispatched without a dispatch note.

(b) Dispatch

- Dispatch notes should be pre-numbered and a register kept of them to relate to sales invoices and orders
- Goods dispatch notes should be authorized as goods leave and checked periodically to ensure they are complete and that all have been invoiced.

(c) Invoicing and credit notes

- Sales invoices should be authorized by a responsible official and referenced to the original authorized order and dispatch note.
- All invoices and credit notes should be entered in sales day book records, the accounts receivable ledger, and accounts receivable ledger control account. Batch totals should be maintained for his purpose.
- Sales invoices and credit notes should be checked for prices, costs and calculations by a person other than one preparing the invoice.

- All invoices and credit notes should be serially pre-numbered and regular sequence checks should be carried out.
- Credit notes should be authorized by someone unconnected with dispatch or accounts receivable ledger functions.
- Copies of cancelled invoices should be retained.
- Any invoices cancellation should lead to a cancellation of the appropriate dispatch note.
- Cancelled and free of charge invoices should be signed by a responsible official.
- Each invoice should distinguish between different types of sales and nay sales taxes. Any coding of invoices should be periodically checked independently.

(d) Returns

(i) Any goods returned by the customer should be checked for obvious damage and, when accepted, a document should be raised.
(ii) All goods returned should be used to prepare appropriate credit notes.

(e) Receivables

(i) A receivables ledger control account should be prepared regularly and checked to individual sales ledger balances by an independent official.
(ii) Receivables ledger personnel should be independent of dispatch and cash receipt functions
(iii) Statements should be sent regularly to customers.

CHAPTER SUMMARY

- The basic differences between computerised and conventional systems have different implications on the auditor's approach. They can be classified as follows:

  (a) The complexity of computerised systems:
  (b) A separation between the computer and the user department:
  (c) Lack of visible evidence:
  (d) Most data on computer files is retained for short periods:
  (e) Computers systems can have programmed or automatic controls:
  (g) Use of outside agencies:

- The extent of reliance depends on many factors including:

  a. The **materiality** of the areas or items to be tested.
  b. The level of **audit** risk inherent in the areas or items
  c. The level of **judgement** required.
  d. The sufficiency of **complementary** audit evidence.
  e. **Specialist** skills possessed by internal audit staff.

- A strong control environment does not, by itself, ensure the effectiveness of the overall internal control system and factors reflected in the control environment are:

    1) The philosophy and operating style of the directors and management
    2) The entity's organizational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory controls)
    3) The directors' methods of imposing control, including the internal audit function, the functions of the board of directors and personnel policies and procedures.

- The control objectives for all systems are

    i. That only authorized transactions are promptly recorded at the correct amount is the appropriate accounts in the proper accounting period,

    ii. That access to assets is only in accordance with proper authorization and

    iii. That recorded assets are compared with existing assets.

CHAPTER QUIZ

1. Define risk assessment.

2. What are the possible indicators of irregularities during auditing?

3. As described in ISA 200, what are the Objectives and General Principles Governing an Audit of Financial Statements?

4. What are the stages in system development?

ANSWERS TO THE CHAPTER QUIZ

1. This is the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

2.
(a) Missing documents or vouchers, these could have been deliberately destroyed to conceal an irregularity;

(b) Evidence of altered documents: alterations can take place after the transaction has been approved;

(c) Unsatisfactory explanation: these are explanations that are vague and are unsupported;

(d) Evidence of disputes;

(e) Existence of suspense accounts or unexplained differences on reconciliations;

(f) Evidence that internal control is not operating as it is intended to;

(g) Unduly lavish life styles of employees and officers;

(h) Figures not agreeing with expectations

3. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. An audit conducted in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

4. feasibility, system analysis, program testing, parallel running, file conversion

PAST PAPER ANALYSIS

This is a fertile area for examiners. Invariably in every examination paper set on auditing there will always be a question on internal controls. Questions that have focused this area include; 12/00, 6/01 Question 1, 12/01 question 2, 6/02.

EXAM QUESTIONS

Question one

(a) State the respective responsibilities of the directors and management of a company and its external auditors with respect to the financial statements. (6 marks)

(b) Describe the inherent limitations facing auditors in undertaking their work.(6 marks)
(**Hint: Don not confuse inherent limitations with inherent risk**)

(c) Describe the significant types of judgments made by auditors in:

i. Gathering evidence (4 marks)
ii. Arriving at an opinion on the financial statements. (4 marks)

(**Total: 20 marks)**

Question two

You are the auditor of Fixit Ltd. The company consists of a head office and a chain of 200 shoe repair and key-cutting kiosks. These kiosks are located in supermarkets and shopping centers and each is run by a single staff member who repairs shoes and cuts keys while customers wait.

In an attempt to increase turnover, Fixit Ltd recently advertised that all workmanship in the kiosks would be guaranteed for three months. However, this additional service has not resulted in the expected additional sales. Management believes incremental revenue is being misappropriated by certain kiosk operators.

In addition, it has come to your attention that various components, namely heels, soles and keys are being removed from kiosks by certain operators and sold to competitors. Instances have also been found where operators regularly repair shoes for friends without charging them.

Although each kiosk has a register, controls and procedures in the chain are currently weak and head office management has asked for your advice on desirable internal control procedure.

Required:

Detail the internal control procedure you would expect to find that would provide adequate control over:

(a) Cash sales (10 marks)
(b) Stock (10 marks)

(Total 20 marks

STUDY TEXT

Question three

You are the auditor of Tropical Garments Ltd., one if Kenya's largest garment manufacturing companies. Because of the size of the company's operations, labour costs represent the major portion of the company's production costs for the year.

The managing director, Mr. Lawson, has consulted you concerning the company's accounting systems and systems of internal control. He is particularly concerned with the payroll system as the company's accountant, whose services were terminated last month; he had neglected his duties generally, and in particular, had left the management of the payroll system totally to his junior staff.

The company employs approximately 300 workers in six (6) departments. Within the departments, there are a number of supervisors each of whom is responsible for 10 to 20 workers. A production manager and his assistant are responsible for the overall operations of the factory.

The payroll cost is currently approximately Sh.1,800,000 per week and Mr. Lawson suspects that there may be a number of irregularities such as payments to none existent employees and/or the payment of a full week's wages to employees who took time off.

Initially, Mr. Lawson wanted you to criticize the company's existing system, but he has now requested you to design a new system from scratch. Owing to a shortage of resources, the company is not able to:

- Increase its administrative staff. At present there are four administrative staff, the accountant, an accounts assistant and two clerks.
- Computerize the payroll system
- Outsource the preparation of the payroll (outsourcing is giving the work to an independent, third party such as computer bureau)
- Establish a separate Human Resources function. At present the production manager and his assistant perform this function. Mr. Lawson has already implemented the following controls:
  - The production manager of his assistant approves the employment of new staff in writing. A new employee form is used.
  - The company obtains proof of identification such as a copy of each worker's identity card.
  - The employees' normal hours of work are subject to an agreement between the company and a trade union.
  - Minimum rates of pay have been agreed with the trade union. The company generally pays rates in excess of the required minimum rate of pay as agreed with the union.
  - Mr. Lawson approves all rates of pay increases in writing.
  - The company issues workers with formal written contr4acts of employment, which are signed by Mr. Lawson.
  - The above documents are then sent to one of the clerks and retained in a permanent employee file for each worker.

- Any termination of employment is advised to the clerk in wiring
- Mr. Lawson has also mentioned that:
- Owing to pressure from the trade union, the company is forced to pay the weekly wages in cash and cannot implement a system of payment by bank transfer
- Employees are expected to work overtime from time to time
- A mechanical time clock is located at each of the two entrances to the factory.

Required:

Draft a letter to Tropical Garments Ltd. in which you set out your recommendation for a suitable system of internal control over the payment of weekly wages. **(Total: 20 marks)**

CASE STUDY

(Courtesy of www.ezrstats.com)

Overview

Duplicate payments/invoices can arise due to a variety of reasons; one of the most common of those reasons is when duplicate vendors have been setup. Testing for these duplicates is a common audit activity, but can often become complex because of such things as multiple platforms, difficulty of data conversion/extraction, large processing volumes, etc. For these and other reasons, the function is sometimes outsourced.

Making the situation even more complicated, there can be instances where employees override system built-in controls. Also, judgment is required in order to identify what constitutes a "duplicate". For example, a transposed invoice number may have been entered once and then the correct invoice number entered a second time. Not all systems will detect such a duplicate payment.

Besides duplicate payments, some payments may be mis-keyed as to amount, e.g. Sh 12,500 instead of Ksh125.00. These types of errors can be often be identified through a review of outliers or by performing the "relative value" test.

An additional test which can be relevant in certain instances is to obtain a distribution as to the last two digits of the invoice amount, in order to see if there appears to be rounding or other unusual patterns.

Estimates as to losses due to duplicate payments vary, ranging from as little as .1% to 1% or more. It is essential to detect when instances of this may be happening, as the dollar amounts involved can become quite large.

Audit Objective

The objective is to identify potential instances of duplicate payments and possibly determine the control weaknesses that allowed this.

STUDY TEXT

Audit Procedures / Audit Program

1. Obtain invoice data in electronic format, note data elements.

2. Sort the data by vendor.

3. Perform an automated search for duplicate payments, by specifying the names of the fields, i.e. which field is the vendor, which field is the invoice number, and which field contains an invoice date.

4. Determine potential outlier amounts by vendor.

5. Summarize the data in order to determine the range of values and the variability expected.

6. For each vendor, perform a test of relative values, in order to identify potential keying errors.

7. Write a report explaining your observations, and provide conclusions and recommendations.

Description of Analytical Procedures Performed

First sort the file provided in Vendor sequence
This can be done by opening the file in Excel, sorting and then saving as a tab separated file, or use EZ-R Stats for Windows Tools | Sort, and specify the input file as "InvoiceData.tab", the output file as "SortedInvoiceData.tab" and the sort key as surveyor.

Using EZ-R Stats for Excel, choose the menu option Tools | Cash Recovery.
Specify input file "SortedInvoiceData.tab", output file "PotentialDuplicates.tab"
Variable to be tested will be InvoiceAmount, Vendor is Vendor, InvoiceDate is InvoiceDate
By variable name is Vendor.

CHAPTER THREE

STUDY TEXT

THE AUDIT PROCESS: PLANNING AND QUALITY CONTROL


CHAPTER THREE

THE AUDIT PROCESS: PLANNING AND QUALITY CONTROL

▶ OBJECTIVES

When you have studied this chapter you should be able to:

- Plan and justify audit strategy
- Discuss and apply the concept of materiality and audit risk to the audit process
- Explain how personal computers can help auditors In their work
- Discuss and explain the special problems of auditing where a client has a Computerised
  System.

▶ INTRODUCTION

This chapter will basically covers the procedures involved in the conduct of an audit. This includes audit planning and programs. It will also cover the different risks that during the general conduct of an audit and their implications on the general conduct of the audit and the auditors report.

▶ DEFINITION OF KEY TERMS

1. **Planning** means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audit in an efficient and timely manner.
2. **Audit plan** describes the expected scope and conduct of the audit.
3. **Audit program** sets out the nature, timing and extent of planned audit procedures required to implement the overall audit plan.
4. **Substantive procedures** This involves creating and using audit programs for material account balances and transactions.

▶ EXAM CONTEXT

The examiner requires the examinee to suggest quality control procedure that a firm should implement in specific circumstance. You may also be required to review a firm's procedure and assess their adequacy. Scenario based question are usually asked.

▶ INDUSTRIAL CONTEXT

Quality control is primarily the responsibility of the management. However the auditor has also the responsibility of controlling the quality of his work. This is done through proper planning of hid audit work and delegation of duties to qualified and competent staff.

3.1 THE STAGES OF A MODERN AUDIT

The main features of an audit are as follows, with a brief note on the procedures to use:

i. **Ascertainment** of the nature and constitution of the client's business and how it is carried on. Procedures would include visits to the client's premises, discussions with officers, study of documents such as past accounts, prospectuses, audit files, etc.

ii. **Planning and subsequently controlling the audit**. Procedures would include preparation of an "audit memorandum" setting out work to be done and timing and staff requirements. A preliminary review of the client's management accounts and previous audit files would also have been required.

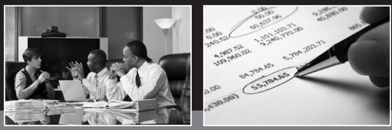
iii. **Ascertaining, evaluating and testing the client's accounting systems and internal controls**. There are several ways of dealing with this. A modern way is to ascertain by asking `grass roots' staff; recording the facts by means of flow charts etc. and evaluating by the use of the `key' questions and criteria questions using a hypothetical or normative model of the appropriate systems.

iv. **Carrying out tests on the systems to determine if they are effective and are consistently applied at all relevant times**. This is done by means of "compliance" tests preferably operated on a statistically valid basis.

v. **Verifying the existence, title and amounts included in the balance sheet in respect of assets, liabilities and capital.** This is done by a variety of means including assessment of internal control procedures and by means of "substantive" tests which give direct evidence of the items to the auditor, e.g. bank letter, and debtors circularisation.

vi. **Checking the financial statement with the accounting records**. This is a requirement of the 7th Schedule of the Companies Act and is achieved by simply making such a comparison.

vii. **Examining the income statement to confirm that it reflects the results of the operations of the enterprise.** This is achieved by assessment of internal control procedures and the quality of the records, by seeking direct evidence, and by seeking out and probing anomalies or differences from expectations.



viii. **Examining the financial statements for conformity with acceptable accounting practices and for compliance with legal and other disclosure requirements**. This is achieved by the use of check lists.

ix. **Considering the financial statements as a whole and reviewing the audit work and conclusions drawn there from in order to determine whether such statements give a true and fair view**. This is achieved by a review conducted by experienced personnel considering the audit working papers; any revealed anomalies and any uncertainties and any disagreements with directors or other parties responsible for the preparation of the accounts.

x. **The drafting of an auditor's report giving the auditor's opinion on the truth and fairness and compliance with statute of the accounts**. The wording of the report will depend on the conclusion drawn by the auditor from his audit, and the report may be qualified or unqualified.

3.2 INTRODUCTION TO PLANNING

The primary objective of an audit is the expression of an expert and independent opinion on the truth and fairness of the information contained in the annual financial statements expressed in the audit report and the ascertainment and evaluation of the accounting systems as the basis for the preparation of financial statements.

It is for the auditor to decide the extent of audit work he considers necessary in order to support his opinion.

ISA 200 Objectives and General Principles governing an audit of financial statements states that the auditor should carry out an audit in accordance with ISAs and ethical principles to provide reasonable assurance that the financial statements are free from material misstatement.

The auditor should plan the audit work so that the audit will be performed in an effective manner.

"Planning" means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audit in an efficient and timely manner.

International Standard on Auditing (ISA) 300 Planning establishes standards and provides guidance on planning an audit of financial statements.

An audit is an assignment. To complete the assignment efficiently and effectively in an economical and cost effective manner then it must be planned for in some detail before commencement and the strategy constantly reviewed as the audit progresses. Planning consists of determining what is to be done, determining when it is to be done, determining who is to do it; and determining what it will cost in terms of hours and money.

Audit Planning Memorandum

Planning must be formalised in a written document ordinarily called an Audit Planning Memorandum (APM).

In practice, such a plan includes the following information:

1. **Section 1** can be a summary of the terms of engagement, basically summarizing the expected scope of the assignment and the reports or other communications called for under the terms of engagement.

2. **Section 2** would consist of the history or a brief background of the client and any major changes that have taken place since the previous audit visit. Accordingly, this paragraph will cover such matters as the kind of business the client is in, the products, the spread of the company's products, the location from which the client operates, changes in key personnel, accounting policies and procedures, legislation and even changes in the industry structure.

   If the company is a part of a group, then a summary of the relationship with other companies in the group may also be provided.

3. **Section 3** would summarize those areas with high inherent risk. These are those areas whereby because of the nature of the business environment, in which the client operates, there is a high chance of misstatement or misreporting those are areas where the auditor could reach a wrong conclusion unless special audit procedures are adopted.

4. **Section 4** could summarize the financial position and results. This normally involves summarizing the balance sheet and the profit and loss account for the last audited year and having alongside those figures the latest a management accounts figures as well as the budgeted figures. The auditor then carries out a ratio analysis on the financial information to identify other audit risk areas or areas where apparently there have been new developments or significant changes that require investigation and explanations.

5. **Section 5** could consist of a listing of incomes, expenses, assets and liabilities i.e. the significant components of the financial statements and a brief description of the methods to be adapted to verify them.

6. **Section 6** is materiality levels, which would be set for every material component of the financial statements and the related audit approach.

7. **An outline of the proposed** audit approach. The aspects that would be covered here include:
   - The expected client staff assistance in the preparation of supporting schedules
   - The expected reliance on the Internal Control Systems (ICS)
   - The intended use of internal auditor's work
   - The intended use of experts or specialists

   This section would also highlight the expected levels of assurance to be derived from:
   - tests of control
   - analytical review procedures
   - substantive procedures of details

8. **Section 8** could consist of a timetable on timing of key events or activities such as the proposed date of the AGM, the date of audit clearance, the date of the stock take and the date of the various audit units.

9. **Section 9** could deal with the staffing arrangements, identifying the partner responsible for the audit, the manger, the accountant in charge and the audit assistants.

10. **Section 10** could be for the budget and a fee quotation. This would show for every staff member, the number of man hour as well as the cost of throe hours.

Note that the plan must be approved by the partner in writing before the audit commences.

3.3 IMPORTANCE OF AUDIT PLANNING

Adequate planning of the audit work helps to ensure:

- That appropriate attention is devoted to important areas of the audit,
- That potential problems are identified
- That work is completed expeditiously.
- Proper assignment of work to assistants
- Coordination of work done by other auditors and experts.

The extent of planning will vary according to the size of the entity, the complexity of the audit and the auditor's experience with the entity and knowledge of the business.

Obtaining knowledge of the business is an important part of planning the work.

The auditor's knowledge of the business assists in the identification of events, transactions and practices which may have a material effect on the financial statements.

The auditor may wish to discuss elements of the overall audit plan and certain audit procedures with the entity's audit committee, management and staff to improve the effectiveness and efficiency of the audit and to coordinate audit procedures with work of the entity's personnel.

The overall audit plan and the audit program; however, remain the auditor's responsibility.

Controlling

The auditor carries out his work using different levels of staff. To achieve the plan requires control at all stages. The elements of control are:

(a)	Directing or Direction:	Staff must have the instructions to follow. This could be Formalised audit programmes clearly setting out what the staff must do.
(b)	Supervision:	Every member of the audit team should be subject to supervision by his superior to ensure that the plan is being carried out as expected and all necessary work is being done.
(c)	Reviewing:	The work done would be reviewed at all levels and evidence of this review should be available.
(d)	Recording:	The entire audit process must be properly documented in the form of working papers.

3.4 THE OVERALL AUDIT PLAN

The auditor should develop and document an **overall audit plan** describing the expected scope and conduct of the audit. While the record of the overall audit plan will need to be sufficiently detailed to guide the development of the audit program, its precise form and content will vary depending on the size of the entity, the complexity of the audit and the specific methodology and technology used by the auditor.

Matters to be considered by the auditor in developing the overall audit plan include the following:

Knowledge of the Business

- General economic factors and industry conditions affecting the entity's business.
- Important characteristics of the entity, its business, its financial performance and its reporting requirements including changes since the date of the prior audit.
- The general level of competence of management.

Understanding the Accounting and Internal Control Systems

- The accounting policies adopted by the entity and changes in those policies.


- The effect of new accounting or auditing pronouncements.
- The auditor's cumulative knowledge of the accounting and internal control systems and the relative emphasis expected to be placed on tests of control and substantive procedures.

Risk and Materiality

- The expected assessments of inherent and control risks and the identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- The possibility of material misstatement, including the experience of past periods, or fraud.
- The identification of complex accounting areas including those involving accounting estimates.

Nature, Timing and Extent of Procedures

- Possible change of emphasis on specific audit areas.
- The effect of information technology on the audit.
- The work of internal auditing and its expected effect on external audit procedures.

Coordination, Direction, Supervision and Review

- The involvement of other auditors in the audit of components, for example, subsidiaries, branches and divisions.
- The involvement of experts.
- The number of locations.
- Staffing requirements.

AUDITING

Other Matters

- The possibility that the going concern assumption may be subject to question.
- Conditions requiring special attention, such as the existence of related parties.
- The terms of the engagement and any statutory responsibilities.
- The nature and timing of reports or other communication with the entity that are expected under the engagement.

3.5 THE AUDIT PROGRAM

The auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan.

The audit program serves as a set of instructions to assistants involved in the audit and as a means to control and record the proper execution of the work. The audit program may also contain the audit objectives for each area and a time budget in which hours are budgeted for the various audit areas or procedures.

In preparing the audit program, the auditor would consider the specific assessments of inherent and control risks and the required level of assurance to be provided by substantive procedures. The auditor would also consider the timing of tests of controls and substantive procedures, the coordination of any assistance expected from the entity, the availability of assistants and the involvement of other auditors or experts.

Changes to the Overall Audit Plan and Audit Program

The overall audit plan and the audit program should be revised as necessary during the course of the audit. Planning is continuous throughout the engagement because of changes in conditions or unexpected results of audit procedures. The reasons for significant changes would be recorded.

3.6 AUDIT APPROACHES

1. Substantive procedures
2. Balance sheet Approach
3. Audit Risk Approach
4. Business Risk Approach
5. Systems Based Audit approach
6. Directional Testing
7. Analytical Procedures

3.6.1 Substantive procedures

This involves creating and using audit programs for material account balances and transactions. The two categories of substantive testing include tests of detail of transactions and balances and analytical procedures.

3.6.2 Balance sheet Approach

This approach is based on the assumption that the balance sheet is the most important aspect of the financial statements and therefore if the balance sheet is correct, the other statements must be correct. It is suitable for small companies and larger property companies. It concentrates audit testing on the account balances with limited testing of the profit and loss account.

3.6.3 Audit Risk Approach

AUDIT RISK

As we have seen many parties rely on the audit opinion to make decisions, and therefore it is now a well established fact that if the auditor gives an audit opinion that is wrong in some particular then they stand a chance of suffering some damage.

Audit risk therefore could be defined as the chance of damage to the audit firm as a result of giving an opinion that is wrong in some particular. Or put another way, it could be explained as the possibility that financial statements contain material mis-statements which had escaped detection by both an internal control on which the auditor has relied and on the auditor's own substantive tests and other work.

It could be looked at also as: the possibility that the auditor may be required to pay damages to the client or other persons as a consequence of:

1. The financial statements containing a mis-statement;
2. The complaining party suffering a loss as a direct consequence of relying on the financial statement and
3. Negligence by the auditor in not detecting any reporting on the mis-statement which can be demonstrated.

Damage to the audit firm or the auditor may be in the form of monetary damages paid to the complainant as compensation or simply damage to their reputation with a client or the business community.

All audits involve an element of risk such that however strong the audit evidence and however careful the auditor, there is always a possibility of an error or a fraud going undetected. It is generally known that the auditor who organises his office and staff in a competent manner and follows auditing standards and guidelines is unlikely to be found negligent and to pay damages as a consequence of fraud or error not being discovered by him.

Audit risk can be either normal or higher than normal.

Normal audit risk

Indications that an audit is a normal risk audit are:

(a) The client having management and staff who are competent and have integrity;
(b) Where the client has an accounting system that is well designed, works and is subject to strong internal controls;
(c) Where the client has no special financial problems;
(d) The auditor's past experience;
(e) Where the client is old, well established and the business of the entity is not subject to rapid change;
(f) If the client's board of directors are actively engaged in the company and they provide control and leadership of a good quality;
(g) If the board of directors has competent non-executive directors;
(h) If the organization has an audit committee.

When the auditor is faced with the normal audit risk, the audit approach adopted is usually one of reliance on key controls supported by substantive tests, compliance tests and analytical review.

Higher than normal risk

Several audit assignments involve high audit risk and usually in any client there will always be at least one high risk area. Indications that an audit has an element of higher than normal audit risk include:

(a) Poor management with lack of control and poor book-keeping;
(b) Liquidity problems and high gearing;
(c) The opposite of all the factors mentioned in the normal risk above;
(d) Recent changes in ownership, control or key staff;
(e) Changes in accounting policies or procedures;
(f) Future plans to seek quotation on the Nairobi Stock Exchange;
(g) Over-reliance on a few products, customers, suppliers and investments in new ventures or products;
(h) Problems inherent in the nature of the business for example difficulties in stock counting or valuation, difficulties in determining the extent of claims and provisions and cut-off problems;
(i) The existence of put upon enquiry situations, dominance by the single person and lack of involvement of directors or proprietors. In such a situation, the auditor approaches his audit in a manner that is:

- Sceptical, relying on high calibre staff
- Collection of audit evidence in each area from a wide range of sources
- Taking extreme care in the preparation of audit working papers
- Investigating thoroughly high risk and problematic areas
- Exercising extreme care in drafting the audit report

In addition to normal risk and higher than normal risk discussed above, the auditor can also be exposed by sub-standard work such as:

i. His failure to recognise put upon enquiry situation
ii. His failure to draw correct inferences from audit evidence and the analytical review
iii. His use of wrong procedures in a particular situation
iv. His failure to perform necessary audit work because of time and cost consideration
v. His failure to detect errors or fraud because of poor sampling methods or the selection of inadequate sample sizes

It is essential that an audit firm should organize itself in such a way that it can minimise the risk of suffering any damage. We can look at these measures from two points of view. Broad measures taken by the profession as a whole and measures to be taken by the individual auditor in minimising this audit risk.

The Measures Taken By the Profession as A Whole

These have been adequately covered under the section on independence in CHAPTER 1 and qualities of an auditor whereby we considered the steps taken by the profession to secure the qualities of competence, judgement, objectivity and integrity in an auditor.

Measures To Be Taken By the Individual Auditor

(a) Proper recruitment and training of all staff;
(b) Allocating staff to particular audits where they have the appropriate skills;
(c) Planning the jobs well in advance so that it can be approached in a relaxed but disciplined manner and any timing problems can be accommodated;
(d) Use of audit manuals that conform to audit standards and guidelines;
(e) Use of up-to-date letters of engagements;
(f) Quality control measures that ensure review at every stage of the audit;
(g) Good briefing of auditing staff so that they can recognise put upon enquiry situation;
(h) Emphasising on materiality and use of adequate sample sizes

Procedures the Auditor Adopts

The auditors procedures will include:

a) Getting an understanding of the entity as a whole in order to see the accounting system in proper perspective and thus be able to assess how effective and appropriate the system is;

b) By use of enquiry or internal control questionnaires or reading manuals ascertain the complete system;

c) Record the system that he has ascertained either in the form of narrative notes, flow charts, check lists or answers to the ICQ;

d) If the auditor intends to rely on the internal control then he further has to record the system of controls in detail;

e) If the system's record was provided by the client or was obtained through reading manuals, then the auditor must perform walk through tests to confirm the correctness of the record and also his own understanding of the system;

f) The auditor then performs a preliminary assessment of the system, and if he is relying on controls then he performs a preliminary evaluation of those controls;

g) If the system of controls and accounting seems adequate and the auditor feels that he can rely upon the controls he then designs and performs compliance tests. However, if he does not wish to rely on the controls then he performs substantive tests on the records;

h) He has to evaluate his evidence and form an opinion on whether proper books of accounts have been kept and whether the books of accounts form a reliable basis for the preparation of the financial statements.

3.6.4 BUSINESS RISK APPROACH

This approach requires the auditor to determine what are the very important business risks which the client faces. This line of approach both helps the client and also enables the auditor to appreciate and understand his clients business and appreciate all aspects of the business activities. It is then for the auditor to determine where the risks are likely or unlikely and whether the risks are likely to produce serious consequences. This enable the audit to be focussed on those matters where there is a possibility of misstatement. This is the basis of revised auditing standards.

The big firms have largely adopted this approach within their audit methodology.

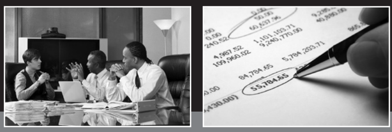
The history of auditing shows a gradual change over time as detailed testing of transactions moved to system audits. The next development was the audit risk model which focuses the audit and the extent of audit procedures on to the areas of an audit where the auditor was most at risk of giving an inappropriate opinion.

Here we consider concept of risk from the view point of the business as a whole:

3.6.4.1 The Business Risk Approach to Auditing

In recent years the broader concept of business risk has been developed by the larger firms. It was the subject of the ICAEW auditing road show 'Tomorrow's audit today' in the late 1990s in the UK. The concept has not been fully refined but its main principles are now well established.

Business risk is the threat that an event or action will adversely affect a business's ability to achieve its ongoing objective. It can be split between external and internal factors.



The business risk approach to auditing involves examining the business in it's entirely and evaluating the various risks to which it is exposed. The business risks are factors which affect the company's ability to meet its goals. The risks may be controllable (to some extent) or uncontrollable (for example, external factors). It may be possible to trade-off some risks (e.g. insurance). The auditor is concerned about those risks which may impact upon the financial statements and therefore needs a full understanding of the business and its risks in order to do this. The auditor will then plan the audit strategy with these business risks clearly focused in mind.

3.6.4.2 The Effects of the Business Risk Approach

There are some general points which can be made about the business risk approach and the effect it has had on the auditing process.

- This 'top down' approach to the audit, beginning with business risk and ending with the financial statements
- There is still a lack of clarity in the relationship between business risk and audit risk
- The ideas of inherent risk and control risk have tended to merge into the larger concept of business risk.
- The ideas of inherent risk and control risk can be called residual risk which has to be minimized by audit action. An audit action carries with it detection risk.
- The approach is very much a high level approach and should include consideration of all matters which are critical to the business. For example, 'could the client lose the XYZ franchise and what would be the possible consequences for the company and its financial statements?'
- Because of the high level of understanding required of a client's business it is possible to use analytical procedures more frequently as a procedure for verification of financial statement assertions
- It is an aid to the firm's acceptance and continuation procedures for clients (do we want this client?)
- Business failure risk is an important aspect of overall business risk. The assessment of business failure risk will assist the auditor when considering the going concern status of the clients business.
- The audit needs to be tailor made and a generalized approach to audits is neither productive nor economical
- Auditors need more understanding of business and to that end the larger firms set up larger databases of information about the economy and the business world
- The concept implies a continuing relationship with the client rather than a one off view with each year being separate.

As should be evident from this summary the business risk approach is a more holistic approach to the audit. The business risk approach starts at a stage back from the traditional audit risk model and offers more benefit to auditors and clients alike.

Business activity information financial statements

Whereas the audit risk model encompasses the last two aspects the business risk approach starts with examining the business activity and identifies the risk relating to it, before examining the risks of the information and subsequently the financial statements being misstated.

The consequences of the business risk approach should be a more efficient and focused performed by a more knowledgeable auditor resulting in a better auditor – client relationship. For example, the audit will have less emphasis on transactions. The auditor may well provide other benefit to the client given this greater understanding of the business and its risk profile.

3.6.4.3 Advantages of the Business Risk Approach

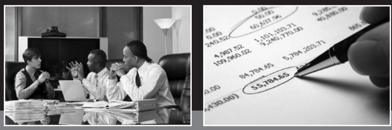
The advantages of the business risk approach are as follows:

- Research showed that processing errors were rarely a cause of audit problems
- Major audit problems (e.g. companies going bust shortly after a clean audit report) typically arise out of issues such as going concern, major fraud by top management, larger scale systems breakdown etc.
- Investigation of business risk enables the auditor to have a profound knowledge of the business (as required by ISA 310 knowledge of the business).
- The approach focuses the audit on to the high risk areas which are material to the business.
- The approach adds value to the audit and enables the auditor to offer some commercial benefits to the audit.
- The previous emphasis on transactions and systems was expensive and uneconomic
- The pace of change in business and in computing and communications means that companies are much more at risk of failure than ever before.
- Auditing needs to be aware of such changes
- Audit firms wish to be in van of innovation to attract clients.
- Audit firms are anxious to show product differentiation to potential clients
- The business environment and corporate governance issues, and the nature of management control are all now more significant for and translate more quickly into the financial statements
- The approach tends to involve partners and senior mangers much more in the planning stages of an audit
- The business risk review may show up areas where the auditor can suggest that its highly paid services can be offered to the client.

3.6.4.4 Disadvantages of the Business Risk Approach

There are some disadvantages to the approach, as follows:

- More highly qualified and competent staff are required
- The added value idea does tend to oppose the notion of independence



3.6.4.5 Business Risk Analysis

Business risk can be analyzed between external and internal risks

External risks

- Changing legislation (e.g. minimum wage)
- Changing interest rates (especially with highly geared companies)
- Changing exchange rates
- Public opinion, attitudes, fashions (e.g. environmental factors)
- Price wars initiated by competitors (e.g. supermarkets)
- Import competition (e.g. the textile trade)
- Untried technologies and ideas (e.g. dot.com traders)
- Natural hazards (e.g. fire or flood or effects of global warming)
- Bad debts
- Litigation
- Environmental matters
- Inflation
- Political factors

Internal Risks

Internal risks can also damage the company. These include:

- Failure to modernize products, processes, labour elations, marketing resulting in loss of competitive edge
- Employees (e.g. ineffective recruitment or training policies)
- Board members (e.g. ineffective corporate governance)
- The process of dealing with suppliers or customers
- Excessive reliance on a dominance chief executive (thereby weakening internal control)
- Inadequate cash flow and the risk of corporate failure
- Inappropriate gearing (resulting in a lack of financial efficiency)
- Related parties resting in inappropriate terms of trading
- Inappropriate acquisitions and poor future prospects
- Overtrading resulting in cash shortages
- Excessive reliance on one of a few products, customers, suppliers
- Internal control weaknesses
- Computer systems failure and loss of records
- Fraud

3.6.4.6 Companies' Modes of Operation

Some companies (especially small ones) operate without any overtly expressed plan and simply carry out the business as always, responding to market changes as they happen. Such companies are often very adaptable and survive well.

Large companies normally plan their activities in a hierarchal way, as follows:

- Mission statement
- Strategic plan
- Budgets

Businesses are at risk if their business objectives are not achieved. It is therefore desirable for the management to identify all business risks and if necessary to amend the plan to accommodate the risks or make contingency plans to survive.

For example, a company which has over reliance on one customer might decide actively to seek new customers or markets, perhaps by acquisition. Another example would be a company which is totally reliant on is computer system should have backup facilities.

3.6.4.7 Classification of Individual Business Risk

Individual business risk can be low or high impact and low or high likelihood. Here are some examples for a satirical magazine.

	High Likelihood	Low Likelihood
High impact	Legal action for libel. Such a scenario is important as the going concern of the magazine may be threatened	'Act of God' such as fire or flood. Such risks are often ignored or disaster recovery contingency plans made if the cost is not too high.
Low impact	The launch of a new newspaper – the magazine's readership tends to be drawn from the readers of broadsheets. The magazine would be largely unaffected	Events outside the field of media and politics which do not affect the magazine's stakeholders or costs

What can management do about risks once they are identified? Clearly what to do depends on the risk and there are an infinite variety of risks. One possible classification of potential reactions by management is as follows:

- Do nothing and hope for the best
- Develop internal controls
- Develop quality controls over production of goods, production of services, staff recruitment
- Join in government schemes like Famine Relief or Poverty Reduction
- Train staff
- Diversify – acquisition, new products, multiple sourcing, adding to customer base perhaps by exporting

- Risk reduction – raising staff awareness of risk, tighter discipline in all areas, physical measures such as sprinklers. Diversified computer systems instead of one complex one
- Transfer of risk – by insurance, sub-contracting, outsourcing
- Avoidance – e.g. leaving a market such as the USA to avoid product liability

In the end, the business of the entrepreneur is risk raking and all risk cannot be removed. The basic economic truism is that there is a correlation between risk and return and high returns are not possible without risk.

3.6.4.8 Audit Risk and Business Risk

We saw in earlier studies that audit risk is often categorized as the product of inherent risk, control risk and detection risk

Auditors should consider business risk in three ways:

- By enquiring into and assessing business risk, thereby gaining an excellent knowledge of the business. This is a basic requirement in all audit engagements.
- By helping their clients to recognize, assess and respond to risk – by welcoming it, ignoring it, managing it, eliminating it, developing a recovery plan, insuring against it etc. This can be a lucrative source of fees. They may also help to eliminate or mange risk, which reduces audit risk in the future.
- By seeing the connection between audit risk and business risk and the risk of misstatement in the financial statements, which focuses the audit or risks likely to lead to possible misstatement.

3.6.4.9 The Implications of Business Risk for the Audit

Below is a checklist of the possible planning implications for the audit of business risk

- Is the control environment good?
- Does the management manage risk effectively?
- Is the accounting system adequate?
- Do any risks threaten the going concern status of the company?
- Do any of the risks have implications for cash flow?
- Is there a high risk of fraud – e.g. poor controls, management override, overwhelming ambition and arrogance in the chief executive?
- Are there related parties with different agendas?
- Is the business under threat of being taken over, with the risk of management misstating financial statements?
- Is there a risk of litigation against the company?
- Is there any risk of withdrawal of support by loan or trade payables?

Ultimately many of the audit risks come down to the following factors or a combination of them.

- Possible misstatements due to lack of controls. Recent company failures (often shortly after clean audit reports) have been caused by overvaluation of inventory under allowance for bad debtors etc.
- Working capital shortage leading to cash flow difficulties and technical insolvency, often due to expansion which has been rapid.
- Inappropriate accounting policies. These can often lead to overstatement of assets or understatement of liabilities.
- Suppression of liabilities
- Fraud by management
- Related parties' transactions or activities
- Going concern appropriateness
- Computer failures
- Litigation or regulatory problems

Test Your Understanding

As manager responsible for prospective new clients you have visited Hard bridge Lorry Component Ltd which supplies a small range of components for lorry manufacturers. The chief executive and majority shareholder is Mr. Alfred and he has asked your firm to make a proposal for the company's audit and other services.

During the initial meeting you have ascertained the following information:

- The company's turnover has increased by about 30% a year for the last three years
- Mr. Alfred is a dominating personality who seems tireless and has limitless ambition
- The company has two major customers and a few small ones
- The largest customer has recently announced major expansion plans and Harbridge have already purchased additional land and have signed a contract for more building to increase production. You have read in *The Daily Times* that the customer's expansion plans are viewed with some skepticism by the city which seems to doubt the company's viability.
- Harbridge has borrowed heavily from its bank and a major repayment of the loan is due shortly. The company is already on its overdraft limit and has yet to fund the new building construction. Mr. Alfred is in negotiation with a Middle Eastern bank for further finance.
- Many of the company's parts are sourced in a country with an exchange rate which is very favourable to the UK. The financial press has lately suggested that this rate may change in the near future.
- The company recently purchased a very large and very complex computer system to control all its affairs. Mr. Alfred admits that his admin staff (headed by his brother, who has recently returned from five years back packing abroad) does not really have the competence to run it properly.
- The company recently purchased a company jet aircraft which Mr. Alfred says he finds essential for visiting customers and suppliers. Mr. Alfred pilots the aircraft himself. He has just been to Miami where there are neither customers nor suppliers.
- Mr. Alfred admitted that the company had recently been issued with writs alleging that

the company had breached a patent in one of its vital processes and that the company had failed to pay the sum due to a supplier. Mr. Alfred did not consider this as serious and said that failure to pay was because the new computer system had not agreed the amount due with the supplier's statement

- The company has no formal management accounting system. The new computer system is supposed to remedy that but nothing has been done as yet.
- Mr. Alfred has plans to float the company in the near future.

Required

(a) Identify and describe the principal business risks relating to Harbridge Lorry Components ltd.

(b) Justify an appropriate audit strategy for the first audit of Harbridge Lorry Components Ltd.

(c) Suggest some procedures that Harbridge could implement immediately to improve is accounting procedures and financial controls.

Business risk is the risk that the audited entity will fail to achieve its objectives. This approach is said to offer a top down, rational, value added, focused and economical audit with good coverage of audit work. The business risk approach is to be preferred because it should result in a more efficient and focused audit performance by a more knowledgeable auditor resulting in a better auditor client relationship.

3.6.5 Systems Based audit approach

The basis of IAS 400, Risk Assessment and Internal Control

The term systems audit refers to the typical audit approach to medium and large companies and is based on the assumption that such companies have internal control systems which will hopefully constitute a reliable base for the preparation of the accounts. In other words, the characteristic of a systems audit is an examination of internal control.

We have already established that many small companies cannot achieve satisfactory internal control and it is hence clearly futile for the auditor to seek to rely on controls if they don't exist or are patently unreliable. For such enterprises the auditor has no alternative but to carry out a so called 'substantive audit' involving extensive verification of transactions followed by a detailed examination of the balance sheet (verification of assets and liabilities and review of the financial statements).

The contemporary audit approach to reasonably sophisticated companies is therefore to carry out a system-based audit during the course of the accounting year, followed by a balance sheet audit at the year end - if the systems audit work is successful, i.e. the controls prove reliable, the auditor can use his judgement to reduce the extent of the balance sheet work (in no circumstances will the balance sheet work be eliminated entirely!).

3.6.6 Directional Testing

The concept of directional testing recognises that it is the purpose of the audit test which will determine the direction of the test.

CHAPTER SUMMARY

- Adequate planning of the audit work helps to ensure:

  (1) That appropriate attention is devoted to important areas of the audit,
  (2) That potential problems are identified
  (3) That work is completed expeditiously.
  (4) Proper assignment of work to assistants
  (5) Coordination of work done by other auditors and experts.

- Auditors should consider business risk in three ways:

  (1) By enquiring into and assessing business risk, thereby gaining an excellent knowledge of the business. This is a basic requirement in all audit engagements.
  (2) By helping their clients to recognize, assess and respond to risk – by welcoming it, ignoring it, managing it, eliminating it, developing a recovery plan, insuring against it etc. This can be a lucrative source of fees. They may also help to eliminate or mange risk, which reduces audit risk in the future.
  (3) By seeing the connection between audit risk and business risk and the risk of misstatement in the financial statements, which focuses the audit or risks likely to lead to possible misstatement.

- Although rare, the auditor may be required to pay damages to the client or other persons as a consequence of:

  1. The financial statements containing a mis-statement;
  2. The complaining party suffering a loss as a direct consequence of relying on the financial statement and
  3. Negligence by the auditor in not detecting any reporting on the mis-statement which can be demonstrated.

- The Audit Approaches that can be used during auditing are
  1. Substantive procedures
  2. Balance sheet Approach
  3. Audit Risk Approach
  4. Business Risk Approach
  5. Systems Based Audit approach
  6. Directional Testing
  7. Analytical Procedures

STUDY TEXT

- During an audit, the auditor carries out his work using different levels of staff and to achieve the plan requires control at all stages. The elements of control are:

  (a) Directing or Direction:
  (b) Supervision:
  (c) Reviewing:
  (d) Recording:

CHAPTER QUIZ

1) What are the stages of a modern audit

2) What are the stages of audit planning

3) Name the seven Audit approach

4) What are the indicators of normal audit risk

ANSWERS TO THE CHAPTER QUIZ

1.

i. Ascertainment
ii. Planning and subsequently controlling the audit.
iii. Ascertaining, evaluating and testing the client's accounting systems and internal controls.
iv. Carrying out tests on the systems to determine if they are effective and are consistently applied at all relevant times.
v. Verifying the existence, title and amounts included in the balance sheet in respect of assets, liabilities and capital
vi. Checking the financial statement with the accounting records.
vii. Examining the income statement to confirm that it reflects the results of the operations of the enterprise.
viii. Examining the financial statements for conformity with acceptable accounting practices and for compliance with legal and other disclosure requirements.
ix. Considering the financial statements as a whole and reviewing the audit work and conclusions drawn there from in order to determine whether such statements give a true and fair view
x. The drafting of an auditor's report giving the auditor's opinion on the truth and fairness and compliance with statute of the accounts

2. Ensure that

- That appropriate attention is devoted to important areas of the audit,
- That potential problems are identified
- That work is completed expeditiously.
- Proper assignment of work to assistants
- Coordination of work done by other auditors and experts.

3.

- Substantive procedures
- Balance sheet Approach
- Audit Risk Approach
- Business Risk Approach
- Systems Based Audit approach
- Directional Testing
- Analytical Procedures

4.

(a) The client having management and staff who are competent and have integrity;
(b) Where the client has an accounting system that is well designed, works and is subject to strong internal controls;
(c) Where the client has no special financial problems;
(d) The auditor's past experience;
(e) Where the client is old, well established and the business of the entity is not subject to rapid change;

STUDY TEXT

(f) If the client's board of directors are actively engaged in the company and they provide control and leadership of a good quality;
(g) If the board of directors has competent non-executive directors;
(h) If the organization has an audit committee.

PAST PAPER ANALYSIS

This is a potential examination area but recently it has been combined with other chapters and mostly given as a case study analysis. Its encouraged that student get a deep understanding of this chapter. Sittings where this chapter was brought out well include; 6/00 Question2, 7/00 Question 3,12/07 Question 1

EXAM QUESTIONS

Question one

You are the audit manager at Zainabu and Associates responsible for the audit of the books of account of Ziwani Spares Ltd. In the course of the audit of the financial statements for the year ended 30 June 2004, your preliminary evaluation of the internal controls indicated that reliance could be placed on the system. However, compliance tests carried out during the audit disclosed that the system was not operating effectively. This situation has necessitated various amendments and additions to your original audit plan.

Required:

Describe the changes to be effected:

a) During the interim audit. (13 marks)

b) After the end of the financial year. (7 marks)
(Total: 20 marks)

Question two

The Board of D Ltd., a company quoted on the stock exchanger, has decided to introduce an internal audit function. As a first step, the Board wishes to outsource the service and has invited your audit firm to tender for the contract. The terms of reference will entail a range of activities including:

- Review accounting, internal control and risk management systems.
- Examination of financial and operating information.

Your firm has provided a number of services to this client for many years including, he statutory audit of he annual financial statements and on-going consultancy work.

Required:

(a) Explain the importance of the concept of independence to external auditing. (6 marks)

(b) Identify and discuss the threats to your audit firm's independence which may arise from he provision of all the services outlines above and suggest how these treats may be resolved by your firm. (14 marks)

(Total 20 marks)

Question three

You are the manager responsible for the audit of BCD Stores Ltd. which has a number of stores which sell household products to the general public, including furniture, electrical equipment, cooking equipment and carpets. The company has annual sales of about Sh.1,600 million. In previous years' audits, there have been problems with:

1. Misappropriations of inventory by employees and customers.
2. Slow moving and damaged goods which are worth less than cost, and
3. Incomplete recording of sales when the customers pay by cash (these represent 55% of all sales)

The company has a small internal audit department, the staff of which visit branches and perform appropriate audit work at the head office.

Required:

(a) Describe the work you will carry out and the matters you will consider in planning the audit prior to the commencement of the detailed audit work, including consideration of the timetable for the audit. (12 marks)

(b) Describe the procedure you will carry out to control the audit including reviewing the work of the audit staff. (8 marks)

(**Total: 20 marks)**


CASE STUDY

(Courtesy of www.ezrstats.com)

Overview

When surveys are taken, the situation can arise where one or more of the persons taking the survey do not actually interview a person, but instead, make up the data. There are a number of reasons why this may happen - e.g. time pressure to complete the results, inconvenient to visit, too far to drive, too late in the day, etc. The industry term for this is “curb stoning”, inspired by an image of the surveyor completing the survey while sitting on a curb stone.

It is essential to detect when instances of this may be happening, as the data is made up, it can invalidate the survey study results. One means of detecting potential instances of curb stoning is through the application of Benford’s Law, which provides an expected distribution for the frequency of first digits. This law has been found to apply to many numerical results, such as lengths of rivers, number of people residing in a household, etc.

Audit Objective

The objective is to identify potential instances of curb stoning based upon a comparison of the survey data completed compared with that which would be expected, if the data distribution conformed with Benford’s Law. Note that some elements of a survey will NOT comply with Benford’s law where they are of a predetermined range. However, in this case, all the data elements should conform - i.e. street address number, number of people in the household, and the distance to the nearest church.

Audit Procedures / Audit Program

1. Obtain survey data in electronic format, note data elements and state whether they would beexpected to conform with Benford’s law.

2. Sort the data by surveyor.

3. For each surveyor and each data element expected to conform with Benford’s law, prepare a population distribution and a chart, using the first digit.

4. For each surveyor and each applicable survey element, compute the D-Statistic using the Kolmogorov-Smirnov metric.

5. Review each chart and data table prepared to determine if the data appears to conform with Benford’s Law.

6. For data which does not appear to conform, how does the D-Statistic compare with the others?

7. Write a report explaining your observations, and provide conclusions and recommendations

CHAPTER FOUR

STUDY TEXT

AUDIT EVIDENCE AND DOCUMENTATION


CHAPTER FOUR

AUDIT EVIDENCE AND DOCUMENTATION

▶ OBJECTIVES

- When you have studied this CHAPTER you should be able to:
- Explain the nature and importance of audit evidence
- Explain the importance of working papers and their review
- Explain the sources, sufficiency appropriateness and others issues on audit evidence.

▶ INTRODUCTION

This chapter will cover audit evidence. Auditing is an evidence gathering exercise. It is an exercise carried out to confirm the assertions made by the management in carrying out the management duties and in producing accounts meant to give a true and fair view. The authoritative document is the **ISA 501 Audit Evidence**.

The auditor proceeds by:

a) Identifying the assertions made by the directors expressed or implied for every item in the accounts;

b) The evaluation of every assertion for relative importance so as to assess the quantity and quality of audit evidence required;

c) Using both compliance and substantive procedures to collect information and evidence to support the amount at which items have been disclosed and the nature of that disclosure;

d) The evaluation of the evidence collected to ensure that it is relevant, reliable and sufficient;

e) to formulate a judgement on the truth and fair presentation of the items.

Having formulated the judgement on each item included or excluded from the accounts, the auditor then formulates a judgement on the truth and fairness of the accounts taken as a whole. To do this he will find that he needs other evidence in addition to the judgement he made on the individual items.

▶ DEFINITION OF KEY TERMS

1. **Audit evidence** This is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information.

2. **An expert or a specialist** a person or a firm possessing special skills, knowledge and experience in a particular field other than accounting and auditing

3. **Management Representations** provides standards and guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

4. **Audit sampling** this is the application of a compliance or substantive procedure to less than 100% of the items within an account balance or class of transactions such that all sampling units have a chance of selection to enable the auditor to obtain and evaluate evidence of some characteristics of the balance or class and to form or assist in forming a conclusion concerning the population from which the sample is drawn..

▶ EXAM CONTEXT

Examination issues to be discussed in this paper may be the more complex issues relating to other parties, management letters and the use of other people works especially the experts. . the use of sampling is also be discussed in this paper.

▶ INDUSTRIAL CONTEXT

Companies prepare financial statements to show the position of the operation of the company and a specific date or over a period of time. Auditors usually use these documents as evidence and may request the management to write further representations.

DEFINITION

"Audit evidence" is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to address all information that may exist. Audit evidence, which is cumulative in nature, includes audit evidence obtained from audit procedures performed during the course of the audit and may include audit evidence obtained from other sources such as previous audits and a firm's quality control procedures for client acceptance and continuance.

4.2 SOURCES OF EVIDENCE

The ISA identifies sources of evidence as being the accounting systems and the underlying documentation, the tangible assets, the management, the employees, customers, suppliers and other third parties who have dealings with or knowledge of the entity or its business.

4.2.1 The nature of audit evidence

The nature of audit evidence can be: visual, documentary or oral.

4.2.2 Sufficiency

The audit evidence should in total enable the auditor to form an opinion on the financial statements. Sufficiency is a measure of the quantity of evidence obtained. How much evidence to obtain, what source to use, and the form the evidence should take is an issue left to the auditor to exercise his judgement in the light of the opinion called for under the terms of his engagement. Of crucial importance however, he will be influenced by the materiality of the matter being examined, the relevance and reliability of evidence available from each source and the cost and time involved in obtaining it. Quite often the auditor obtains evidence from several sources which when put together gives him the necessary assurance. Factors that affect sufficiency are usually dictated by the degree of risk of misstatement. The risk itself is affected by the nature of the item, the adequacy of internal control, the nature of the business carried on by the entity, situations which may exact an unusual influence on management, the financial position of the entity, the materiality of the item in relation to the financial statements taken as a whole, the auditor's experience as to the reliability of the management staff of the enterprise and its records, the results of auditing procedures including fraud or error which may have been found and the type of information available.

4.2.3 Relevance

The auditor obtains evidence either through compliance testing of the internal controls or through substantive tests of the information contained in the financial statements and the underlying records. When management establish a system of internal control they make certain assertions. As far as internal controls are concerned, these assertions are:

1. Existence: that the controls exists;
   - ii. Effectiveness: that not only does the control exist but that it is effective;
   - iii. Continuity: not only does it exists and is effective but the control operates throughout the period of intended reliance. So when the auditor is carrying out the compliance tests, any evidence to confirm these assertions is relevant.

2. The relevance of audit evidence has to be considered in relation to the overall objective of forming an opinion and reporting on the financial statements. To achieve this objective, the auditor needs evidence to enable him to draw reasonable conclusions. Compliance tests alone cannot provide him with this evidence. He therefore has to use substantive tests. Here also there are certain assertions that the management is making and the auditor seeks evidence to confirm this.

   a) **Existence:** do the recorded assets and liabilities exist at the balance sheet date.

   b) **Rights and obligations**: are the assets owned by the enterprise and are the liabilities properly those of the enterprise.

   c) **Occurrence:** did the recorded transactions in fact occur and do they relate to the enterprise.

   d) **Completeness**: have all the assets and liabilities been recorded. Have all income and expenses been recorded.

   e) **Valuation:** have the amounts attributed to the assets and liabilities been arrived at in accordance with stated accounting policies on an acceptable and consistent basis.

   f) **Measurement:** Have the income and expenses been measured in accordance with stated accounting policies on an acceptable and consistent basis.

   g) **Presentation and disclosure**: have the assets, liabilities, capital and reserves been properly disclosed. Have income and expenses been properly disclosed where appropriate.

   Answers to these questions provided by audit evidence obtained are relevant in confirming the assertions made by the management. Remember that audit evidence obtained in confirming one assertion cannot compensate for failure to obtain evidence to confirm another assertion.

Reliability

Reliability of audit evidence is influenced by its source and its nature and although it is dependant upon the particular circumstances, we can make some generalizations:

a) Audit evidence is more reliable when it is obtained from independent sources outside the entity.

b) Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.

c) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

d) Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

e) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

Techniques of obtaining evidence

ISA 501 mentions them as:

a) Inspection of records or documents ,
b) Inspection of tangible assets,
c) Observation,
d) Inquiry,
e) Confirmation,
f) Recalculation,
g) Re-performance and
h) Analytical procedures.

These can be further analyzed as follows:

a) The physical examination of tangible assets and counting them;

b) Confirmation. These should be in writing, external sources being preferable to internal sources;

c) Examination of original documents. Vouching should be carried out that is comparing original documents with entries in the books;

d) Re-computation: This involves carrying out additions, calculations, extracting balances, rechecking postings and summaries.

e) Scanning: This is useful in seeking the unusual or extra-ordinary item. It involves just flipping through the records and documents looking out for the odd items.

f) Inquiry: This is asking questions of knowledgeable persons within and outside the entity. It is a necessary and valid technique. Auditors however, prefer confirmation to oral answers.

g) Correlation: This is seeking consistency in the records and in the accounts and using evidence obtained in other areas to provide additional assurance in other areas.

h) Observation: Visual evidence is more satisfactory therefore, observing a procedure being performed is the best possible confirmation. However, observation has the draw back that you can only rely on it at the time you are observing. You can never be sure that the procedure is carried out that way all the time.

4.4 FORMS OF EVIDENCE

a) Observation, is usually witnessing internal control and book-keeping procedures. It includes attendance at wages pay out. Observation of stock-take, opening of mail and receipting and issuing procedures at the stores warehouse.

b) Inspection: examining of physical assets to confirm their existence and their condition as an aid in determining their value for accounts purposes. It includes examining the records to ensure that book-keeping and internal control procedures have been carried out.

c) Testimony from independent third parties. These are obtaining bank letters, debtors circularisation, lawyer's letters etc.

d) Review of authoritative documents: e.g. title deeds, share and loan certificates, leases, contract, supplier's invoices, minutes of board meetings, internal sales invoices.

e) Testimony from management and employees: This can be formal for example a letter of representation or informal for example replies to questions in questionnaires.

f) Satisfactory internal control: Where the volume of transaction is large for example sales, purchases, wages and salaries, receipts and payments, this may be the most useful evidence.

g) Calculations performed by the auditor: These give him evidence of the correctness of many figures.

h) Review of post balance sheet events: In most cases the final audit is performed well after the end of the year and since the present is a function of the future many assertions can be verified by reference to subsequent events.

i) Relationship evidence: Evidence confirming truth about one item may confirm the truth about another, for example verifying the expense rates confirms to some extent existence and ownership of the property.

j) Agreement with expectation: Computation and comparison of ratios and absolute magnitude with those achieved in the past, by other companies, or budgeted can assist in verification. Also inconsistencies, unusual, abnormal or unexpected items can alert the auditor.

k) External events: The auditor must consider external events in using his knowledge of current events to assist him in the assessment of a company's accounts. He must therefore consider prevailing economic circumstances that affect his client; he must also consider the political situation and legislation.

Limitations of audit evidence

The quality and quantity of evidence is constrained by the following factors:

a) Absolute proof is not possible;

b) Some assertions are not material;

c) Time and cost must be considered as accounts must be produced within certain time scales and the auditor may have to do with less than perfection, and ideal evidence may be too expensive to obtain.

d) Sensitivity: some items are of greater importance than others or are capable of greater variations.

To summarise: the auditor's degree of assurance is greater when evidence obtained from different sources is consistent with each other. However, when evidence from one source is inconsistent with that obtained from another then further procedures may have to be performed to resolve the inconsistency.

The Use of Assertions in Obtaining Audit Evidence

Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. In representing that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

The auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks. Other ISAs discuss specific situations where the auditor is

Required to obtain audit evidence at the assertion level.

Assertions used by the auditor fall into the following categories

Assertions about classes of transactions and events for the period under audit:

a) **Occurrence** — transactions and events that have been recorded have occurred and pertain to the entity.

b) **Completeness** — all transactions and events that should have been recorded have been recorded.

c) **Accuracy** — amounts and other data relating to recorded transactions and events have been recorded appropriately.

d) **Cutoff** — transactions and events have been recorded in the correct accounting period.

e) **Classification** — transactions and events have been recorded in the proper accounts.

Assertions about account balances at the period end:

a) **Existence**—assets, liabilities, and equity interests exist.

b) **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

c) **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded.

d) **Valuation and allocation**—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Assertions about presentation and disclosure:

a) **Occurrence and rights and obligations**—disclosed events, transactions, and other matters have occurred and pertain to the entity.

b) **Completeness**—all disclosures that should have been included in the financial statements have been included.

c) **Classification and understandability**—financial information is appropriately presented and described, and disclosures are clearly expressed.

d) **Accuracy and valuation**—financial and other information are disclosed fairly and at appropriate amounts.


The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

Experts as a source of Audit Evidence

Usually the auditor's work on evidence obtained from within the entity supported by confirmations from third parties will give him enough reliable evidence that can enable him to give an unqualified opinion. There are however, certain circumstances when his knowledge is insufficient and he may see the need to rely on the opinion of other experts to help him form his own opinion.

The authoritative document on this subject **ISA 620: Using the work of an expert**. It defines an expert or a specialist as a person or a firm possessing special skills, knowledge and experience in a particular field other than accounting and auditing. The expert may be engaged by the client or by the auditor; he may be employed by the client or by auditor.

Examples of specialists or experts whose work may be relied upon include:

a) For valuations such as land and buildings, plant and machinery, works of art and precious stones — valuers;

b) For the determination of quantities of physical condition of assets for example: minerals stores in stock piles, underground minerals and petroleum reserves – geologists;

c) Determination of amounts using specialised techniques or methods for example: an actuarial valuation – Actuaries, on the liability to be included for pension scheme liabilities;

d) The measurement of work completed and to be completed on long term contracts in progress for the purpose of revenue recognition – Quantity Surveyors.

e) Legal opinions concerning interpretations of agreements, laws and regulations – Lawyers.

f) Determining the value of stock exchange securities – Stock Brokers.

When determining whether to use the work of an expert the auditor should consider the materiality of the financial statement item being considered, the risk of misstatement based on the nature and complexity of the item being considered and the quantity and quality of other audit evidence.

The skills and competence of the expert

When planning to use the work of an expert, the auditor should assess the professional competence of the expert.

The auditor should satisfy himself as to the expert's skills, experience and competence by considering the professional qualifications, the licence or membership of an appropriate professional body, experience and reputation in the field in which the auditor is seeking evidence.

Objectivity of the expert

The auditor should assess the objectivity of the expert. Just like in his own case, whereby his objectivity has to be jealously guarded the auditor must consider the objectivity of the expert. The expert's objectivity can be impaired where the expert is employed by the client or is related in some other manner to the client for example being financially dependent upon or having an investment in the client. The auditor may have to perform more extensive procedures than would otherwise have been planned, or he should consider engaging another expert.

4.7.3 Communication with the expert

If the auditor intends to use the work of an expert then he must communicate with the expert well in advance to confirm the terms of engagement and also to cover other matters such as:

a) The objectives and scope of work;

b) An outline of the specific items the auditor expects to be covered in the report;

c) The intended use by the auditor of the expert's work including possible communication with third parties as to the expert's identity and extent of involvement.

d) Extent of access to appropriate records and files by the expert.

e) Clarification of the expert's relationship with the client;

f) Confidentiality of the client's information;

g) The assumptions and methods intended to be used by the expert and how consistent they are with those used in the past;

h) The recording of any further information required as audit evidence.

The auditor should obtain sufficient appropriate audit evidence that the scope of the experts work is adequate for the purpose of the audit.

Procedures in evaluating the work of the expert:

The auditor must obtain reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information. He must therefore consider the source data used and whether it is appropriate in the circumstances, the assumptions and method used and their consistency with prior periods and the results of the expert's work in the light of the auditor's overall knowledge of the business and the results of his other audit procedures. He should satisfy himself that the substance of the expert's finding is properly reflected in the financial information. How appropriate, reasonable the assumptions and methods used are and how they have been applied is the expert's responsibility. The auditor does not have the same expertise so he cannot always challenge the expert's assumptions and methods. Although the auditor is not an expert on the expert's field of speciality, the auditor must be able to determine what is reasonable and what is not. Therefore he must obtain an understanding of the assumptions and the methods to determine that they are reasonable. There are times when the work of the expert does not support the related representations in the financial statements then the auditor should attempt to resolve the inconsistency by holding discussions with the client and the expert. He may need to engage another expert in resolving the inconsistency.

If after performing all these procedures the auditor concludes that:

i. The work of the expert is inconsistent with the information in the financial statement or that
ii. The work of the expert does not constitute sufficient appropriate audit evidence, then he should;

Express a qualified opinion, a disclaimer of opinion or an adverse opinion as appropriate.

Reference to an expert in the auditors report

When issuing an unmodified auditors report, the auditor should not refer to the work of the expert. This is because such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility neither of which is intended.

Occasionally the auditor may feel that even though he is expressing an unqualified opinion it may benefit the reader of the accounts if he refers to the work of the expert then the auditor must obtain the permission of the expert. If permission is refused and the auditor believes that such a reference is necessary he should seek legal advice.

Management Representations as a Source of Audit Evidence

International Standard on Auditing **ISA 580 Written Representations** provides standards and guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

The auditor should obtain appropriate representations from management

The auditor should obtain evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements. The auditor can obtain evidence of management's acknowledgment of such responsibility and approval from relevant minutes of meetings of the board of directors or similar body or by obtaining a written representation from management or a signed copy of the financial statements.

The thing to note is that during the course of the audit the auditor obtains various representations from the management which can be categorised into three types:

a) Not material to the financial statements. Examples being queries on missing documents or errors in book-keeping or

b) Capable of being corroborated by other evidence or

c) Where the knowledge of the facts is confined to the management. For example, the management's intention to close down a major branch and where the matter is principally one of judgement and opinion for example the realizability of obsolete stock.

In (a) and (b), there is no need for the auditor to obtain separate written representations by the management. In (c) however, the auditor should:

- Ensure that there is no conflicting evidence
- If he is unable to obtain corroborating evidence, then the auditor should obtain a written confirmation from the management of any representations made.
- The auditor must decide for himself whether the total of other evidence and the management's written representation are sufficient for him to form an unqualified opinion.

The procedures adopted are clearly stated in ISA 580. The letter should not include routine matters but only matters which are material to the financial statements and the auditor cannot obtain independent corroborating evidence. Please note that the letter of representation is simply one more piece of evidence and the auditor should not rely on it rashly but there are times it is the only source of evidence open to the auditor.

If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.


4.8.1 Documentation of Representations by Management

The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.

A written representation is better audit evidence than an oral representation and can take the form of:

(a) A representation letter from management;

(b) A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or

(c) Relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.

4.8.2 Basic Elements of a Management Representation Letter

When requesting a management representation letter, the auditor would request that it be addressed to the auditor, contain specified information and be appropriately dated and signed.

A management representation letter would ordinarily be dated the same date as the auditor's report. However, in certain circumstances, a separate representation letter regarding specific transactions or other events may also be obtained during the course of the audit or at a date after the date of the auditor's report, for example, on the date of a public offering.

A management representation letter would ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects (ordinarily the senior executive officer and the senior financial officer) based on the best of their knowledge and belief. In certain circumstances, the auditor may wish to obtain representation letters from other members of management. For example, the auditor may wish to obtain a written representation about the completeness of all minutes of the meetings of shareholders, the board of directors and important committees from the individual responsible for keeping such minutes.

4.8.3 Action if Management Refuses to Provide Representations

If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion. In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider if the other implications of the refusal may have any additional effect on the auditor's report.

1. Audit Sampling

ISA 530 Audit Sampling and Other Selective Testing Procedures defines **Audit sampling** is the application of a compliance or substantive procedure to less than 100% of the items within an account balance or class of transactions such that all sampling units have a chance of selection. To enable the auditor to obtain and evaluate evidence of some characteristics of the balance or class and to form or assist in forming a conclusion concerning the population from which the sample is drawn..

Purpose of audit sampling

Sampling is performed because it is more efficient than testing 100% of a population. in tax audits, if the taxpayer and the department can agree on a representative sample, it can save both parties time and money. By definition, any procedure that does not examine 100% of the items in question is a sampling procedure.

When not to sample

There are many audit procedures which do not involve sampling.

Inquiry and observation:

- Reviewing records for the method of accounting and other information.
- Observing accounting procedures.
- Discussing methods of accounting and reporting with taxpayer.
- Scanning documents for possible issues.

Analytical review procedures:

- Comparing records reports and other information.
- Recomputing or estimating amounts.
- Reviewing trends in reporting.
- Comparing similar businesses.

One-hundred percent examination:

- Reviewing all fixed asset purchases, where appropriate.
- Examining all contracts, where there are a small number.
- Reconciling each years gross receipts to cit a sales factors or schedule c receipts.

Zero percent examination:

This occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested.

Note: even though 100% examination may be done where appropriate. it is not mandatory for any particular taxpayers or tax programs. Sampling procedures discussed below may be more cost effective.

Sampling risk

Overall tax audit risk is made up of the risk of inaccurate records and the risk of misapplication of the tax law. Both of these risks are made up of two components as well.

1. Risk that there are errors (inherent risk).
2. Risk that procedures will not find errors (audit risk).

Audit risk, in turn is made up of two components, the risk that a procedure is not effective and sampling risk. Sampling risk is the probability that the sample results are not representative of the entire population. In general, factors that may lessen sampling risk include:

1. Taking larger size samples
2. Using random sample selection methods
3. Stratifying the sample
4. Properly defining the test objective
5. Properly defining a deviation
6. Exclusion of non-recurring, non-systematic errors.
7. Properly evaluating errors.

Statistical vs. non-statistical sampling

The difference between statistical and non-statistical sampling is that statistical sampling allows the user to measure the sampling risk associated with the procedure. Statistical sampling applies the laws of probability to determine the percent likelihood that the sample does not accurately reflect the population.

In essence, the laws of probability say that large, relatively homogeneous populations have similar distributions and other features so that if a random sample is taken, it will consistently reflect the population within certain limits. In order for the sample to be a "statistical" sample, the results must be evaluated and two calculations made. These calculations tell the user how likely it is that the sample results are within a given range of the actual population.

Designing a sampling application

There are several steps in designing a sampling application for an audit or investigation. the steps are discussed in detail in the next pages:

1. Define the objectives of the test

2. Determine the type of test to be performed
   a. variables sampling
   b. attribute sampling

3. Define the deviation conditions

4. Define the population
   a. decide what period will be covered by the test
   b. define the sampling unit
   c. consider the completeness of the population
   d. consider how the error rate will be extrapolated

5. Determine the method of selecting the sample
   a. random-number sampling
   b. systematic sampling
   c. other sampling

6. Determine the sample size
   a. variables sampling
   b. attribute sampling

7. Perform the sample
   a. compare the sample to the population before completing the sample

8. Evaluate the sample results
   a. interpret results
   b. extrapolate results
   c. consider the qualitative aspects of the deviations
   d. reaching an overall conclusion about the population

9. document the sampling procedure

Define the objectives of the test-step 1

The auditor must have a definite question to be answered by the test. examples of questions to be answered are.

1. Does the sales summary contain all invoices and is information recorded accurately?

2. How often are invoices voided without explanation?

3. Does the taxpayer record all supplies pulled from inventory in the inventory log?

4. Does the sales supervisor correctly batch sales by destination so that they can be recorded by state in the summary journal?

5. What is the amount of deductions not supported by nttc's?

6. What is the percentage of sales of services to the government relative to total sales?

7. What percentage of supplies is pulled from inventory held for sale each month?

8. What percentage of supplies purchased outside nm have not had tax paid or accrued?

Auditors should record the objective of the test within the audit narrative and/ or other work papers. not only does that help the reviewer, but it also clarifies the objective for the auditor so that the proper audit procedure and sampling application can be defined. if the auditor can create a one sentence question, like the ones above, to be answered, he or she is less likely to perform an inappropriate procedure or use the wrong sampling application.

Determine the type of test to be performed-step 2

The type of sampling application, whether statistical or non-statistical, is usually defined by the conclusion which the auditor is attempting to reach. "Variables sampling" is used to reach a conclusion about a population in terms of an amount. Variables sampling is commonly used to determine the amount size of a population or to determine if the stated amount size is correct.

"Attribute sampling" is used when the auditor is only concerned with acceptance or rejection of a hypothesis. it is used to reach a **yes or no answer** about a question.

the reason that defining the type of application is so important is that sample size is dependent on which type of application is being performed. Below is the same list of questions given on the previous page, and an explanation of the type of application required for each.

Sampling application analysis

Question to be answered	Type of application	Explanation
Does the sales summary contain all invoices and is information recorded accurately?	attribute	The auditor doesn't want to know what percentage or how much, only yes or no.
How often are invoices voided without explanation?	variables	Here, the auditor wants to know a specific amount.
Does the taxpayer record all supplies pulled from inventory in the inventory log?	attribute	Presumably, if there are supplies not recorded, the auditor will not "accept" the inventory record.
Does the sales supervisor correctly batch sales by destination so that they can be recorded by state in the summary journal?	attribute	This is a yes or no question, which will result in accepting or rejecting the data in the summary journal.
What is the amount of deductions not supported by nttc's?	variables	The auditor needs to know a specific amount.
What is the percentage of sales of services to the government relative to total sales?	variables	If the auditor asked the question, "is the percentage 20%," attribute sampling could be used. But here the auditor wants to know the exact rate.
What percentages of supplies are pulled from inventory held for sale each month?	variables	same as above
What percentage of supplies purchased outside nm have not had tax paid or accrued?	variables	same as above

Sampling applications can also be classified by the type of audit procedure in which they are used. "Compliance tests" are tests which determine whether controls are being complied with. the answer to a compliance test is yes or no. "Substantive tests" are tests which determine the amount of some class of items. Attribute sampling is most often used in compliance tests and variables sampling is most often used in substantive tests.

Compliance tests

Compliance tests are most often used by tax auditors to determine if controls which ensure the accuracy of records are in place and working correctly. These tests can be performed directly on the control feature itself or indirectly on the outcome of the control.

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An example of a direct test would be a test to determine that invoices are pre-numbered, used in sequence and accounted for by those issuing the invoices. Such a test would be helpful in assuring the auditor that all invoices issued in a period are used or voided.

An example of an indirect test would be a tracing of a sample of invoices to a summary journal to determine that the controls over recording invoices in the summary journal are working. in this case, the controls themselves are not actually tested, but the results of those controls are examined, and the question of whether the summary record is reliable will be answered yes or no.

Note that tax auditors do not use formal compliance testing as frequently as other types of auditors. However, tax auditors do make judgments about the level of risk of incorrect records and the risk of misapplication of the tax law. These are the types of judgments that can be backed up by compliance tests.

The decision to test controls or the accuracy of records is based on auditor judgment and the circumstances of the audit. The decision should be documented. Compliance testing may help to limit the scope of the audit to areas of higher risk or point out problems with records that may have otherwise appeared reliable.

The main reason for performing compliance tests is to reduce the amount of substantive tests that need to be performed. Therefore, the decision of whether to perform compliance tests should weigh the possible compliance tests against the possible substantive tests that could be performed to determine which test will be most efficient and effective.

For instance, if an auditor decides that he can either test the taxpayer's summary records or use them to perform the audit, or, rely on comparing reports to bank statements, then he or she should determine which method will be more efficient. If a compliance test of the summary records is performed and the records prove to be unreliable, then the auditor may still have to rely on bank statements. However, it may be that using the summary records will be much more efficient than using bank statements. Therefore, testing those records is worth the time needed and the risk that the test results will be negative. Before relying on the summary records the auditor should perform a test of transactions to determine the records are reliable.

Substantive tests

Substantive tests are used to determine the amount, usually the amount, of a specific group of items. if the auditor seeks to determine the amount of disallowed deductions, for instance, the result of the sample will be a amount figure of disallowed deductions found in the sample. The assumption is that the same proportion of disallowed deductions will exist in the population. Therefore, the final result of the test will be a amount of disallowed deductions for the population which will be used as a basis for assessment.

Often, samples can be designed to serve both compliance and substantive tests. When it is likely that records will be needed for both types of applications, the auditor should strive to pull one sample. This is called dual-purpose testing.

Define the deviation conditions-step 3

If you are performing a direct test of controls, such as checking for supervisor approval before selling goods free of tax, a deviation will be any noted lapse in the control. In this case if the control is documented in some way, such as with initials of the supervisor on the invoice, a deviation would be the lack of initials. If the control is not documented, you will have to rely on direct observation of the control being performed, or on indirect evidence.

If you are testing controls indirectly, you would look at the error which the control is intended to prevent and would base your deviation on what defines that error. In the case above, the control in place is intended to prevent salesmen from not charging tax on sales that should be taxed. A deviation would therefore be defined as an invoice that did not have tax and should have.

If you are performing a substantive test, the item(s) you are picking up might not necessarily be thought of as deviations. For instance, you may be trying to determine the average New Mexico inventory value over a period for testing the cit property factor. However, the same principle applies. You need to define which items meet the criteria necessary to reach the objective of the test. In this example, that might be inventory control log entries backed up by shipping and receiving reports.

Auditors should be careful not to include factors in the deviation, which do not affect the objective of the test. For instance, in the first test described above, invoices where the customer name was misspelled would not affect the objective of the test and should not be treated as deviations. On the other hand, auditors should also be careful to include all factors, which may affect the objective of the test. For instance, if an invoice contains the initials of a supervisor from another department who is not familiar with the customers who have non taxable transaction certificates (nttc's) on file, the invoice should be picked up as a deviation, even though it contains a supervisor's initials.

Some of the most common problems faced by auditors performing any kind of test come from not properly defining the deviation, and finding out after the test has been performed that there were other conditions that should have been considered.

Define the population-step 4

The auditor should determine if the population from which the sample is selected is appropriate for the specific audit objective, because sample results can be projected to only the population from which the sample was selected. If a change in the business results in more than one distinct population, then each needs to be tested separately. The auditor should also evaluate the reliability of the data presented as the population. The data should be complete and should also tie to other records such as crs-1s, journals, summary reports, etc.

Analysis may reveal that the taxpayer changed a specific control procedure during the period under audit. The auditor needs to decide whether to design one sample and test both controls or do two separate samples. The auditor might also discover that the non-taxable sales do not match the crs-1 reports due to the exclusion of a particular type of sale or due to the inclusion of non-new Mexico sales.

Decide what period will be covered by the test

Generally, a sample should be drawn from the entire period to which the test results will be applied. However, there are many situations when this is not practical. In any test where the auditor decides to limit the period from which the sample will be drawn, the auditor should evaluate sample results, as well as the period outside the sample, and determine the following:

1. What were the results of the sample and could they reasonably be expected to apply to the period not sampled.

2. What is the nature of the remaining period, does it have similar characteristics to the period tested?

3. How large is the remaining period? Ideally, the period from which the sample is drawn should be as large as possible. Limiting the period to a day out of each year or a week from the total audit period is not a sound basis for extrapolating results to the period not sampled. The more the sample is spread throughout the audit period, the more reliable the results will be.

4. What is the nature and amount of the transactions involved? The more homogeneous the population and the greater the size, the more likely a sample taken from only part of the period under audit will be representative.

5. What tests can be done of the remaining period to further substantiate the sample results?

6. What other matters are relevant to the sample results? Have conditions which might affect the results changed in the remaining period?

Define the sampling unit

A sampling unit is any of the individual elements constituting the population. The auditor should define the sampling unit in light of what is being tested and the type of records kept by the taxpayer. a sampling unit may be, for example, a document, an entry in a journal, a line item, or a single transaction.

It is possible to sample based on time period representations such as days, weeks, or months. The department has set minimums of 30, 25, and 9 respectively. The days, weeks, or months should be randomly selected from the entire audit period. Random sampling within the selected days, weeks, or months is encouraged. Regardless of the type of time period selected the number of items of interest (invoices, line items, transactions, etc) must be achieved for the population type. In most time period samples the items of interest will exceed the minimum required.

Consider the completeness of the population

The population is physically represented by some form of record. For instance, sales invoices, entries in a sales journal or summary entries in a ledger may represent total sales. The auditor actually selects sampling units from this physical representation and so must confirm that all sample units from this record are included in the entire population. If the physical representation differs from the actual population, the auditor might make erroneous conclusions about the population. A simple example of this is testing a depreciation schedule where a page of the schedule is missing.

Therefore, the auditor should be careful to determine that the records used to draw the sample are complete and reflect the actual population being tested. One means of doing this is comparing different records and reconciling differences found.

Determine the method of selecting the sample-step 5

Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an equal opportunity to be selected.

Random-number selection

The auditor may select a random sample by corresponding random numbers generated by a computer or selected from a random number table with document numbers. The random number generating software programs utilized by the department provide seed numbers which can be used to duplicate a specific list of random numbers. The seed number should be documented within the audit work papers.

Examples of random selection:

When a listing is available, even if the items are unnumbered or have non-continuous or non-systematic numbering systems, the random number sampling can be accomplished by making use of the page and line number.

For instance, the auditor might want to obtain a random number sample of items sold to one customer. Assume that a computer listing is available which consists of pages containing a total of 20,000 items. The pages of the listing can be easily numbered or their numbers determined by counting. There may be the same number of lines on most pages, with perhaps fewer on some.

Assume that there are 400 pages in the listing with 50 lines on most pages. The auditor would draw two lists of random numbers, one for three digit numbers between 1 and 400 and one for two digit numbers between 1 and 50. Items would then be selected by pairing numbers from the first and second list to identify the page and line on which the item to be selected is located.

Systematic selection

For this method, the auditor determines a uniform interval by dividing the number of physical units in the population by the sample size then rounding up. A starting point is randomly selected and each item after that is selected at the uniform interval. If the population is arranged randomly, systematic selection is essentially the same as random number selection. However, if the population is not randomly arranged, for instance, if sales are listed by item, rather than in the order made, there may be problems with this method.

One way to ensure more randomness in a systematic sample is to re-compute the interval each time by use of a random-number table. In this approach the auditor would select a list of random numbers. The first number would be the starting point. The second number would tell the auditor the interval to count to the next item to be selected. For instance, if the first two random numbers are 503 and 219, the auditor would select item 503 to start, then item 722 (503 + 219). In this approach, the auditor might have to go through the population more than once to finish drawing all the items. The number of digits to be used for the random numbers should make intervals that are large enough to go through the entire population a least once.

Determine the sample size step 6

Attribute sampling (yes/no)

To perform an attribute test, sample size should be determined as follows:

1. If the sample is drawn from the entire audit period, use an initial sample of 50 items. If the sample is drawn from a block, or if the population is limited in some other way, the initial sample should be 100 items.

2. If **one or more** deviations are found in the sample, the auditor must either reject the item being tested, or may expand the sample. If the auditor chooses to expand the sample, an additional number of items equal to the initial sample should be tested.

3. If **one or more** additional deviations are found, the auditor must either reject the item being tested, or may expand the sample to the appropriate variables sample size and use the results to estimate the amount of error in the item being tested.

See the section on evaluating the sampling results to determine whether qualitative aspects of a deviation may determine whether a deviation can be overlooked in an attribute sample.

Variables sampling (numbers)

A critical question must be answered before the sample size for a variables sample can be computed. **Is the population relatively homogeneous?**

Homogeneous populations can be tested using smaller size samples since there are fewer exceptional items to skew the results. Non-homogeneous populations require larger size samples.

Homogeneity is the tendency of items in a population to be similar, or closer to the same amount value. For instance, a population containing sales of three kinds of mid-priced property will be far more homogeneous than a population containing all sales of a department store.

If a population is non-homogeneous, the auditor can reduce the sample size through stratification and identifying individually significant items. See step 7 on performing the sample for an explanation of how stratification should be done.

The audit sampling workpaper, aud-21, can be used to document whether a population is homogeneous or not. Whether or not this workpaper used, the auditor should document why the population was either determined to be homogeneous or non-homogeneous.

Sampling size table

This table gives sample sizes for any population over 500 items where variables testing is performed. Populations smaller than 500 items should be examined in detail

	selection method		Population type (see flow chart for determination of population type)	
			non-homogeneous **homogeneous**	
unlimited **limited**	**1**	**individual item**	**500 items of interest**	**250 items of interest**
	1	individual item **stratified**	**100 items per strata (5 strata max)**	**75 items per strata (5 strata max)**
	2	**day ***	**30 days (1000 items of interest)**	**30 days (500 items of interest)**
	3	**week ***	**25 weeks (1000 items of interest)**	**25 weeks (500 items of interest)**
	4	**month ***	**9 months (1000 items of interest)**	**9 months (500 items of interest)**

(Note: the number to the left of the selection method is the order of preference for selection methods. a 1 indicates the most preferred methods and a 4 indicates the least preferred) *limited month, week, and day samples should examine two times the minimum required items of interest for the population type being tested, whenever possible. Random sampling of items of interest within the time period selected is encouraged. When using the month selection method the auditor must evaluate all months that have unusual balances and determine the circumstances for variance before including the months in the sample or in the extrapolation procedure. **Limited sampling is always our last choice and the reason for its use should be adequately documented.**

If the auditor determines that the population to be sampled is diluted with transactions that are not of interest then the sample size should be increased. In the case of a test of deductions where taxable and non-taxable sales are commingled the auditor would first need to determine the percentage of non-taxable sales in the population and then use this percentage to compute the increased sample size.

(Non –taxable sales ÷ total sales) x 100 = % of non-taxable sales

250 ÷ (% of non-taxable sales) = sample size

Perform the sample-step 7

After the sampling plan has been designed, the auditor selects the sample and examines the selected items to determine if they contain deviations. Test the viability of the sample plan using approximately 25% of the items you intended to select. If the planned procedures work and the results meet your expectations continue to sample the balance of the units. The sample should also be evaluated to determine if it is representative of the population. The average value of the sample should be similar to the average value of the population. If expectations are not met or if the average values are not similar to the sample the plan may need to be modified or a new sample may need to be selected.

The following problems may arise during the sample procedure.

Voided documents: if an auditor randomly or otherwise selects a voided item to be included in the sample, and has reasonable assurance that the item was properly voided, it should be replaced with another item selected in accordance with the sampling procedure. the rule here is not absolute, the auditor or supervisor may make a judgment decision based on the circumstances associated with the voided transaction.

Credits: most populations will contain credits. it may be possible in certain situations to remove the credits prior to sampling, but care should be taken to avoid inflating the population's total value. If the credits offset debits it is important to remove both. When stratifying a population it is necessary to use absolute values in order to keep credits and matching debits within the same strata. A credit will generally not produce a reduction in the exception total (the numerator in the error calculation). One example of a credit that might generate a reduction in a compensating tax exception total is the return of an item which had compensating tax accrued and paid at the time of purchase. a reduction would be acceptable if a reversal of the accrual did not take place and if the auditor has reasonable assurance that the return is not an unusual event.

Unused or inapplicable documents: the auditor's consideration of unused or inapplicable documents is the same. For example, a sequence of vouchers might include unused vouchers or an intentional omission of certain numbers. If the auditor selects such a document, he should obtain reasonable assurance that the voucher number actually represents an unused voucher and does not represent a deviation. The unused voucher may then be replaced with an additional voucher.

Errors in random-number selection: in a situation where the auditor generates a random number that is not part of the population, that number should be replaced with another random number which is part of the population.

Inability to examine selected items: if an item selected is missing and it cannot be determined what happened to the item, it should normally be considered a deviation.

Stratification

In order to make a population more homogeneous for variables sampling, the auditor can use stratification. Described below are some ways to stratify a population. This list is not all-inclusive and auditors may find other appropriate ways to stratify a population.

It is important to note that generally, stratification requires that the sample results be extrapolated to each stratum separately. in other words, if an auditor divides the population into two groups, sales of tangibles and sales of services, to make both groups more homogeneous, then the results of the sample from the tangible group should only be extrapolated to the total tangible sales and the results of the sample from the services group should only be extrapolated to the service sales.

Where the sample is limited to specific time periods, the auditor will need to confirm that the data from the entire population can be stratified before the resulting error rates can be applied.

Stratification is most often performed during computer assisted audits. Computer software applications can easily segregate a population and provide subtotals. it is required that auditors contact the computer assisted audit team when working with a high volume of transactions or with large data files.

A minimum of three errors per strata is necessary for extrapolation to strata population.

The following are some methods of stratification.

By amount - this is the most common type of stratification used by auditors. The auditor needs to identify the number of different ranges, and their amount values, into which the population most usually falls. For instance, if the auditor is testing sales of equipment and the taxpayer sells several low-priced, several medium-priced and two high-priced models, the auditor may decide to make strata from ksh7, 000 to ksh12,000, ksh12,001 to ksh18,000 and ksh18,001 to ksh25,000.

Remember, the results of the sample pulled from each stratum would be extrapolated only to the total of that stratum.

By nature of the items: an easy way to stratify a total population is to stratify based on the nature of the transactions, such as sales of tangibles and sales of services.

Any relevant attribute can be used so long as stratifying by that attribute tends to make the population more homogeneous in amount amounts.

By nature of the test - another way to stratify a population is to divide the items into groups according to the nature of the test to be performed. For instance, if the auditor is testing deductions for supporting documentation, the population could be divided into groups where an nttc is required and where one is not required.

The methods for stratifying described above may be used separately or in combination. for instance, the auditor may stratify first by the nature of the items, then by amount.

Stratification example:

Taxpayer a sells three types of computer equipment: laptops, desktops and network servers. The auditor decides to stratify the total population of sales by type of computer equipment, since that tends to create more homogeneous sub-populations. Since this is still a non-homogeneous, stratified population the sample size computed from the sampling size table is 100 per strata.

There were ksh2,000,000 total laptop sales during the period, ksh3,000,000 total desktop sales and ksh5,000,000 server sales. The auditor should allocate the total sample size as follows:

100 from laptop sales

100 from desktop sales

100 from network sales

the results were as follows:

5% under-reported laptop sales x ksh2,000,000 = ksh100,000

5% over-reported desktop sales x ksh3,000,000 = (ksh150,000)

10% under-reported network sales x ksh5,000,000 = ksh500,000

The total exception in this case would be the sum of the separately extrapolated sample results, the net amount of ksh450,000 under reported.

(Note: this is another example of a credit reducing an exception total)

Identifying individually significant items

When planning a sample for a substantive test, the auditor uses his or her judgment to determine which items, if any, in an account balance or class of transactions should be tested individually and which items, if any, should be subject to sampling. The auditor should perform a detailed test of each item for which, in his judgment, acceptance of some sampling risk is not justified. The auditor might also identify unusual balances and transactions as individually significant items.

Any items that the auditor has decided to test 100 % are not part of the items subject to sampling.

Evaluating the sampling results-step 8

After completing the examination of the sampling units and summarizing the deviations from prescribed control procedures, the auditor evaluates the results. Whether the sample is statistical or non-statistical, the auditor uses judgment in evaluating the results and reaching an overall conclusion.

Interpreting results

The auditor must determine how the outcome of the sample affects the test conclusions and the overall audit approach. If the auditor is testing the reliability of a certain record, the outcome of the attribute sample will either show deviations or no deviations. It there are deviations, the auditor must expand the sample as described under step 6 for attribute sampling or reject the record as unreliable. This in turn may affect the audit approach.

Extrapolating results (when 5 or more deviations are found)

If the test is a variables sample and five or more errors are found, the auditor must extrapolate the results to the remainder of the population. This procedure calculates the Percentage of Error (POE) found in the sample and applies that result to the population tested. To calculate the POE, take the amount value of the deviations (or other sample result), divide by the amount value of the total sample. Then multiply that POE times the amount value of the population.

$$\frac{\textbf{Ksh deviations (or sample results)}}{\textbf{Ksh total sample}} \times \textbf{Ksh population}$$

Note: if fewer than five deviations are found in a non-stratified sample the auditor should detail the exceptions instead of extrapolating. If working with a stratified sample the auditor should detail the errors in each strata sample that contains fewer than three errors.

There are three rules for extrapolating:

The numerator should be the sample representation of what the auditor is trying to determine about the population (or strata).

The denominator should be the sample representation of the population (or strata).

The population should be complete and should not include items that do not represent the population as defined by the test.

For instance, it would not be appropriate to draw a sample of deductions taken and test them for validity, then divide the exceptions found by total deductions tested and apply that percentage to gross receipts reported. In this example, gross receipts are not the population; deductions reported are the population.

Considering the qualitative aspects of deviations

In addition to evaluating the frequency of deviations, the auditor should consider the qualitative aspects of the deviations. Qualitative characteristics of the nature and cause of the deviations are:

Whether the deviations are errors or irregularities

Whether the deviations are due to misunderstanding instructions or carelessness, and

The relationship of the deviations to other phases of the audit.

Non-recurring errors are defined as errors that are caused by factors that do not affect the rest of the population. An example of a non-recurring error is a sale that was never recorded due to the fact that the salesman died right after closing the sale.

Errors that are determined to be non-recurring should be extracted from the results of the sample and from the total sample. They should not be used to extrapolate sample results to the total population.

For example, the auditor knows that some sales allocated to Texas actually had New Mexico delivery addresses. A sample is taken of Texas sales to determine what percentage of sales allocated to Texas should be reallocated to New Mexico. The sample of 100 items, totaling ksh2,000 showed three items that should have been included as New Mexico sales. One item was non-recurring and amounted to ksh100. The other two items amounted to a ksh40 total. The rate of error in the population would be computed as follows:

ksh40/1,900 = 2.105%

The ksh100 error would not be used to extrapolate sample results, but would be picked up as a separate exception.

Non-systematic errors are errors that are caused by factors that may affect the rest of the population but whose effects are not predictable. An example of a non-systematic error is an error caused by the taxpayer's occasional use of salesmen to do accounting work.

Errors that are determined to be non-systematic should also be extracted from the sample results. However, since such errors may be recurring in the population, the auditor should understand the cause of the errors and try determining the total population error.

For example, a sample test of ksh1,000 worth of sales reveals a systematic, recurring error of ksh100 and a non-systematic error totaling ksh50 in the sample. Investigation of the non-systematic errors shows that these errors generally occur at the end of the third and fourth quarters. The taxpayer explains that they are caused by differences in estimates used in recording end of quarter sales for those quarters in order to prepare the financial reports. Sometimes these estimates are reversed and the actual amounts are entered and sometimes they are not. The ksh50 found is a net under-reported amount due to these estimates. In this case it may be appropriate to examine all such entries to see which ones were reversed properly and which ones were not.

Alternatively, the auditor may conduct a separate sample of those estimates to determine the percentage difference resulting from improper reversal. if either of these is done, then the results of the entire test would be computed as shown in the following table.

total amount value of the population being tested	**minus**	**total amount of the estimated entries made**	**times**	**ksh100/950 (the ratio of systematic errors to sample less non-systematic errors)**
plus				
Total net difference caused by estimates not reversed (picked up by detail test).	**or**	**Extrapolated net difference based on sample of the estimates and the difference found.**		

Document the sample procedures - step 9

Examples of items the auditor should include in the documentation of the sampling test are:

- A description of the purpose of the test
- The definition of the population, the sampling unit, and the item of interest (if different)
- The definition of a deviation

- Was the population determined to be homogeneous or not and how was the determination made.
- How was the sample size determined?
- How were the sampling procedures performed?
- How were deviations evaluated?
- What were the results of the sample?
- How were the sample results used in the audit (how were they extrapolated)?

If a variables sample is planned, the population must be tested to determine if it is homogeneous.There are two approaches to sampling in auditing:

i. Judgement sampling (or non statistical)
ii. Statistical sampling

4.9.1 Judgmental Sampling

Judgement sampling is where the auditor using his own experience and knowledge of the client's business and circumstances selects the sample to be tested without use of any mathematical or statistical tools. Statistical sampling is the drawing of inferences about a large volume of data by an examination of a sample using statistical methods in its selection.

The advantages of judgment sampling

a) The approach is well understood and has been refined by experience over many years;
b) The auditor is given an opportunity to bring his judgement and expertise into play. After all auditing is an exercise in professional judgement;
c) No special knowledge of statistics is required;
d) No time is wasted playing with mathematics;

Its disadvantages are

a) It is unscientific;
b) It is wasteful and usually too large samples are selected;
c) You cannot extrapolate the results to the population as a whole as the samples are not representative;
d) Personal bias in selecting the sample is unavoidable;
e) There is no logic to the selection of the sample or its size;
f) The sample selection is so erratic that it cannot be said to have applied to all items in the year;
g) The conclusions reached are usually vague.

Judgement sampling is still the preferred method by the majority of auditors and this is defended on the grounds that the auditor is weighing several pieces of evidence and is investigating several things at the same time that the whole process is too complex to be reduced to simple formulas.

4.92 Statistical sampling – Advantages

a) It is scientific and defensible;
b) It provides a precise mathematical statement about probabilities of being correct;
c) It is efficient as over large samples are not taken;
d) It tends to cause uniform standards among different auditing firms;
e) It can be used by lower grade staff who due to lack of experience may be lacking the necessary judgement needed by the judgement sampling.

Factors to be taken into consideration before adopting statistical techniques:

a) The number of clients to whom it is appropriate because set up costs and training can be very high;
b) Large populations must exist as statistics is the science of large numbers;
c) Adequate controls must exist and the objective being to test them it is obvious that where no controls exist then you cannot apply statistical sampling;
d) The populations being tested must be homogenous in materiality. They must also be homogenous in that the same system and controls must apply to each one of them. In other words they must be subject to the same treatment.
e) Too many variables cannot be tested at once;
f) Items must be separately identifiable; therefore sequential numbering is essential;
g) The error must be defined;
h) Materiality: the auditor must consider the total value of the population and any variances from it;
i) The risk factor: some items have more risk than others;
j) The availability of other evidence. If evidence can be obtained through other means, then statistical sampling may only be a top up.

Related Parties

IAS 24 prescribes the disclosures necessary to draw attention to the possibility that the financial position and profit or loss of an entity may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

Definitions of related party and related party transactions from IAS 24, "Related Party Disclosures" are as follows:

Related party—parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions.

Related party transactions—a transfer of resources or obligations between related parties, regardless of whether a price is charged.


A party is related to an entity if it:

- Directly or indirectly, controls, is controlled by, or is under common control with, The entity;
- Has significant influence over the entity;
- has joint control over the entity;
- Is a close member of the family of any individual who controls, or has significant Influence or joint control over, the entity;
- Is an associate of the entity;
- Is a joint venture in which the entity is a venturer;
- Is a member of the key management personnel of the entity or its parent;
- Is a close member of the family of any of the aforementioned key management Personnel;
- Is an entity that is controlled, jointly controlled or significantly influenced by, or For which significant voting power in such entity resides with, any of the key Management personnel or their close family members;
- Is a post-employment benefit plan for the benefit of employees of the entity, or of Any of its related parties.

IAS 24 requires the following related party disclosures:

- Nature of relationships between parents and subsidiaries, even if there were no transactions between those related parties;
- The name of the entity's parent and, if different, the ultimate controlling party;
- Compensation of key management personnel;
- If there have been transactions between related parties, the nature of the relationship and information about the transactions and outstanding balances with related parties. Such disclosures are made separately for each of the following categories: the parent; entities with joint control or significant influence over the entity; subsidiaries; associates; joint ventures in which the entity is a venturer; key management personnel; and other related parties.

Importance of Related Party Transactions

While the existence of related parties and transactions between such parties are considered ordinary features of business, **the auditor needs to be aware of them because**:

a) The financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as those required by IAS 24;

b) The existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws in various jurisdictions which require special consideration when related parties exist;

c) The source of audit evidence affects the auditor's assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties; and

d) A related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

Transactions with related parties are important for several reasons:

(a) Several financial scandals involving related parties frequently appear in the headlines;
(b) A true and fair view of the entity's affairs may not be given unless full disclosure is made;
i Statutory requirements must be compiled with e.g. loans to directors.

There are basically two types of transactions that arise between a company and a related party:

(a) Those entered into in the ordinary course of business. It is usual for members of a group to trade with each other.

(b) Those not engaged into in the ordinary course of business or which may involve misleading presentation of the accounts or fraud on the company, its members or creditors.

Type (a) generally deserves no special audit attention. The auditor must however ensure that they actually arise in the ordinary course of business at arms length.

Type (b) is where problems may arise and where scandals have occurred.

The Companies Act prohibits loans to directors and where they occur requires full disclosure. The law prohibits the giving of financial assistance for the purchase of or subscription for a company's own shares. The law restricts the rights of directors to acquire non-cash assets from the company or for the company to acquire non-cash assets from its directors. Significant shareholding of more than 5% must be notified to the company within seven days.

Auditors Responsibilities with regard to related parties

ISA 550 Related Parties states that the auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by

Management of related parties and the effect of related party transactions that are material to the financial statements. However, an audit cannot be expected to detect all related party transactions.

The Audit Procedures can be summarised as follows:

Step 1: Identifying the related parties

The auditor should review information provided by the directors and management identifying the names of all known related parties and should perform the following procedures in respect of the


completeness of this information:

a) Review prior year working papers for names of known related parties;
b) Review the entity’s procedures for identification of related parties; Inquire as to the affiliation of directors and officers with other entities;
c) Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;
d) Review minutes of the meetings of shareholders and the board of directors and other relevant statutory records such as the register of directors’ interests;
e) Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and
f) Review the entity’s income tax returns and other information supplied to regulatory agencies.

If, in the auditor’s judgment, the risk of significant related parties remaining undetected is low, these procedures may be modified as appropriate.

Where the financial reporting framework requires disclosure of related party relationships (such as IAS 24), the auditor should be satisfied that the disclosure is adequate.

Step 2: Distribute the list to audit staff requesting them to ensure that any transaction with related parties of which they come across should be looked at carefully.

Step 3: Seek out transactions with the related parties. During the course of the audit, the auditor carries out procedures which may identify the existence of transactions with related parties. Examples include the following:

a) Performing detailed tests of transactions and balances.
b) Reviewing minutes of meetings of shareholders and directors.
c) Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
d) Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
e) Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties.

Examples include the following:

a) Transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms.
b) Transactions which lack an apparent logical business reason for their occurrence.
c) Transactions in which substance differs from form.
d) Transactions processed in an unusual manner.
e) High volume or significant transactions with certain customers or suppliers as compared with others.
f) Unrecorded transactions such as the receipt or provision of management services at no charge.

Examining Identified Related Party Transactions

In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.

Management Representations

The auditor should obtain a written representation from management concerning:

a) The completeness of information provided regarding the identification of related parties; and
b) The adequacy of related party disclosures in the financial statements.

4.10.4 Audit Conclusions and Reporting

If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should modify the auditor's report appropriately.

AUDIT DOCUMENTATION: ISA 230

Purpose of working papers

It is essential that all audit work is documented – the working papers are the tangible evidence of the work done in support of the audit opinion.


The ISA identifies the reasons for preparing audit working as follow:

a) The reporting partner needs to be able to satisfy himself that work delegated by him has been properly performed. The reporting partner can generally only do this by having available to him detailed working papers prepared by the audit staff who performed the work.

b) Working papers provide for future reference, details of problems encountered, together with evidence of work performed and conclusions drawn there from in arriving at the audit opinion.

c) The preparation of working papers encourages the auditor to adopt a methodical approach.

The exact form that working papers should take cannot be prescribed each firm will have its own disciplines. Whatever form the papers take, however, they must achieve the main objectives set out above.

Contents of working papers

The ISA 230 No.3 stresses that audit working papers should always be sufficiently complete and detailed to enable an experienced auditor with no previous connection with the audit to ascertain from them what work was performed and to support the conclusions reached. It also emphasizes the special care needed to record difficult questions of principle or of judgment. The auditor should record all relevant information known to him at the time, the conclusions to be reached based on that information and the views of the management.

Although the guideline does not attempt to define precisely the form of working papers it does indicate what might physically be contained therein as follows:

a) Information which will be of continuing importance to the audit (e.g. Memorandum and Articles of Association);
b) Audit planning information;
c) The auditor’s assessment of the enterprise’s accounting system and, if appropriate, his review and evaluation of its internal controls;
d) Details of the audit work carried out, notes of errors or exceptions found and action taken thereon, together with the conclusions, drawn by the audit staff who performed the various sections of the work;
e) Evidence that the work of the audit staff has been properly reviewed;
f) Records of relevant balances and other financial information including analysis and summaries supporting the financial statements;
g) A summary of significant points affecting the financial statements and the audit report, showing how these points were dealt with.

Working papers are conventionally subdivided into current and permanent files for convenience and control. The characteristic of current working papers is that they relate specifically to the audit of a particular set of accounts whereas permanent papers comprise matters of continuing importance affecting the client. Hence items (a) and (c) above are typically retained on the permanent file.

Permanent Audit File

The permanent audit file might include, inter alia:

a) A copy of the enterprise's statutes and other legal or statutory documents governing the enterprise's existence;

b) Other important legal documents and agreements;

c) Description of the business, its operations, together with the address of its locations. This section might also include details of specific matters relating to the industry or activity in which the enterprise is involved and which might affect the audit;

d) An organization chart showing the (top) management functions and the division of responsibilities;

e) Details of the system of accounting, including, where applicable, details of computer applications;

f) An internal control questionnaire, memorandum or other means of assessing the adequacy of the internal control system, including those areas where information is processed by means of a computer;

g) a letter of engagement defining the auditor's understanding of the work to be performed and his responsibilities, together with confirmation from the client that the letter set out the position as the client also understands it;

h) Correspondence, or notes of discussions with the client on internal control matters;

i) In the case of group companies details of all companies in the group including names and addresses of the auditors of the subsidiaries; this section might also contain a record of all information concerning other auditors on whose work reliance is placed for the purpose of the audit of group accounts;

j) The principal accounting policies followed, key ratios, history of capital, profits and reserves;

k) A reasoned description of the audit approach adopted;

l) Details of important matters arising from each audit, and a record of what decisions were taken and how they were arrived at.

Current Audit File

The current audit file might include inter alia:

a) A copy of the audited financial statements and any report prepared as a result of audit work carried out;

b) An annual audit programme detailing the audit steps to be taken and Audit documentation steps carried out;

c) Details of the audit plan, including time budgets, staffing and statement of the scope and level of tests;

d) Schedules showing an analysis of the individual items in the financial statements, the notes thereto and the management's report; the schedules should also show comparative figures and state how the auditor has verified the existence, ownership and the amounts and fairness of the presentation of items in the financial statements has been considered. These schedules should contain the auditor's conclusions, and should be cross referenced to supporting schedules and external documentary evidence, as appropriate;

e) Notes of meetings and all correspondence relating to the audit, including all certificates and other third party audit confirmations;

f) Extracts from meetings of shareholders, management, directors and other relevant bodies;

g) Records of detailed audit tests carried out, the reasons for the timing and level of the test, together with the conclusions drawn from those tests;

h) The information received from the other auditors regarding the financial statements audited by them;

i) Records of queries raised by the auditors and how such queries have been dealt with;

j) A letter or a statement from the management representing that they have supplied the auditors with all the information and explanations relevant to the audit and disclosed in the financial statement all matters required by statute and accounting standards;

k) A review of post balance sheet date events up to the date of signing the audit report;

l) Names and initials of the audit staff;

Standardization of working papers

The ICPAK guideline states that the use of standardized working papers may improve the efficiency with which they are prepared and reviewed. Used properly they help to instruct audit staff and facilitate the delegation of work while providing a means to control its quality.

However, despite the advantages of standardising the routine documentation of the audit (e.g. checklists, specimen letters, standard organization of the working papers) it is never appropriate to follow mechanically a `standard' approach to the conduct and documentation of the audit without regard to the need to exercise professional judgement.

On balance, there should be a degree of standardization of working papers and practically all firms recognise this need. Finally, it should be noted that working papers are the property of the auditor and he should adopt procedures to ensure their safe custody and confidentiality—leaving them on the bus or matatu should therefore be avoided.

CHAPTER SUMMARY

- There are two approaches to sampling in auditing:

  i. Judgement sampling (or non statistical)
  ii. Statistical sampling

- A written representation is better audit evidence than an oral representation and can take the form of:

  (a) A representation letter from management;

  (b) A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or
  (c) Relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.

- Transactions with related parties are important for several reasons:

  (a) Several financial scandals involving related parties frequently appear in the headlines;

  (b) A true and fair view of the entity's affairs may not be given unless full disclosure is made;

- The auditor should obtain a written representation from management concerning:
  b. The completeness of information provided regarding the identification of related parties; and
  c. The adequacy of related party disclosures in the financial statements.

- The ISA identifies the reasons for preparing audit working as follow:

  a) The reporting partner needs to be able to satisfy himself that work delegated by him has been properly performed. The reporting partner can generally only do this by having available to him detailed working papers prepared by the audit staff who performed the work.

  b) Working papers provide for future reference, details of problems encountered, together with evidence of work performed and conclusions drawn there from in arriving at the audit opinion.

  c) The preparation of working papers encourages the auditor to adopt a methodical approach.

CHAPTER QUIZ

1. ………………is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information
2. What are the assertions that management make and the auditors seek to confirm.
3. What are the forms of evidence?
4. List the limitations of audit evidence
5. What are the two approaches to audit sampling

ANSWERS TO THE CHAPTER QUIZ

1. **Audit evidence**

2.

a) **Existence:** do the recorded assets and liabilities exist at the balance sheet date.

b) **Rights and obligations**: are the assets owned by the enterprise and are the liabilities properly those of the enterprise.

c) **Occurrence:** did the recorded transactions in fact occur and do they relate to the enterprise.

d) **Completeness**: have all the assets and liabilities been recorded. Have all income and expenses been recorded.

e) **Valuation:** have the amounts attributed to the assets and liabilities been arrived at in accordance with stated accounting policies on an acceptable and consistent basis.

f) **Measurement:** Have the income and expenses been measured in accordance with stated accounting policies on an acceptable and consistent basis.

g) **Presentation and disclosure**: have the assets, liabilities, capital and reserves been properly disclosed. Have income and expenses been properly disclosed where appropriate.

3. a) Observation,

b) Inspection:

c) Testimony from independent third parties.

d) Review of authoritative documents:.

e) Testimony from management and employees:

f) Satisfactory internal control:

g) Calculations performed by the auditor:

h) Review of post balance sheet events

i) Relationship evidence:

j) Agreement with expectation:

k) External events:

4.

a) Absolute proof is not possible;

b) Some assertions are not material;

c) Time and cost must be considered as accounts must be produced within certain time scales and the auditor may have to do with less than perfection, and ideal evidence may be too expensive to obtain.

d) Sensitivity: some items are of greater importance than others or are capable of greater variations.

5.

i. Judgement sampling (or non statistical)

ii. Statistical sampling

PAST PAPER ANALYSIS

In the recent past, this area has not been tested as a stand alone topic but its knowledge helps the student tackle the other question with a display of understanding, knowledge and confidence. Paper in which this topic has been tested strongly include; 12/00 Question 5, 12/07 Question 3.

EXAM QUESTIONS

Question one

You are the auditor senior for Kenya Computer Sales Ltd., a distributor of microcomputers, and have just completed the interim audit. When you and your staff were auditing the accounting records, systems and controls, you recorded in your files the following information:

1. The credit limits for four customers of Kenya Computer Sales Ltd. had been substantially exceeded and new customers in the last twelve months had not been allocated credit limits.

2. When testing a sample of fifteen purchase invoices, you noted that one purchase invoice had been posted twice to the purchases ledger by mistake and two other purchase invoices could not be traced.
3. The results of a stock take conducted at the half year revealed that some microcomputers supposed to be in stock were missing and that other microcomputers which had been returned by customers were in stock but had not been recorded as having been returned. A few of the missing microcomputers have been traced to directors and staff who have borrowed them for personal use at home.
4. Leasing agreement for microcomputers offered by Kenya Computers Sales Ltd. to its customers have been queried by the Kenya Revenue Authority (KRA) who are not satisfied that the terms of the agreement which give the customer the right to purchase the equipment at a future date, qualify them as leases as opposed to hire purchase agreements. These agreements have been in use for a number of years and were vetted by your firm.

Required:

(a) Draft a management letter addressed to the board of directors commenting on the weaknesses you have discovered, the risks arising from those weaknesses and your recommendations for improvements. (14 marks)

(b) Comment on any significant impact these matters may have on your year-end audit work. (6 marks)

(Total: 20 marks)

Question two

(a) State the respective responsibilities of the directors and management of a company and its external auditors with respect to the financial statements. (6 marks)

(b) Describe the inherent limitations facing auditors in undertaking their work. (6 marks) (**Hint: Don not confuse inherent limitations with inherent risk**)

(c) Describe the significant types of judgments made by auditors in:

i. Gathering evidence (4 marks)

ii. Arriving at an opinion on the financial statements. (4 marks)

(**Total: 20 marks)**

Question three

You are the partner in charge of the audit of Futuristic Components Limited, a private company which intends to seek a public quotation for its shares.

The company is required to prepare a prospectus which must incorporate a report by the auditors of the company. The directors intend to include a profit in the prospects and you, as the company auditor, will therefore be required by the Stock Exchange to report on the base and calculations for the forecast.

Required:

(a) What are the preliminary considerations to be borne in mind before you would accept responsibility for reporting on the profit forecast? (6 marks)

(b) In your staff briefing as to the method of approach to be adopted in the profit forecast review, list six pertinent issues which staff should consider in their examination of procedures followed by the company in preparing the forecast. (12 marks)

CHAPTER FIVE

THE AUDIT PROCESS: VERIFICATION OF ASSETS AND LIABILITIES

CHAPTER FIVE

THE AUDIT PROCESS: VERIFICATION OF ASSETS AND LIABILITIES

▶ OBJECTIVES

When you have studied this chapter you should be able to:

- Explain the nature and importance of verification of assets and liabilities
- Explain the importance and purpose of substantive procedures in relation to financial statement assertions concerning assets and liabilities.
- Explain the sources, sufficiency appropriateness and others issues on audit evidence.

▶ INTRODUCTION

Despite any reliance on any controls, this chapter will elaborate that the auditor must substantiate the substance of the accounts. He must obtain evidence that the accounts give a true and fair view. To do that he has to verify the amounts attached to assets and liabilities in the accounts.

Verification is defined as proving the authenticity of the recorded amounts of assets and liabilities. Verification is achieved by confirming certain factors about an asset or a liability balance.

Whilst you study this chapter you should have in mind at all time the objective of the auditor and the purpose of the evidence being sought. *ISA 501 Audit Evidence* was introduced in chapter 4 in which we established the financial statement assertions of:

a) Existence
b) Right and obligations
c) Occurrence
d) Completeness
e) Valuation
f) Measurement
g) Presentation and disclosure.

▶ DEFINITION OF KEY TERMS

1) **Verification** this is proving the authenticity of the recorded amounts of assets and liabilities. Verification is achieved by confirming certain factors about an asset or a liability balance.

2) **Current assets** are those assets which are expected to be sold or consumed in the course of the operating cycle or assets which are held primarily for short term trading purposes and are expected to be realised with in 12 months of the reporting date or cash and cash equivalents.

3) **Goodwill** this is the excess of the cost over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities and is recognized as an asset.

4) **Research original** and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

5) **Development** the application of research findings or other knowledge o a plan or design for the production of new or substantially improved materials, products devices etc. prior to the commencement of commercial production or use.

▶ EXAM CONTEXT

This paper basically assumes you can audit and verify all assets and liabilities. This is likely to be tested in a scenario based case study type of question illustrating the procedure you would use in the auditing of asserts and liabilities.

▶ INDUSTRIAL CONTEXT

All companies have assets and liabilities which the auditor verifies. In the general conduct of an audit, this is an area the auditor has to deal with. It's highly applicable in practice.

5.1 SUBSTANTIVE PROCEDURES

The auditor needs to substantiate these assertions with substantive procedures.

You should keep in mind the audit testing techniques (Analytical procedures, Enquiry, Inspection, Observation, and Computation). Remember that audit evidence should be sufficient and appropriate.

You will also need to have a thorough knowledge of the accounting standard requirement from your financial accounting studies (for example, financial accounting III and IV). Please also note that the detail of the accounting standard requirements IS NOT repeated in this textbook.

Armed with these 'tools' and common sense approach you should be able to design an audit programme to deal with all areas of the financial statement. You should bear in mind also that most of the following matters have a similar theme. They are likely to have some or all of the following conditions in common:

a) Be a critical area of the financial statements

b) The subject of an accounting standard which has specifics disclosure requirements and recognition and measurement principles.

c) A contentious or subjective accounting area which has alternative treatments

d) A high risk matter

e) An area involving high degree of judgment

f) An area where the main source of evidence is that from management.

The examiner is likely to ask questions on areas of the financial statements which require students to demonstrate that they can apply an effective audit strategy to them.

Assertions

Verification has objectives very similar to the objectives of substantive tests that we covered under audit evidence and these are:

5.1.1 Cost:

This represents the original monetary amount at which an asset was acquired or a liability was incurred. It is crucial to determine cost because for most assets under the historical cost accounting convention valuation is a function of cost.

5.1.2 Authorization:

This is to ensure that there is proper authority to acquire the asset or incur the liability. Thus every transaction that results into an asset or a liability must be authorised at the appropriate level.

5.1.3 Valuation:

Assets and liabilities should be disclosed at the appropriate carrying amount. Assets are usually valued at cost less a provision thus; fixed assets are valued at cost less depreciation. Stocks are valued at cost less provision for obsolescence; debtors are valued at cost less provision for bad and doubtful debts. Fixed assets can also be valued at a valuation less depreciation based on that valuation. Liabilities are normally valued at cost unless they involve interest for late payments or foreign exchange transactions.

5.1.4 Existence:

Not only should assets and liabilities have a cost and a value there has to be evidence that they actually exist, because assets could have been lost, stolen or otherwise deteriorated.

5.1.5 Beneficial Ownership (Rights and Obligation)

This is exactly the same as rights and obligations under audit evidence. The assets may exist, they may have a value, the company may even have paid for them but does a company own them? So we want to ensure that assets and the rights of the entity and liabilities are obligations of the entity. We have to consider here also substance over form. Substance over form requires consideration of the financial and commercial reality of transactions and not merely their legal form.

5.1.6 Presentation:

Presentation in the accounts should be clear and unambiguous, appropriate to the nature of the business, in accordance with relevant accounting standards, in accordance with relevant legislation and consistent with previous years. Materiality must be considered in all these matters so that trivial matters are not given undue prominence in the classification, description and categorisation of accounts balances.

Examination papers will invariably contain a question on verification of assets and liabilities. Therefore the student must remember these seven important words mentioned above, because their knowledge can be applied to any question on verification and the student can achieve a good result.

a) Cost,

b) Authorization,

c) Valuation,

d) Existence,

e) Beneficial ownership and

f) Presentation.

5.2 SPECIFIC CONSIDERATIONS AND PROCEDURES

5.2.1 Cost and Authorization

Cost and authorization can be vouched to appropriate documentation such as invoices, cash book, agreements, local purchase orders, director's minutes. Another important factor to consider under cost is the distinction between capital and revenue expenditure. A check has to be made to ensure that all appropriate items of capital expenditure have been capitalised.

5.2.2 Valuation and allocation

As we saw assets are usually valued at cost or a valuation less a provision for usage or loss of value. We have to ensure therefore that the accounting policy adopted in determining the amount of provision to be written off in any one year is in accordance with the relevant IAS or generally accepted accounting principles or Companies Acts requirements. The IAS often allows several accounting policies in a given set of circumstances. So the question can often arise as to whether the particular accounting policy chosen is appropriate. Often it falls on the auditor to decide on this appropriateness. To do so, he has to consider the general practice in the industry, the previous practice in the company and the requirements of the true and fair view. Sometimes the requirements of appropriateness will override those of the IAS itself. A policy used for valuation apart from being appropriate and acceptable, must be consistently applied within the industry, within the entity and from period to period and must be in accordance with IAS.

Liabilities as we said are usually valued at cost, however where they involve estimation or they are provisions for specific liabilities then they too must be in accordance with clearly stated accounting policies. All these values must be determined on a historical cost basis and not replacement cost.

5.2.3 Existence

In the case of tangible assets existence is verified by the auditor visually, seeing the asset concerned and examining its condition. This is important in that visual evidence gives the auditor a good idea as to the reasonableness of the value attached to the asset. Where it is not possible to visually see the asset concerned, then we have to look for related evidence for example, if a company claims to own land payment of rates to the appropriate local authority is evidence that the plot of land exists. For assets that cannot be physically examined, independent confirmation from third parties would suffice. We have to take into account cut off arrangements to ensure that existence is at the balance sheet date and not at any other time.

5.2.4 Beneficial ownership: (Rights and obligations)

Here we have to examine documents of title, e.g. title deeds, motor vehicles log books. Where however there are no titles, implied ownership can suffice, for example stock items may have no title documents but the fact that we ordered them, we paid for them, we received them, they are in our warehouse, nobody else is laying claim on them, then it follows by implication that they are ours. This also involves substance over form transactions. If the commercial reality of a transaction is that the rewards and risks of ownership reside in the user then there is strong evidence that the user for all practical purposes is the owner of the asset and should recognise it as such despite contrary indications due to legal arrangements in existence.

5.2.5 Presentation and disclosure

Proper presentation includes presentation in accordance with the appropriate IFRS/IAS or International Accounting Standards. Adoption of accounting policies which are appropriate to the circumstances of the company and are adequately stated. Consistent application of accounting policies and where change in policy is deemed necessary with Companies Acts, Nairobi stock exchange and IAS requirements and taking into account materiality.

5.3 AUDIT OF ASSETS

Non current assets have the fundamental characteristic that they are held for use in the business and not for resale. *IAS 1 Presentation of financial statements* defines current assets as those assets which are expected to be sold or consumed in the course of the operating cycle or assets which are held primarily for short term trading purposes and are expected to be realised with in 12 months of the reporting date or cash and cash equivalents. All other assets are classified as non current assets which are also described as long term assets or fixed assets.

5.3.1 Non Current Assets (Fixed Assets)

In most countries, non current assets are generally classified as:

a) Intangible assets

- Patents
- Licences
- Development Costs
- Goodwill

b) Tangible Assets
- Land and buildings
- Plant and Equipment
- Furniture, fixtures and fittings

c) Investments
- Loans
- Shares

5.3.2 Tangible Non Current Assets

The verification approach is essentially similar in all these. Extensive disclosure is required in most countries and *IAS 16 Property Plant and Equipment, IAS 36 Impairment of Assets* and IFRS 5 Non Current Assets held for Sale and Discontinued Operations are the authoritative accounting documentations. (Also *IAS 8*)

(a) Land and buildings - Freehold

Accounting Principles

Verification Procedures

Cost and authorization

The cost of land and building acquired during the year should be vouched to appropriate documentation.

These are contract of sale, surveyor's certificates, solicitor's correspondence, cash book and in the case where a loan was obtained correspondence with the bank. The auditor must determine what the client considers to be cost. Where the buildings have been constructed by the client, then the auditor must review completion certificates and costing sheets with regard to internal labour and materials expended on the building as these are often overlooked. For authorization, the auditor should look to the directors' minutes and to confirm that the company's seal was used to seal the agreement of purchase.

Valuation

IAS 16 requires that all assets for use by the business should be valued on the basis of depreciated historic costs with one exception. IAS 16 states that freehold land should not be depreciated except in the event that the reduction in value is due to depletion through for example mining or due to changed economic circumstances. The reason for not depreciating freehold land is quite apparent when one looks at the definition of depreciation. Depreciation is the allocation of historic costs over the useful life of the asset. As freehold land has no finite useful life, there is no basis for calculating depreciation. Freehold buildings should be depreciated and the auditor must check that the estimated useful life is reasonable and that the calculations have been correctly made. The split therefore between freehold land and the buildings on that land must be established to be reasonable.

STUDY TEXT

Existence

Existence of Land and buildings is not difficult to prove. You may even be sitting in the building. However, the auditor needs to be sure that the land and buildings that he is seeing are the actual land and buildings referred to in the accounts. He may therefore need evidence from a map of the area concerned.

Beneficial ownership

Title deeds would usually be available for freehold land and they must be examined to ensure that they are validly in the name of the company. Land is often subject to mortgage so the auditor must be careful to ensure that such charges are correctly disclosed in the accounts. Such charges should also be recorded in the company's register of charges. Title deeds should be examined automatically on every audit. There is no title deed to a building therefore beneficial ownership is implied, that is the building is on our land we paid for it, the title deed of the land is in our name, we occupy that building, it follows that the building is also ours.

Presentation

Presentation will be covered when all other fixed assets have also been considered.

5.3.3 Leasehold property

Exactly the same procedures are adopted for leasehold land and buildings as applied to freehold land and buildings except in the issue of depreciation. There is no split between land and buildings when it is leasehold. In this case the land and buildings are amortised over the life of the lease even though the buildings may have an economic life longer than that of the lease. The argument for this is that the landlord after the end of the lease can comfortably ask you to take your building and go and he wants his land back. The term used is amortisation not depreciation.

☐ The authoritative document is IAS 17 Leases

The appropriate method of depreciation or amortisation to use in the case of freehold buildings and leasehold property is straight-line. This is because there is no objective basis of determining whether one year has benefited more from the use of the land and building than any other year.

The main problem in the audit of leased assets in the books of the user of the asset is to ensure that a proper split has been made between assets under an operating lease and assets under a finance lease. It should be recognized that there may be a high risk in this area due to the client preferring the asset to be recognized as an operating lease as this will keep the asset and the liability off the balance sheet.

The definition of a finance lease (one under which substantially all risks and regards of ownership are transferred to the lessee) is not easy to apply in practice.

The calculations used to determine whether a lease is a finance lease can be quite complex and thus the auditor must ensure that he understands the principals behind the calculations and that the assumptions used (e.g. the implicit rate of interest) are reasonable. Having understood the principles, a sample of the calculations need to be checked for all leases i.e. including those which the client has designated as operating leases.

For the leases which have been classified as finance leases, a sample needs to be checked for the following matters:

(i) Check method used to split interest and capital

(ii) Check the method is correctly applied to lease payments

(iii) Check depreciation is based on the shorter of the lease term and the useful life of the asset to the lessee.

In addition 'normal' audit tests apply to verification of the asset as for any other non current asset.

If the lease has been classified as an operating lease, then a check is required of the manner in which the rentals have been charged to the income statement. A check should also be made on the physical existence of the asset if at the time of the audit the lease is still in existence.

Finally regard should be made to the possibility of assets being held under leases also being shown in normal non current assets in the balance sheet. This is particularly relevant to operating leases where the existence of a physical asset at the balance sheet date may be used to support the inclusion of the asset in the non current asset account.

5.3.4 Plant and machinery

Cost and authorization

Significant plant and machinery acquired during the year is vouched to supporting documentation such as supplier's invoices, cash books, approved budgets, local purchase orders etc. The auditor should ensure that the related expenditure such as carriage inwards, installation charges have been included as appropriate.

Valuation

Valued at depreciated historic costs. Auditor's responsibility is to ensure that the accounting policy for depreciation is appropriate. For example if the diminution in value of an asset is related largely to time it would not be appropriate to use a reducing balance method but rather straight-line method should be used. The auditor has to ensure that the accounting policy is in accordance with IAS 16. He has to consider whether the useful lives of the assets are appropriate and he has to check that the calculations are correctly made.

Existence

This should normally be checked by physical inspection, however a problem arises. Items of plant and machinery can be mobile, numerous, portable and valuable. It becomes difficult therefore for the auditor to be assured that the value attached to plant and machinery represents plant and machinery that actually exists at the balance sheet date. We shall therefore digress a little and consider a record that is crucial in ensuring the existence of fixed assets under this category and this is the **fixed assets register.**

The fixed asset register is an important independent register which auditors invariably encourage their clients to maintain. For it to be a truly independent register the person maintaining it must have no responsibility for:

a) Ordering or authorising the purchase of fixed assets.
b) The custody of the fixed assets.
c) Authorising the disposal of fixed assets.
d) Maintaining general ledger accounts.
e) Custody of readily realisable assets.

If the register is properly maintained then it has the following advantages for the auditor:

a) The internal control over fixed assets is strengthened and there is an independent record of all fixed assets showing particularly their location. This record can be independently checked to the assets themselves on a periodic basis.
b) Accurate depreciation records can be maintained for every asset.
c) It assists the auditor in checking the completeness and existence of the assets, it would be almost impossible to do this from the general ledger.
d) It provides a good record for tax purposes in calculations of wear and tear.

The register can usefully contain the following information:

i. Fixed asset number.
ii. Fixed asset location and responsibility for custody.
iii. Nature and description of the asset.
iv. The cost and the date of purchase.
v. the estimated useful life and the residual value.vi. The accounting policy for depreciation.
vii. The accumulated depreciation and net book value.
viii. The gain or loss on disposal.
ix. Capital allowances.

When the fixed register is reconciled to the general ledger the auditor can check the asset for physical existence by reference to the numbers and locations recorded.

Beneficial ownership

For plant and machinery usually implied and unless there is clear evidence to the contrary, proof of purchase and possession will suffice as evidence of ownership.

5.3.5 Motor vehicles

Similar considerations govern the audit of motor vehicles as to those relating to plant and machinery. The only issue of consideration here is existence and ownership. Motor vehicles being mobile may not be available for the auditor to physically verify when he pays his visit. Related evidence can suffice however to prove existence for example if we own the motor vehicle we expect that if it is being used it will incur costs such as insurance, repairs and maintenance, and fuel. The engine and chassis numbers should be checked against the log book to ensure that it is the same vehicle that we are looking at as clients have been known to change the registration number plates from one vehicle to another.

Beneficial ownership

Ensure that the log book is in your client's name.

5.3.6 Furniture, fixtures and fittings

The only issue here to note is the depreciation of fixtures and fittings. Because of their nature, this is usually done on replacement basis rather than calculated and charged on an annual basis. In other words the initial cost is capitalised and any subsequent replacement are charged to the profit and loss account as they are incurred. Furniture is depreciated just like plant and machinery.

5.3.7 Disposal of Non-current Assets

The issue here is authorization for disposal and the elimination of the assets concerned from the records. The auditor also tries to ensure that the value obtained was reasonable either by looking at valuations obtained independently from professional valuers before the disposal and looking at the book value of the asset and related values for assets of that nature.

5.3.8 Presentation and Disclosure (The requirements of International Accounting Standards.)

IAS 16 provides exclusive disclosure requirements.

Fixed assets should be split into appropriate classes and the following should be disclosed:

a) The depreciation methods used
b) The useful lives or the rates of depreciation used
c) The total depreciation for the period and
d) The gross amount of depreciable assets and the related accumulated depreciation

The split between freehold and leasehold land must be shown together with the split between long and short term leases. Presently where the client has fully depreciated assets which are material their cost and notional depreciation charge are also disclosed. Where fixed assets have been re-valued and incorporated in the accounts then also the name of the valuer, the qualification of the valuer, the address of the valuer and the date of valuation must also be disclosed. In this case, the modification of the historical cost accounts must also be disclosed as a note to the accounts.

IAS 20 Accounting for government grants and disclosures of government assistance

The auditor needs to verify the grants have been properly identified as related to income and capital expenditure in the accounting period. In particular, the auditor should ensure that the conditions of the grant are being met; they may be repayable under certain circumstances.

It is also necessary to confirm that the grants have been accounted for in accordance with IAS 20. For example that capital grants are recognized over the expected useful life of the related asset and revenue grants are matched against the related expenditure.

There are two acceptable methods of accounting for capital grants. They can either be netted of against the asset (and the net cost of the asset is then depreciated) or the grant can be treated as deferred income and then allocated to the income statement on the same basis as depreciation is charged on the related asset. Re-performance and accuracy tests should be performed by the auditor.

The auditor should ensure that the accounting policy is appropriate in accordance with the standard and properly discussed.

5.4 INTANGIBLE ASSETS

5.4.1 Goodwill and Business Combinations

Goodwill is the most strange of all assets because it cannot be distinguished from the business. It cannot be sold on its own as asset. It is the most difficult to ascribe a value to. There is no reliable basis for determining the value of this asset.

The problem with internally generated goodwill is trying to quantify the asset. Therefore, internally generated goodwill should not be recognised as an asset in accounts meant to give a true and fair view. Therefore if the auditor finds a set of accounts where internally generated goodwill has been recognised as an asset in the balance sheet then, he should be aware that this treatment is against the requirements of IAS and should accordingly qualify his report.

Accounting Principles

IFRS 3 prescribes the financial reporting by an entity when it undertakes a business combination. A business combination is the bringing together of separate entities or businesses into one reporting entity.

All business combinations are accounted for by applying the purchase method, which views the business combination from the perspective of the acquirer. The acquirer is the combining entity that obtains control of the other combining entities or businesses (The acquiree).

The acquirer measures the cost of a business combination as the aggregate of:

- The fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus
- Any costs directly attributable to the business combination.

Any adjustment to the cost of the combination, that is contingent on future events, is included in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably.

The acquirer allocates the cost of the business combination by recognizing the acquiree's identifiable assets, liabilities and contingent liabilities at their fair value at the date of acquisition, except for non-current assets that are classified as held for sale in accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*. Such assets held for sale are recognized at fair value less costs to sell.

Goodwill, being the excess of the cost over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities, is recognized as an asset.

Goodwill is subsequently carried at cost less any accumulated impairment losses in accordance with IAS 36 *Impairment of Assets*. If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities exceeds the cost of the combination, the acquirer:

- Reassesses the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and
- Recognizes immediately in profit or loss any excess remaining after that reassessment.

IFRS 3 specifies the accounting treatment:

- For business combinations that are achieved in stages;
- Where fair values can only be determined provisionally in the period of acquisition;
- Where deferred tax assets are recognized after the accounting for the acquisition is complete; and
- For previously recognized goodwill, negative goodwill and intangible assets.

Disclosure Requirements

IFRS 3 also specifies disclosures about business combinations and any related goodwill.

Audit Procedures

The auditor's procedures as far as goodwill is concerned would include:

a) Vouching for details as per the purchase agreement of the values attributed to the assets purchased and whether the price obtained was reasonable considering similar businesses.

b) Review of the accounts of the business concerned and determining whether the business is profitable and can therefore justify the continued recognition of goodwill as an asset.

c) Consider impairment tests in accordance with IAS 36. (Top down and bottom up tests under IAS 36 Impairment of Assets)

d) Consider the requirements of ISA 540 Auditing of accounting estimates, including fair value accounting estimates and related disclosures

5.4.2 Research and Development

Introduction

History of business is littered with cases of companies that have collapsed as a result of over indulgence in research and development on products that have proved totally unprofitable. Unfortunately most of these could not have been easily seen from the preceding financial statements. A lot of companies simply capitalized research and auditors made little attempt to find out whether the values attributed to this asset were realistic.

Research is a necessary expense in earning revenue and can justifiably be matched against it. However, when research and development expenditure is incurred now, there is no telling when and if the associated revenue will materialise. The concept of prudence would dictate that such expenditure be written off as it is incurred.

The authoritative document on research and development is International Accounting Standard No.38 Intangible Assets.

IAS 38 *Intangible Assets* was issued in March 2004 and is applied to the accounting for intangible assets acquired in business combinations after 31 March 2004, and to all other intangible assets for annual periods beginning on or after 31 March 2004.

IAS 38 prescribes the accounting treatment for intangible assets, except:

a) Intangible assets that are within the scope of another Standard. For example, IAS 2 *Inventories* applies to intangible assets held for sale in the ordinary course of business;
b) Mineral rights and expenditure on exploration for, or development and extraction of non-regenerative resources.

An intangible asset is initially recognized at cost if all of the following criteria are met:

a) The asset meets the definition of an intangible asset i.e. it is identifiable and controlled by the entity;
b) It is probable that future economic benefits that are attributable to the asset will flow to the entity; and
c) The cost of the asset can be measured reliably.

Internally generated goodwill, brands, mastheads, publishing titles, customer lists and similar items are not recognized as assets. Expenditure on research is recognized as an expense. There is no recognition of an intangible asset arising from research. An intangible asset arising from development is recognized only if specified criteria are met.

If an intangible item des not meet the criteria for recognition as an asset, the expenditure is recognized as an expense when incurred. Expenditure that was initially recognized as an expense is not included in the cost of an intangible asset at a later date.

Subsequent to initial recognition, an intangible asset is carried at:

a) Cost, less any accumulated amortization and any accumulated impairment losses; Or
b) Revalued amount, less any subsequent accumulated amortization and any accumulated impairment losses. The revalued amount is fair value at the date of revaluation and is determined by reference to an active market.

An intangible asset can only be carried at revalued amount if there is an active market for the asset. Any revaluation increase is credited directly to equity as revaluation surplus, unless it reverses a revaluation decrease of the same asset previously recognized in profit or loss. Any revaluation decrease is recognized in profit or loss. However, the decrease is debited directly to the revaluation surplus in equity to the extent of any credit balance in revaluation surplus in respect of that asset.

An entity assesses whether the useful life of an intangible asset is finite or indefinite; the useful life is indefinite if there is no foreseeable limit to the period over which the asset is expected to generate net cash flows. The depreciable amount of an intangible asset with a finite life is amortized on a systematic basis over its useful life.

An intangible asset with an indefinite useful life is not amortized, but is tested for impairment at least annually. Impairment of intangible assets is recognized in accordance with IAS 36 I*mpairment of Assets*.

The gain or loss on derecognizing of an intangible asset is the difference between the net disposal proceeds, if any, and the carrying amount of the item. The gain or loss is recognized in profit or loss.

Disclosure Requirements

IAS 38 specifies disclosures about intangible assets.

Audit Procedures

The auditor should ensure that:

a) Any costs incurred in the purchase of fixed assets in order to provide facilities for research and development over a number of accounting years are to be capitalised and written off over their useful lives;

b) Expenditure on *research* should be written off as it is incurred;

c) Development expenditure should also be written off as it is incurred except in the very special circumstances mentioned above. If development costs are as defined, they should be amortised on the basis of sales or use of the product or process. The amount deferred should be reviewed each year and if there are any doubts as to its recoverability, it should be written off immediately. Once written off, research and development expenditure should not be reinstated;

d) Movements and balances of deferred development costs should be fully disclosed in the accounts as a separate item and not included in current assets. The accounting policy adopted should be fully explained. The movements that need to be disclosed are: the balance at the beginning of the year, additional expenditure during the year, less expenditure written off during the year and the amount carried forward.

The two key issues in the audit of intangible assets are:

(a) Recognition of intangible assets

The audit problem here is to ensure that all the requirements of IAS 38 are net before intangible assets are recognized. The identification, measurement and distinction between 'research' and 'development' expenditure are potentially difficult areas for the auditor.

(b) Measurement after initial recognition

Intangible may only be revalued upwards (although in practice this may be rare) if an active market in them exists. If an active market does exist evidence of valuation will be available. Active markets are typical in many industries. For example fishing quotas in the fishing industry may be purchased by a company at Kshs. per tonne. This increase can be reflected in the financial statements by the company provided that it is verifiable from observed activity of buying and selling of quotas on the market and the verification of price evidence.

The standard defines research and development as follows:

(a) Research – original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
(b) Development – the application of research findings or other knowledge o a plan or design for the production of new or substantially improved materials, products devices etc. prior to the commencement of commercial production or use.

Research costs should be expensed in the period in which they are incurred

Enterprises costs should be expenses in the period in which they are incurred

Enterprise should write off all development costs, unless they can demonstrate (a) to (f) below, in which case the cost should be recognized as an asset.

(a) The technical feasibility of completing the intangible asset and use or sell it
(b) The intention to complete the intangible asset and use or sell it
(c) The ability to use or sell the intangible asset

(d) How the intangible asset will generate probable future economic benefits. Among other this, the enterprise should demonstrate the existence of a market for the output of the intangible asset pr the intangible asset itself or if it is to be used internally the usefulness of the intangible asset.

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset, and

(f) The ability to measure the expenditure attributable to the intangible asset during its development reliably.

Costs which were originally recognized as expenses cannot be recognized as assets in subsequent periods.

Amortization – capitalized costs should be amortized to reflect the pattern in which the related economic benefits are recognized.

Once commercial production has commenced development costs should be amortized over the period of production that has benefited from the development expenditure. This may be done on a time basis or using a 'unit production' method.

Impairment – deferred development expenditure should be reviewed at the end of each accounting period and where the circumstances which have justified the deferral of the expenditure no longer apply, the expenditure should be written off immediately.

The main procedures in audit work to verify compliance with IAS 38 are to check that the conditions noted above for recognition of development costs have been complied with.

5.4.3 Trade marks and patent

Trade marks and patents may be capitalized and then written off over their useful lives with any renewal fees being charged to revenue. If a trade mark or patent is abandoned then the net book amount should be written off immediately. Normally the company should keep a register of all material items which should be checked against the agreements, the accounting records, and third party confirmation from the patent agent of the existence and company's title to the assets. Auditors will need to consider the valuation of the assets. This will include a review of the future income arising from the trade mark and patent to see whether it justifies the value placed on it. In assessing the future income it will be necessary to consider the possibility that income will not arise due for example to expiry or changes in the client's business.

You should also recall from your accounting knowledge that the goodwill impairment could be determined using 'top-down' or 'bottom-up' tests.

The 'bottom-up' test involves identifying the goodwill in the balance sheet that can be allocated on a reasonable basis to the cash generating unit.

The 'top-down' test involves identifying the smallest cash generating unit which the goodwill belongs and then apportioning any unallocated goodwill on a reasonable basis to the cash generating unit.

In each case above, impairment has occurred where the recoverable amount of the cash generating unit is less than the carrying amount of the assets plus the allocated goodwill.

You should recall from your earlier studies that the 'top-down' test is required where there is no reasonable basis for carrying out a 'bottom up' test.

Management's justification of the process of carrying out the impairment review must be carefully examined. The auditor should consider the sufficiency and reliability of the evidence available. When examining 'economic value' or 'value-in-use' evidence will be required to support (for example) future cash flow projections, interest rates growth rates, product life cycles, future production costs etc. These are subjective areas whereas determining the 'net selling proceeds' is more easily verifiable by reference to evidence from current market activity.

It is particularly important that the auditor reviews the notes to the financial statements to ensure that the disclosures in respect of the accounting policy and treatment are sufficient and appropriate.

Goodwill and fair value

The main points the auditor needs to verify for any goodwill arising in the accounting period are as follows:

(i) Examine the methods used to determine the fair value of the consideration given to purchase the shares of the subsidiary and the fair value of the net assets in the subsidiary at the date of acquisition. The usual verification procedures should be used, although the auditor should consider the need for an expert valuation.

(ii) The accounting treatment of the goodwill once it has been quantified needs to be checked to ensure it is being accounted for incompliance with IFRS 3

(iii) A check is required that the detailed disclosure requirements of IFRS 3 are complied with.

5.4.4 Brand names

Some companies in recent years have placed valuations on the brand names of the goods that they sell. The valuation is shown on the balance sheet. The reason for doing this is that the brand name is valuable to the company in that it helps to sell the company's goods. For example, may people would rather buy a 'branded' tin of soap powder, rather than the 'own make' offered by a supermarket. IAS 38 prohibits recognition of internally generated brands.

For purchased brands, the auditor must consider:

(i) Is the brand name valued according to an acceptable method, and not just 'guessed' by the directors?
(ii) Is the value being amortized over an acceptable time period which relates to the future sales of the brand?
(iii) Has the credit entry for the debit been adequately shown as a non-distributable reserve on the balance sheet
(iv) Is there adequate disclosure of the accounting policy in the financial statements?

IAS 36 Impairment of assets

It is important for the auditor to check the client's procedures for determining and accounting for impairments. Under IAS 36, 'impairment' has occurred where recoverable amount has fallen below the asset's carrying value. The recoverable amount is higher of net realizable value and value in use (economic value).

The stages of the audit in this area could be:

(i) Confirm whether the enterprise has carried out any impairment checks and review the validity of the conclusions reached as to whether further investigation of impairment was necessary.

(ii) If the client has concluded that no further work is required and the auditor concurs, no more audit work is needed. If, however, the audit disagrees and considers that the value of some assets has been impaired, it is necessary to discuss the matter with management. If no further action is taken by management it may be necessary to issue a modified audit report giving a qualified opinion based on the disagreement with management and detailing the cause of the disagreement. Of course, in majority of cases further action will be taken by management and a modified report will not be required if the auditor is satisfied with that further action.

(iii) If the client has concluded that impairment checks are needed, the auditor will review the stages of the impairment investigation, paying particular attention to:

(a) The validity of the enterprise's work in arriving at net selling price
(b) The validity of the enterprise's work in calculating value in use, with particular referenceto the acceptability of the basis for estimating future cash flows and of discounting rate adopted.
(c) The validity of the client's procedures in applying the impairment review process to cash-generating units.
(d) Compliance with relevant disclosure requirements.

5.4.5 INVESTMENTS

Note: Authoritative documents:

- IAS 40, IAS 41, 32, 39,27,28,30, IFRS 3, 5
- Requirements of the Companies Act with respect to Investments and Properties.
- Requirements of ISA 540


Introduction

An investment is held for wealth generation (such as dividends and interest on shares and loan notes) and capital growth. Current investments are readily realizable and are intended to be held for no more than one year. All other investments are long term investments.

Investments in subsidiaries, associates and joint ventures require special accounting procedures for the preparation of additional financial statements – group accounts, otherwise known as consolidated accounts. From your earlier studies you should be familiar with the definitions relating to group accounts. For example, a subsidiary, broadly, is more than 50% controlled, and an associated company is one over which an entity has a 'significant influence' as evidenced by at least a 20% holding.

Long term investments may be carried at cost, revalued amounts, or the lower of cost and market value determined on a portfolio basis decided by the director.

The carrying amount of a long term investment should be reduced to recognize impairments in value.

Where long term investments are carried at market value a consistent policy should be adopted whereby increases or decreases in the carrying amount should either go through the income statement, or, to a revaluation account in equity. To the extent that there is no revaluation surplus relating to a particular asset, any deficit should be charged to income.

When assets carried at market value are disposed of the company should adopt a policy of crediting outstanding revaluation surpluses to either income, or retained earnings.

Current investments may be carried at market value or the lower cost or market value.

Disclosure requirements

In general terms, the following items should be disclosed in relation to all investments:

(a) The accounting policies for:
- (i) The determination of carrying amount of investments
- (ii) The treatment of changes in market value of current investments carried at market value
- (iii) The treatment of a revaluation surplus on the sale of a revalued investment

(b) The significant amounts included in income for
- (i) Interest, royalties, dividends and rentals on long term and current investments
- (ii) Profits and losses on disposals of current investments
- (iii) Changes in value of such investments

(c) The market value of marketable investments if they are not carried at market value
(d) The fair value of investment properties if they are accounted for as long term investments and not carried at fair value
(e) Significant restrictions on the feasibility of investments or the remittance of income and proceeds of disposal
(f) For long term investments stated at revalued amounts

(i) The policy for the frequency of revaluations
(ii) The date of the latest revaluation
(iii) The basis of revaluation and whether an external value was involved

(g) The movements for the period in revaluation surplus and the nature of such movements
(h) For enterprises whose main business is the holding of investments an analysis of the portfolio of Investments

Internal Control

Where a trading concern holds only a few investments, there is unlikely to be any systematic internal control systems specifically for those investments.

With a larger investment portfolio, there should be a system of internal control which will include:

(i) Authorization procedures for purchases and sales
(ii) Register reconciled with control accounts
(iii) Control over dividend/interest receipts
(iv) Proper division of responsibility and supervision

Verification Procedures

Verification procedures should follow the general approach outlined for tangible non current assets. However, the following specific points should be noted.

ISA 501 Audit Evidence – Additional Consideration for Specified Items states that audit procedures relating to long term investments normally include considering evidence as to whether the entity has the ability to continue to hold the investments on a long term basis, discussing the matter with management and obtaining written representations to that effect. Other procedures would include the following:

(a) Existence and ownership

Establishment of title and beneficial ownership of investments is not conclusively possible. However, evidence is available in the form of:

(i) Share certificates, correspondence with nominee etc
(ii) Payments for securities, brokers,' bought notes' or 'contract notes'
(iii) Dividends/interest from securities, dividends 'warrants'.
(iv) Internal control procedures.

(b) Valuation

Valuation of listed securities is easily conformed to appropriated financial publications. Directors' valuation of unlisted securities is something on which the auditors report, and the basis of the calculations, must therefore be examined. The auditor must also consider whether any write downs for impairment in value are adequate, which may mean examining copies of accounts of companies in which investments are held.

(c) Income

Income from securities can be verified with known interest rates for fixed interest securities, and a share information service for listed shares. Unlisted share income must be verified with copies of the accounts.

5.4.6 IAS 40 Investment Properties

Audit work common to all types of land and building will be required to establish ownership, existence and value.

IAS 40 requires that companies may adopt the cost based approach or the fair value policy for the treatment of investment properties.

If the cost based approach is used, the accounting treatment is as for the benchmark treatment under IAS 16 (Cost less accumulated depreciation and impairment losses) and you should be familiar with the audit procedures normally carried out.

If the fair value policy is adopted, the company is required to revalue the property each year taking gains and losses to the income statement. Fair value will normally be verifiable by reference to current prices on an active market. In the absence of an active market, the auditor may need to consider evidence of valuations from similar markets (suitably adjusted) or discounted cash flow projections. Points peculiar to investment properties for the auditor to review therefore include:

(i) Confirming that the fair value policy is appropriate (for example it is rented to a non group company)

(ii) Assessing the reliability of the evidence on which fair value is based especially when no active market exists

(iii) Correctness of accounting for transfers between classification to for from investment properties where (and only where) a change of use has occurred. (You should re-familiarize yourself with the accounting treatment where transfers between components are made).

(iv) Completeness of disclosure requirements.

STUDY TEXT

Typical audit evidence might include:

- Physical inspection of the location and condition of the investment property and confirmation that it is not owner occupied.
- Valuer's report (whether external or internal) including the date(s) of valuation; base used (i.e. open market), assumptions made (e.g. full occupancy), etc
- The qualifications, experience and objectivity of the valuer(s)
- The calculations of individual gains/losses on properties disposed of.
- Representations from/enquiries of management in respect of the treatment of investment properties
- Review of previous information for consistency (e.g. financial statements from previous years)
- Management's impairment review, if any
- The proposed note disclosure reflecting the true and fair override.

Accounting requirements

IAS 40 prescribes the accounting treatment for investment property and related disclosure requirements.

Investment property is initially recognized at cost. Subsequent to initial recognition, investment property is carried either at:

- Cost, less accumulated depreciation and any accumulated impairment losses, as prescribed by IAS 16 *Property, Plant and Equipment*, or
- Fair value. Fair value is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Movements in fair value are recognized immediately in profit or loss.

The measurement model is applied consistently to all investment property. However, an entity may choose either the **fair value model** or **the cost model** for investment property backing liabilities that pay a return linked directly to the fair value of specified assets including that investment property, regardless of the model chosen for all other investment property.

Transfers to, or from, the investment property classification are made only when there is evidence of a change in use.

The gain or loss on de-recognition of an item of investment property is the difference between the net disposal proceeds, if any, and the carrying amount of the item. The gain or loss is included in profit or loss.

5.4.7 Financial Instruments (IAS 32 and IAS 39)

IAS 32 and IAS 39 are examinable to the extent that they deal with the presentation and measurement of equity, debt and convertible debt. The typical audit approach will include:

- Verification of the analysis between equity and debt and appropriate designation to capital and reserves or liabilities
- Performing tests for arithmetical accuracy
- Ensuring that the discount rates used are realistic
- Ensuring that other base data in the allocation is correct (e.g. the correct conversion date has been used)
- Ensuring that the detailed disclosures requirements are met.

5.5 AUDIT OF CURRENT ASSETS

5.5.1 Verification of Stocks and Work In Progress

Authoritative documents: IAS 2/ISA 501/501

IAS 1 Preparation of financial statements requires inventories to be disclosed separately and the accounting policy adopted to be disclosed.

IAS 2 inventories prescribes the accounting treatment for inventories, except:

- Work in progress arising under construction contracts (IAS 11 *Construction Contracts*);
- Financial instruments (IAS 39 *Financial Instruments*); and
- Biological assets related to agricultural activity and agricultural produce at the point of harvest (IAS 41 *Agriculture*).

Summary of IAS 2

Inventories are measured at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. The cost of inventories, other than those for which specific identification of costs are appropriate, is assigned by using the first-in, first-out (FIFO) or weighted average cost formula.

When inventories are sold, the carrying amount of those inventories is recognized as an expense in the same period as the revenue.

The amount of any write-down of inventories to net realizable value is recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of a write-down of inventories is recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

IAS 2 specifies disclosures about inventories

In a large manufacturing company, no item in the balance sheet presents verification problems to auditors to the extent that stocks do. The reasons for this generally are:

a) The amounts involved are material;
b) Stock has a one for one impact on the reported profits. In other words an increase of stock by one shilling increases the reported profits by one shilling. It therefore opens itself easily to distortion by the management;
c) Stock does not derive from the normal double entry system, it is usually a figure arrived at by a stock taking exercise held at the end of the year, valued and incorporated into the profit and loss account and balance sheet, any differences being written off to cost of sales.
d) Stocks are portable and valuable opening themselves to pilferage and deterioration either intentional or accidental.
e) The number of items involved is usually numerous creating verification problems as far as existence and condition is concerned.
f) Although stocks are valued at the lower of cost and net realisable value, what constitutes cost can vary from one management to another and the basis of determining that cost can be subject to so many different methods all resulting in different values for the same items.
g) It is an area that is susceptible to manipulation by management as apart from problems of arriving at cost, the provision for obsolescence, slow moving and damaged stocks is a question of judgement therefore it is easy for the auditor and the management to disagree.
h) Stock is usually not one item but many different items, for example; finished goods, work in progress, raw materials, goods in transit, spares, consumables etc. All these can be valued on a different basis and amalgamated and described as stocks.

5.5.2 The auditors duties can be summarized as follows:

a) Ascertaining the accounting policies adopted by the entity for valuing stocks;
b) As the guiding standard on stocks is IAS 2 inventories, the auditor has to consider the suitability of the policies selected by the organization.
   You must note that under IAS 2:
   i. The lower of cost and net realisable value is obligatory. FIFO or weighted average cost is used to allocate costs.
   ii. The cost should where appropriate include a proportion of production overheads whether or not they vary on a time basis. The proportion included must be based upon the normal level of activity.

iii. Where identical items are purchased or made at different times and therefore have differing costs the method of arriving at cost should be FIFO, weighted average

c) The auditor should test check the stock sheets or the continuous stock records with relevant documents such as invoices and costing records to determine if cost has been correctly arrived at.
d) The auditor must examine and test the treatment of overheads.
e) The auditor must test the treatment and examine the available evidence for items valued at net realisable value.
f) The auditor must check the arithmetical accuracy of the calculations made.
g) The auditor must check and confirm the consistency with which the amounts have been computed.
h) The auditor must consider the adequacy of the description used in the accounts and the disclosure of the accounting policies adopted.

5.5.3 Detail work on stocks is imperative in an audit, however there are other review tests that are equally important and these include:

a) Quantity reconciliation of changes in stocks at successive period ends with records of movements i.e. receipts and issues.
b) Comparison of quantities of every kind of stock held at one year end with those held at a previous year end and the related receipts and issues.
c) The gross profit ratio is compared to that of the previous year, other companies and budget.
d) Review of rate of stock turnover with previous year.
e) Comparison of stock figures and budgets for stocks, sales and purchases.
f) Consideration of standard costing records, the treatment of variances in the valuation of stocks and work in progress.

5.5.4 Detailed audit of stock

a. Cost

For the auditor this is restricted usually to determining the methods adopted by the organization in costing stocks. The auditor weighs the acceptability and appropriateness of the policies adopted. The rest of the exercise is a mechanical exercise of testing to confirm that the methods adopted have been correctly applied.

b. Authorization

The purchases cycle produces stocks, therefore audit work of compliance tests, analytical reviews and substantive tests in the area of purchases usually provide the auditor with adequate evidence as to authorization procedures in obtaining stocks.

c. Valuation

IAS 2 prescribes that stock be valued at the lower of cost and net realisable value, it is up to the auditor to ensure that net realisable value is correctly assessed and that the choice between the cost and net realisable value is properly done and is in accordance with IAS 2. IAS 2 states that comparisons should be by individual units of stocks or categories. Comparison cannot be simply on a basis of the total cost of all stocks and the total net realisable value. Stocks is reduced to lower of cost and net realisable value by a provision for obsolete, slow moving and damaged stocks. This is a potential area of disagreement between the auditor and the management because it is subject to judgement. The auditor's concern is to ensure that the provision is neither inadequate nor excessive. To determine this adequacy, the auditor is guided by such factors as the consideration of:

i. The age of the stock;
ii. Its turnover;
iii. Its condition;
iv. Technological advances in the industry concerned;
v. The nature of the stock, it could be perishable or it could be subject to a volatile market;
vi. Economic conditions i.e. recent selling prices, demand for the product, the performance of competing products;
vii. The quantity of the stocks held;
viii. The accounting policies involved;
ix. Subsequent events

All these factors give the auditor a good indication of whether the provision is adequate or not.

Net realisable value based on selling prices relates to the selling prices prevailing at the balance sheet date. Occasionally we review the selling prices after the balance sheet date but the purpose of this is to obtain additional information about conditions existing at the balance sheet date. Temporary fluctuations must be ignored. By temporary we mean fluctuations of less than one month.

d. Existence

In the past the auditor accepted a directors certificate as to the existence of stocks. Until several cases particularly in the United States of America were decided against auditors for their failure to obtain adequate independent evidence that the stocks concerned were in existence. On several occasions, auditors certified accounts as giving a true and fair view when the stocks concerned were non-existent. The unfavourable decisions against the auditor have resulted in the profession making it obligatory that where the stocks are a significant figure in the accounts the auditor must verify existence.

(Refer to ISA 501) This is achieved chiefly through the client arranging for a stock take and the auditor attending to observe the stock take.

If is not the auditor's duty to take stock. He must however satisfy himself as to the validity of the amount attributed to stocks in the accounts that are the subject of his audit. In determining the nature and extent of the audit steps necessary for this purpose the auditors must examine the system of internal control in order to assess its effectiveness relative to the ascertainment and evaluation of stocks and work in progress. While it will not normally be necessary for the auditor to observe the entire stock take or visit all locations their tests should cover a representative section of the stock. Where stocks is held at a number of locations the selection of the location to be visited should be planned so as to cover all significant locations over a period of years.

The amount at which stock is stated in the accounts may be based upon a physical stock taking at the year end or upon information taken from stock records. When stock is based on records these must be substantiated by continuous or periodical physical stock takings. The procedures should ensure:

a) Adequate stock records are kept up to date.
b) Each category of stock is checked at least once a year and a record of checks maintained.
c) If the checking is continuous, it is done systematically over the years or if periodic at suitable times, such as when stocks are low or have reached a specific re-order point.
d) All differences are properly investigated and the records amended accordingly. There should be maintained schedules of differences with details of the action that was taken.

5.5.5 STOCK TAKING

The procedures for carrying out physical stock taking vary in detail according to the size and circumstances of the business and the nature of its stock records. However, definite instructions preferably in writing should be issued in all cases for the guidance of those who will be engaged in the actual stock taking. The stock taking instructions should as a bare minimum contain:

a) Identification of the articles and their ownership.
b) Counting, weighing or measuring.
c) Reporting of stocks which are damaged or otherwise defective.
d) How the stock take is to be recorded.

Stock taking should be planned well in advance and carried out carefully and systematically by persons fully informed of the duties involved. Those taking part should include persons familiar with the various sections of stock and where practicable supervisors and checkers should be drawn from departments which have no control over the usual custody or movement of stocks. Where specialised knowledge is necessary to identify the nature or quality of items of stock the client should ensure that personnel properly qualified for this purpose are available at the stock take. **Arrangements should be made to ensure a proper cut-off.** This means that despatch documentation should have been originated for all goods despatched before stock taking and if still on hand, for all goods in which the property has passed to the customer. The latter should not be included as stock when the count is made. The procedures should ensure that the

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appropriate sales invoices are recorded in the correct financial period. Also liabilities should be set up for all goods received and included in stock and for all goods purchased the property which has been passed to the client. This should be included in the stock even though they are not yet on the company's premises. Arrangements should be made to ensure that goods held in safe custody for others are not recorded as part of the client's stock. Arrangements should be made to confirm and record in the stock sheets details of goods held for the company by outside parties and arrangement should be made to identify slow moving, obsolete or damaged stock.

The stock taking instructions should also call for the following information which should be available to the auditors during and at the conclusion of the stock take.

a) Details of stock movement during the count.
b) The last numbers of goods inward and outward records.
c) The details of the numbering of stock sheets issued of those completed and of those cancelled and unused.

Auditors Procedures

The auditors procedures are covered under three stages, before, during and after.

(a) Before

1) Study of the clients stock taking instructions and recommendations for changes or improvements if the auditor considers them inadequate.
2) Familiarisation with the location of the stocks and the opportunity to plan for the work to be undertaken.
3) Familiarisation with the nature and volume of stocks and especially with high value items.
4) Review of previous year's working papers and discussions with the managers of any significant changes from the previous year.
5) Consideration of the location of stocks and likely points of difficulty e.g. cut-off.

6) Consideration of any involvement of the internal audit department and the extent of reliance to be placed upon their work.
7) Arranging to obtain from third parties confirmation of stocks held by them.
8) Establishing whether expert advice may be needed.

(b) During

The main task during stock taking is to ascertain whether the client's employees are carrying out their instructions properly. It is usually advisable for the auditor to test the efficiency of the counting by counting selected items. In this case the auditor should select items for counting from the records and from the factory flow. The auditor should make notes for follow up purposes of items counted in his presence, details of defective, damaged, obsolete or slow moving items. Incidence of stock taking instructions not being followed. Details of items for cut off purposes.


He must enquire into, observe and discuss with the store keeping staff the procedures for identifying damaged, obsolete and slow moving stocks. He should enquire and test the cut off arrangements. Form a mental impression of the quantity of stock held for comparison with the accounts. Record fully the work done and his impression of the stock take exercise. He must form a conclusion as to whether the stock take can be relied upon. He should take photocopies of the rough stock sheets. He should take details of the sequence of the stock sheets. He should pay special attention to high value items.

(c) After

It is mainly a follow up exercise and it involves:

1) Checking the cut off with the details of last numbers of stock movement forms and goods inward and goods outward notes during the year and after the year end.
2) Ensuring that the final stock sheets have been properly prepared from the count records. He must particularly check that all the forms issued were returned.
3) He should check the final stock sheets for pricing, extensions, casting, summarisation and the necessary improvement.
4) Follow up any notes made and the attendance.
5) Inform the management of any problems in the stock taking exercise so that they can act accordingly.

Non-Attendance at Stock Takes

If the auditor is unable to attend a stock take, because he has numerous clients with the same accounting date, or stock is located at remote locations, the auditor must still certify himself on the stock take. This can be done by:

1) Arranging for the stock take to be done at an earlier date.
2) Appointing agents.
3) Examining perpetual inventory records more thoroughly.
4) Intensifying other verification records and
5) Using rotational methods.

Stock takes need not take place at the end of the year. If the client has a good system of internal control and satisfactory stock records, which clearly identify opening quantities, receipts, issues and closing quantities then the auditor can rely on a stock take carried out before or after the year end. All he has to do is to examine the movements in the intervening periods and substantiate them. (Perpetual inventory techniques)

Beneficial Ownership or Title

In January 1976 the famous case of Aluminium Industries Vaasen B V v. Romalpa Aluminium Ltd radically altered the law with regard to normal trading practices. Commercial law states that title to goods passes to the buyer once they are delivered on a valid contract, therefore if the buying company went into liquidation then the seller company most probably would lose the stocks and money. This was accepted business practice for centuries. The Romalpa case rules that transactions can be made subject to reservation of title until such a time as the buying company makes payment. The case further ruled that such a reservation should be clearly stated in the appropriate sales documentation and that the rights of the selling company over unpaid for stocks can even extend to goods produced from the store and the sale proceeds there from. In the strict legal sense, stocks subject to such a reservation clause should be included in the buying company's accounts until they are paid for. Accounting treatment acknowledges the concept of substance over form and as a result the amounts are shown as sales by the selling company and as purchases and stocks by the buying company. This assumes a situation where the buying company is a going concern. If the financial position of the buying company is in doubt then the amounts in question should be removed from both stocks and creditors in the buying company's books. In the event that the commercial basis of presentation is adopted and the amounts involved are extremely significant, then it may be necessary to reveal in a note to the accounts that creditors of the appropriate amount are secured by a specific stock.

DISCLOSURE AND PRESENTATION

Buyers

These cases are only relevant if creditors include a material amount owed to suppliers who have sold goods subject to reservation of titles. Effectively such creditors are secure. The Companies Act and the presentation of a true and fair view require disclosure of secured creditors even though it is not clear whether the creditors secured in this way are covered by the Companies Act. Under normal trading conditions where the buyer is a going concern, it is doubtful that the seller would reprocess their goods. In liquidation however, the sellers may have a right to their goods. Accounts are drawn up on the going concern assumption. Disclosure of matters which are relevant only in liquidation seems necessary. It is customary however to disclose the amount of creditors who are secured in this way. The problems this creates are:

1) Purchases and creditors subject to reservation of title are not normally separately identifiable from other creditors and purchasers.

2) It is not always clear if a particular purchase subject to this restriction will stand up in a court of law as ordinarily the law requires that any creditors secured on a company's assets should be registered.

Sellers

So far as sellers are concerned, the issue is only relevant in improving the collect ability of debts. Therefore, when reviewing the provision for bad and doubtful debts, the accountant needs to consider these points:

An example of a suitable note to the accounts:

"The company purchases goods from certain suppliers subject to reservation of title. This gives the suppliers the right to claim the goods if they are not paid for. The total of such supplies included in creditors in the balance sheet was Kenya Shillings X".

Auditors Procedures

1) Ascertain what steps the client takes to identify suppliers, selling on terms which reserve title by enquiry of those responsible for purchasing and of the board.

2) Ascertain what steps are taken to quantify the liability to such suppliers for balance sheet purposes, including liabilities not yet reflected in the creditors ledger.

3) Where there are material liabilities to such suppliers:

   a) If the liabilities are quantified in the accounts, review and test the procedures by which the amounts disclosed have been computed.
   b) If the directors consider that quantification is impracticable but have either estimated the liabilities or indicated their existence review and test the information upon which their disclosure is based.
   c) Consider the adequacy of the information disclosed in the accounts.
   d) Ensure that the basis on which the charge for taxation is computed takes account of the accounting treatment adopted and where necessary is adequately disclosed.

4) Where liabilities to such suppliers are said not to exist or to be immaterial, review the terms of sale of major suppliers to confirm that this is so.

5) Obtain formal written representation from the directors either that there are no material liabilities of this nature to be disclosed or that the information disclosed is in their view as accurate as it is reasonably possible to achieve.

Ownership or title to stocks before the advent of the Romalpa case was implied in that if we ordered the goods, have paid for them or have set up a liability for them, have received them, they are in our possession, we are using them for trading, nobody is laying claim to them, then they are ours. The student should noted that Romalpa sales do not cover goods sold on consignment or goods sold on sale or return where a sale will only be made on fulfilment of some agreed event such as the resale of the goods by the consignee.

Presentation

On the face of a balance sheet or in the notes to the accounts, stocks and work in progress should be classified or sub-classified in a manner which is appropriate to the business and so as to indicate the amounts held in each of the main categories. The accounting policy in respect of stocks must be disclosed and if there are changes therein, their impact must also be disclosed.

5.5.6 Work In Progress

What applies to goods for resale applies equally to work in progress even though the items present greater problems of ascertainment and valuation to the directors and to the auditor. The auditors investigations will include:

a) Enquiry into the costing system from which work in progress is ascertained.
b) Enquiry into how reliable the costing system is. A costing system integrated with the financial system will be more reliable because of the discipline of double entry and the inherent checks imposed by external data such as creditors statement.
c) Enquiry into checks that are made as part of the system on statistical data concerning inputs of materials and outputs of products and expectations.
d) Enquiry into the system of inspecting and reporting on work done so that allowance is made for scrapping and rectification work.
e) Determining the basis on which overheads are included in costs and ensuring that this is based on IAS 2.
f) Making enquiry into the basis on which any profit elements are dealt with. Profit should be eliminated from work in progress.
g) Where the organisation constructs internally some of its own fixed assets, the auditor must make sure that such items as are under construction at the year end are not accounted for twice i.e. in fixed assets and in work in progress.

5.6 LONG TERM CONTRACTS

The authoritative document with reference to long term contracts is IAS 11: Construction Contracts and IAS 18: Revenue Recognition, and ISA 600 Reliance on the Work of other Auditor

IAS 11 Construction Contracts

A construction contract is a contract specifically negotiated for the construction of an asset or combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

Such contracts often span more than one accounting period. This gives rise to a number of accounting and therefore auditing issues.

The auditor must examine a schedule of all the construction contracts that the enterprise is currently engaged in, and reach an opinion as to whether attributable profits and losses have been satisfactorily calculated. Furthermore the presentation of contracts in the financial statements must accord with the IAS. Although the auditor should have a working knowledge to be able to deal with many aspects of long term contracts, it may be necessary to contact external experts to seek assurance in specialist areas where the auditor has insufficient expertise himself. For example, determination of the stage of completion of a building in the course of construction.

Whilst the audit process will require verification work (e.g. examination of costing records, verification and allocation of materials, labour and overhead costs to supporting documentation, etc) the more sensitive audit issues are disclosure, recognition and measurement of profits and revenues and valuation matters.

- Contract revenue should be recognized in the accounting period in which the work is performed
- Contract costs should be recognized against the revenue to which they relate
- Expected excesses of total contract cost should be recognized immediately
- Costs which relate to future activity (contract work in progress) should be carried forward as an asset (provided they are recoverable)
- Irrecoverable amounts receivable from recognized contract revenue should be recognized as an expense.

Long-term contracts are those for which the estimated lives are longer than one accounting period. Periodic accounts artificially break down the life of company into specific periods and the need for the matching concepts to be followed makes it necessary to ascribe a proportion of the profit on a contract for each of the accounting periods that it covers. This is in conflict with the prudence concept which would require that costs be accumulated until the completion of the contract, or can be reasonably foreseen through estimates to complete. Generally, when there is conflict between the prudence concept and the matching concept the prudence concept prevails.

(a) Cost and Authorization

The cost incurred to date on a contract can be checked by routine vouching to invoices and suppliers statements.

(b) Valuation

The basis of valuation should be cost plus attributable profit less foreseeable losses and progress payments both received and receivable. It becomes necessary to determine the appropriate amount of profit that can be taken on a contract. This appropriate attributable profit is arrived as follows:

<u>Total costs to Date</u> x Anticipated x Allowance = Attributable
Total anticipated total profit for prudence profit costs on the contract

This formula derives the total profit that can be taken on the contract to date. This profit after it had been worked out must be reduced by any profits taken in previous years to determine the attributable profit for the year. For the auditor, the following points must be noted:

1) Total costs are derived from the current estimated total costs for the contract
2) Total profits is derived from the contract price less total estimated costs
3) Prudence must be taken into account when determining the amount of attributable profits. By prudence in this case we mean you must take into account the likelihood of the profit figure being achieved and this is a function of

    a) Time: that is the longer a contract has to run the more difficult it is to determine the profit.
    b) Consider the company's ability to estimate its costs accurately.
    c) Consider the nature of the contract: a fixed price contract is far more risky than one which allows costs escalation: thus a cost plus contract carries very little risk at all.

You will notice that this exercise is wholly dependant on the company estimating its future costs. This is where the auditor has to be extra careful because the directors can distort the accounts by using unrealistic estimates. Conventional, historic costs techniques are therefore inappropriate and alternative methods must be adopted. They may include:

1) Examination of the company's budgets and budgetary system. Are they a reliable basis for determining future costs or do the figures appear to be pure guess work?

2) Comparison of the costs to date on the contract with the original budget. If they relate reasonably, then it will give some confidence that the future costs are also reasonably stated.

3) Comparison of the results of previous contracts completed with the original budget to determine the company's ability at forecasting.

4) Perform detailed tests to substantiate the future costs by reference to technical data and reports from any independent personnel.

5) Review the progress of contracts in relation to any penalty clauses for late delivery. If the auditor is satisfied that the future costs are fairly stated, he should check the calculation of attributable profits, taking into account the issue of prudence on the basis of the points raised earlier on. If it becomes apparent that on completion of a contract a loss will be made, then such a loss should be charged against income in the year it is foreseen. If any profits have already been taken in the past years they should be written back along with the total loss.

5.7.1 Debtors

Considering what we have gone through on the other assets the audit work to verify the figure of trade debtors would be as follows:

1) Obtain a schedule of debtors, preferably aged.
2) Validate the records and controls over sales and debtors through a selected sample of compliance testing and substantive testing.

3) Detailed examination of the control account including review of the reconciliation between the control account and the debtor's ledger.
4) Circularisation of a sample of debtors strictly to confirm existence.
5) Carrying out cut off test to ensure that sales and stocks have been accounted for in the correct period.
6) Analytical review by comparing sales/debtors ratio with previous years.
7) Looking for evidence to confirm that balances attributed to individual debtors are composed of specific items.
8) Evidence that all included items are bona fide trade debtors.
9) Review of credit notes issued after date to ensure that they do not cancel debtors balances.
10) Examination of debtors for collectability.
11) Ensuring that each account is settled from time to time and also enquiring into credit balances.
12) On the schedule that is obtained, the auditor tests balances on ledger accounts to the schedule and vice versa, he also tests the cast of the schedules and ensures that the totals agree to the balance of the control accounts.
13) The auditor tests the effectiveness of the system of internal control but before he does that he has to determine what the system is, and a good system for debtors should ensure that:

    a) Only bona fide sales bring debtors into being;
    b) All such sales are to approved customers;
    c) All such sales are properly recorded;
    d) Once they have been recorded the dates are only eliminated by receipt of cash or on the authority of a responsible official;
    e) Debts are collected promptly;
    f) Balances are regularly reviewed and aged. A proper system for follow up exists and if necessary adequate provision for bad and doubtful debts are made.

Under debtors the crucial issues for the auditor are the valuation of debtors and the existence of debtors

5.7.2 Valuation of debtors

Debtors are valued just like other assets at the lower of cost and net realisable value. Valuation of debtors is really a consideration of whether the provision for bad and doubtful debts is adequate or not. The auditor must therefore consider the following matters:

i. How adequate is the system of internal control as far as approval of credit and follow up of poor payers is concerned;
ii. The period of credit allowed and taken;
iii. Whether balances have subsequently been settled by the date of the audit
iv. Whether an account is made up of specific items or not;
v. Whether an account is within the maximum credit allowed;
vi. The market values of any securities if any that have been lodged as collateral;

vii. General information about debtors from collectors, trade associations or other publications;
viii. The issue of set off;
ix. Whether there are any legal proceedings, the state of those proceedings and the legal status of any debtor;
x. The effects of the statute of limitations;
xi. Comparing of debtors to sales this year with previous periods, budgets and other companies;
xii. Evidence that any debt is in dispute for non delivery, breakages or poor quality.

It should be noted that any debts which are considered bad should be written off to the profit and loss account.

Provisions for doubtful debts should be set up against debts which are considered doubtful.

Some companies have the habit of making round sums or percentage provisions for doubtful debts. This practice is generally unacceptable to an auditor unless it is based on good statistical evidence which may come from past experience or may come from data about other similar undertakings which is obtainable from trade associations or which is publicly available.

5.7.3 Existence of debtors

The easiest way to establish the existence of a debtor is to ask the debtor whether he exists. This is done by use of a practice known as debtor's circularisation which is basically a direct confirmation from the debtors.

Advantages or reasons for circularising debtors are:

1) To obtain confirmatory direct external evidence of the existence and beneficial ownership of the asset debtors.

2) To give evidence that the figure in the accounts for debtors is a true and fair one.

3) To provide confirmatory evidence that the system of recording and documenting sales and debtors and the controls there on can be relied upon to produce an accurate figure for debtors. Normally, tests which are designed to obtain evidence of the reliability of the system are called compliance tests. Circularisation therefore is useful both for substantive and compliance tests.

4) To provide evidence as to the correctness of cut off. Cut off is the technical term used to ensure that in computing profits sales are accurately compared with the costs of the goods sold. Cut off tests can be substantive i.e. examining last numbers of documents or compliance that is; if controls exist their application can be tested.

5) To provide evidence on the existence of disputed items.

The Audit Approach

The auditor:

1) Must obtain the cooperation of the client, as only the client can authorise third parties to communicate with the auditor.
2) Select the method to use, this can be positive, negative or a combination of both.
3) Select a sample. All customers can be circularised but this is unusual.
4) Draft the circular, but ensure that it is written out on the client letter head and that it requires a reply to be sent direct to the auditor.
5) Fill in the details.
6) Despatch the letter himself.
7) Receive and evaluate replies.
8) Follow up when replies are not received.

Comparison of the Two Methods

Negative

Under this method of circularisation, the customer is asked to communicate only if he does not agree with the balance. Effectively the customer is told that if no reply is received from them then the auditor will conclude that the debtor is in agreement with all the terms in the circular. The major draw back of this method is that if the debtor does not receive the circular, he will not respond, and this could be misconstrued to mean that the debtor received the circular when in fact it was never received and considered. From this standpoint, this method is unreliable and should only be used where there is strong internal control.

Positive

Under the positive method, the customer is asked to reply whether he agrees the balance or not or is asked to supply the balance himself. This method is used where there is weak internal control, suspicion of irregularities or items in dispute and numerous book-keeping errors.

Selection of a Sample

The following accounts must be included in debtors circularisation:

1) Large balances because they are large and the more you can substantiate of the debtors figure, the more assured you are.

2) All unpaid accounts because there may be fictitious balances designed to conceal defalcations or there may be a genuine dispute both of which can cause overstatement.

3) Accounts with round sum payments: this may indicate teeming and lading or that the debtor cannot pay the full amount.

4) Accounts with NIL balances: this is because active debtors through the year may be used to conceal window dressing techniques.

5) Credit balances: a sales system should produce debit balances therefore, if it produces credit balances, they need to be investigated to ensure that they were properly set up. The client may be reluctant to allow you to advise his customers of credit balances in case they have been overlooked and the customer now asks for payment. We resolve such objections by omitting the balance figure from the circular.

6) Accounts where credits or discounts seem excessive or where credit periods are regularly exceeded without follow up.

7) Other accounts that must be considered for circularisation are: accounts not composed of specific items, small balances which are usually large, accounts with related parties and accounts which the auditor feels put him upon enquiry.

What if the debtor does not reply?

1) Send a reminder. Still no response, then the following alternative auditing procedures should be adopted.

   a) Detailed vouching of all entries in the debtors accounts.

   b) Examining post balance events e.g. settlements.

   c) Examining the debtors remittance advice.

   d) Awareness of the possibility of unusual items or mis-statements.

   e) Reviewing correspondence if any with the debtor.

Please note, a debtors' circularisation is an auditing procedure therefore, the auditor must make it clear to its client that the auditor has to control the circularisation. Circularisation should not be used by the client for his own purposes.

If the client refuses to allow the auditor to circularise debtors, then the auditor has to consider whether he has available other audit evidence, if not he would have to consider qualifying his report on grounds of limitation of scope.

A debtor circularisation is very reliable evidence in confirming the existence of the debtor and the title to the asset debtor, but is not designed for establishing the value of debtors. A debtor may confirm existence but that is not proof that the debtor can pay.

5.8 PREPAYMENTS

Prepayments like accruals are not usually checked by the double entry system. This makes them susceptible to error. The auditor's procedures include:

1. That last year's prepayments are written back.
2. Examining last year's prepayments to get an appreciation of the kind of prepayments to expect the organization to have.
3. Comparison of last year's listing with the current listing as prepayments do not change much from year to year, any items missing or substantially greater or less than last year's requires investigation. Of course in the first year of trading such a comparison is not possible.
4. Reliance on his knowledge of the accounts which frequently contain prepayments such as rent, rates, insurance, advertising, etc. The auditor must examine such accounts to determine whether prepayments have been understated.
5. Vouch the listing to support documentation to establish the authenticity of prepayments

5.9 CASH AND BANK BALANCES

5.9.1 Bank

The main concern in this area is to establish the existence of the balances and more recently due to failures in several financial institutions in Kenya valuation of these balances. The client will produce a reconciliation of the cash book and the bank statement. These are checked by the auditor paying particular attention to the reconciling items. These should be genuine reconciling items. Unpresented cheques and uncleared lodgements should appear on the bank statements early in the new year, say within two weeks of the year end. If they do not appear, then these should be investigated as manipulation or fraud could be indicated. Material unpresented cheques could indicate that the bank balance is being distorted for balance sheet purposes as a high balance is indicated of poor utilisation of cash and may reflect adversely upon the directors. Uncleared lodgements present a more serious threat of fraud or distortion. Banks normally clear lodgements within a week, therefore if after a week we have uncleared lodgements that are not up country, cheques, then the position displayed may be probably fictitious. They could have been inserted by management to conceal a shaky liquidity position or by an employee to conceal a misappropriation elsewhere.

A bank reconciliation is a routine matter, what remains is for the auditor to obtain direct confirmation from the bank confirming the balances at the year end. The main purpose of this bank certificate is to confirm that the bank statements are not fraudulent. The bank request a copy of which is given as an appendix at the end of this chapter must be made by the client for the auditor has no right to obtain this information from the client's bankers. The reply must however go directly to the auditors. The normal procedures are in fact for the client to write to the bank authorising the bank to provide the auditor with any information that the auditor may require. With this authority, the auditor then writes to the bank.

Valuation: Till recently, valuation of banks and cash balances was taken for granted until several financial institutions started to fail and this brought into question the value of balances maintained with marginal banking institutions. Therefore as a further test, the auditor must establish that the balances are maintained in a reputable bank that is still a going concern.

Petty-cash: Petty-cash balances are usually not material. They are usually counted by the auditor but this is just because most organizations hold the view that a cash count is an integral part of auditing. As far as possible all cash balances should be counted at the same time to prevent the possibility of substitution. The count must be performed in the presence of the petty-cashier who should be asked to sign the count-sheet, and the count-sheet should also be signed, dated by the auditor. The petty-cashier's presence is important as the auditor could later be held responsible for any shortages. This area is simplified when the client maintains an imprest system. The auditor should obtain a certificate from the cashier.

5.10 SUNDRY DEBTORS AND LOANS

Sundry debtors and loans are not usually material assets of companies other than those companies whose business is to make loans. We shall consider two types of sundry debtors and loans:

a) Dealings with others other than directors: The verification work will involve:

i. Determining, evaluating and testing the systems of internal control. Particular attention being paid to authorization.
ii. Obtaining a schedule of the debtors and testing it for accuracy and completeness.
iii. Obtaining certificates direct from the debtors concerned.
iv. Review of agreements and ensuring that the terms are being followed.
v. The debt may be secured in which case, the security is examined and consideration given to its value and realizability.
vi. The loan may be guaranteed, in which case the status of the guarantor must be examined.
vii. Provisions for bad debts must be reviewed for adequacy. Where loans have been made to employees, they usually become bad if the employee leaves before repayment is completed.

b) Dealings with directors and other related parties: The auditor's duties are as follows:

i. The review of all loans made to directors and connected persons outstanding at any time during the year. Materiality does not apply. All loans must be reviewed.
ii. Certificates of confirmation should be obtained from the directors concerned.
iii. Read the board minutes to ensure that all such advances are subject to proper board minutes.
iv. Ensure compliance with the law.
v. Full disclosure as required should be made.
vi. If the directors fail to give all the relevant information in the accounts the auditor is required to give that information in his report.

5.11 VERIFICATION OF LIABILITIES

Generally speaking, the auditor's duty with regard to liabilities can be summarised as follows:

1. To verify the existence of all liabilities shown in the balance sheet.
2. To verify the correctness of the money amount of such liabilities. That is they are all completely accounted for and properly valued.
3. To verify that the description given to the liabilities in the accounts is appropriate and the disclosure is adequate.
4. To verify that all existing liabilities actually occurred and have been properly included in the accounts.

5.11.1 General Verification Procedures

1. Obtain or prepare a schedule for every class of liability. This would usually show the make up of the liability with the opening balance, any changes if any, and the closing balance.

2. Cut off: the auditor would usually verify cut-offs by ensuring that where a service has been received before the year end, the corresponding liability has been set up. And where a liability has been set up, the corresponding benefit has been received.

3. Review for reasonableness: the auditor must consider reasonableness of a liability ensuring that there are no circumstances which may put him upon enquiry.

4. Review of internal controls: the auditor should determine, evaluate and test the internal control procedures surrounding that liability.

5. Previous year's liability: consider the liabilities at the previous year end and see whether they have been properly cleared or are still applicable bearing in mind the statute of limitation.

6. Terms and Conditions: the auditor should review all terms and conditions agreed when accepting a liability between his client and the creditor. He should then ensure that the agreement is being complied with.

7. Authorization: authority for all liabilities should be sought. These can be found in the company's minutes, director's minutes and for some items the authority is in the Memorandum and Articles.

8. Disclosure and Description: the auditor must ensure that the description in the accounts is adequate.

9. Inspection of Documents: the auditor has to examine all relevant documents. In the case of liabilities, these include invoices, correspondence, debenture deeds, loan agreements, purchase orders etc.

10. Securities: most liabilities are secure in one way or another by either fixed or floating charges. The auditor should enquire into this and enquire that where necessary, they have been registered.

11. Confirmation: the creation of any liability should be vouched and external confirmation obtained.

12. Accounting policies: the auditor needs to certify himself that appropriate acceptable accounting policies are adopted and consistently applied.

13. Related evidence: review of related evidence can assist in confirming liabilities. For example existence of loans can be confirmed by interest payments.

14. Materiality: the materiality of the matter has to be taken into consideration.

15. Review of post-balance sheet events: this is a very important area and has been covered elsewhere.

5.11.2 Completeness of Liabilities

In distortion, the directors tend to include non-existent assets or exclude liabilities. So whereas with assets we are very much concerned with existence, valuation and beneficial ownership, with liabilities, the major concern is with completeness and hence the need to devote some space to this area. It is not enough to be satisfied that all liabilities recorded in the books are correct and incorporated in the final accounts. The auditor must be satisfied also that there are no other liabilities in existence which for one reason or another are not included in the books in the accounts.

Examples of such liabilities are:

a) Claims by employees for injury at work which should be covered by workman's compensation;
b) Claims by ex-employees for unfair dismissal;

c) Unfunded pension liabilities;
d) Bonuses under profit sharing arrangement;
e) Returnable packages or containers;
f) Penalties for VAT and other taxes;
g) Warranties and guarantees;
h) Discounted bills;
i) Pending litigation;
j) Losses on forward contracts penalties for breach of contract;

It is important that the auditor realises that such liabilities can exist and he should take reasonable steps to unearth them if they exist. The procedures to adopt include:

1) Enquiry of the directors and other knowledgeable officers;
2) Representation in a proper letter of representation from the directors;
3) Minutes of meetings where the existence of unrecorded liabilities may be mentioned;
4) Post-balance sheet events review involving the inspection of purchase invoices and payments after date.
5) Reviewing last year's working papers to determine whether any liabilities existing then have been excluded.
6) Being constantly alert to the possibility of such a liability. For example, where the client sells goods subject to warranty period this would alert the auditor immediately of outstanding commitments.

5.12 TRADE CREDITORS

Trade creditors may be substantiated by the review of the system of internal control over the purchases cycle, review of creditor's statements with reconciliation, agreement of the control account with the individual creditor's ledger, effective cut off and analytical review procedures. The auditor may also circularise creditors to obtain direct confirmation.

5.13 PROVISION AND ACCRUALS

Before we consider the audit procedures with regard to provisions and accruals, it is necessary to clarify the meaning of two words in common use which tend to confuse students.

a) **Provision:** this is any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is likely to be incurred or is certain to be incurred but uncertain as to amount or as to the date on which it will arise. Thus a provision is a debit to the profit and loss account that reduces profit and therefore future dividends. It is for a likely or a certain future payment and the amount or the date of payment is uncertain.

b) **Reserve:** this is that part of shareholders funds not accounted for by the nominal value of issued share capital or by the share premium account.

The need to create provisions must receive serious consideration by the directors and also by the auditors. Review of post balance sheet events often casts lights on the amount of the provision required. The auditor's duty is to see that any provisions set up are used for the purpose for which they were set up and that any provisions which are no longer needed are transferred back to profit and loss account. Considerable attention needs to be paid to accruals as like prepayments they are not checked by the double entry system and therefore open themselves to distortion of the accounts by the senior management. The auditor must ensure that last year's accruals are written back. Accruals do not alter much from year to year and therefore comparison of last year's and this year's listing is an essential audit procedure and any that are substantially greater or smaller would call for investigation.

5.14 TAXATION

Companies suffer corporation tax. The Companies Act requires that corporation tax payable on the profits of any particular year should be matched against those profits in the profit and loss account and recognised as a liability in the balance sheet at the end of the period to which the profits relate. This means for example if a company has a calendar trading year, then the profits for the twelve months ended 31 December 2003 should be shown in the profit and loss account together with the corporation tax payable on those profits in 2003. The tax that is payable is computed using income tax rules that are different from accounting rules. The auditor's procedures involve him in:

i. Obtaining the tax computation from his clients and ensuring that it is arithmetically correct. The items disclosed as disallowable are supported by evidence and the items claimed as allowable for example wear and tear allowances have been properly computed in accordance with the Income Tax Act.
ii. Review of correspondence with the Income Tax Department, paying particular attention to queries raised and how they have been resolved, determining outstanding issues and their current status.
iii. Obtaining a schedule summarising the tax liabilities that reflects the balance to be charged to the profit and loss account and the amount to be shown as current liability in the balance sheet.
iv. Disclosure of the tax position should be in accordance with legislation and KAS 10 which both require that the tax charged be disclosed separately in the profit and loss account and the tax payable be shown in the balance sheet under current liabilities and a note to the accounts should amplify the basis of providing for taxation.

5.15 DEFERRED TAXATION

Deferred Taxation results from the fact that the income tax department use different rules for calculating profits from those used by the accountant in financial accounting, for example, capital allowances vs. depreciation. These different rules normally result in a reduced profit for tax purposes in the short term, but they result in a potential payment of deferred taxation in the long term. Also the different rules may result in accounts that would mislead the reader if he tries to compare the tax charged based on the accounting profits with that based on the taxation profits. To resolve this problem the accounting profession has come up with the need to provide for deferred taxation. This can be a highly subjective area and the relevant authority is IAS 12- Income Taxes. Before we look at the audit work involved let us note the ways in which a potential charge for deferred taxation can arise.

i. Short term timing differences: the tax authorities in the most deal with items on a payments and receipts basis, therefore, general provisions will not be allowed until they have actually been paid. Such differences must always be provided against.

ii. Wear and tear allowances vs. depreciation: wear and tear allowances usually on a reducing basis are invariably different from depreciation.

iii. As a result of trading losses, debit balances may result.

iv. Permanent differences as a result of items of expenditure that will remain permanently disallowed by the Income Tax Department such as depreciation on buildings and on the cost of saloon vehicles in excess of Shs.100,000/-.

IAS 12 requires that deferred taxation be provided for on all timing differences on the liability method. If however, the following conditions are complied with then provision is unnecessary. It will be reasonable to assume that timing differences will not reverse and tax liabilities will not crystallize if but only if the company is a going concern and

a) The directors are able to foresee on reasonable evidence that no liability is likely to arise as a result of reversal of timing differences for some considerable period ahead (at least three years) and

b) There is no indication that after this period the situation is likely to change so as to crystallize the liabilities.

Please note that the onus of proof is squarely on the directors, it is for them to prove to the auditor that a provision for deferred tax is not necessary and if they cannot prove, then a provision must be made for all timing differences.

We can therefore distinguish the audit functions as follows:

i. To check the calculation of timing differences;

ii. To ensure that permanent differences have not been taken into account;

iii. Check the directors view of the extent of the provision required by:

a) Ensuring that the company is a going concern
b) Examining the evidence upon which the directors have based their assumption and that no timing difference has been reversed

iv. Ensure that presentation in the accounts is in accordance with KAS 10, is comprehensive, and unambiguous.

Stage a) is a routine matter and the auditors always examine whether the company is a going concern, because many valuations bases would change if the company were not a going concern. So we can now examine the difficulties associated with the reliability of evidence in support of a reduction in the provision for deferred taxation.

i. Capital allowances vs. depreciation: If the client can prove that they will maintain the existing levels of investment in real terms, then there may be justification to accept a reduction of this category of deferred taxation however if investments begin to decline then deferred taxation could be crystallized.

The maintenance of existing capital expenditure levels is dependent upon the sales and profitability of the company, thus the auditor is required effectively to perform an audit of the profit forecast for at least three years ahead. This would seem to be against generally accepted accounting principles which advise against auditing of profit forecasts because in a profit forecast many factors are outside the control of the directors. Capital expenditure and inventory levels are to a certain extent within the control of the directors. This may seem to be a weak argument because profitability affects capital expenditure and there is little likelihood of profit if the directors do not invest prudently, although it may well be within their control to do so. We therefore only require the auditor to assess whether profitability is likely to fall or not rise sufficiently to warrant or support plant capital expenditure. We do not expect him to assess precisely what that profitability is going to be. Evidence is based largely on the company's budgets and longer term forecasts. The procedures the auditor adopts are:

a) Assess the trend of past capital expenditure to see whether it is falling or rising or whether there is no consistent pattern.

b) Assess the company's past profit performance to see whether it is falling or rising and compare this performance with the company's previous budgets and estimates to determine its ability in forecasting as good forecasting in the past provides more confidence for the present.

c) Assess the company's capital, cash and profit forecasts for reliability. This involves determining whether they have been made on the basis of reasonable data or whether they are mere guess work.

d) Examine the directors minutes for evidence of policy changes which might affect future capital expenditure.

e) Take into consideration the economic situation particularly as it affects the client's own industry and the company's exposure to economic or legislative changes to labour disruption or material or components shortages.

i. Short-term timing differences. Their reversal should be easy to identify as if they were general provisions last year we can follow up their utilisation.

iii. Debit balances as a result of trading losses. Review of current results, profit forecasts and agreed tax assessments should provide enough evidence as to the likelihood of these losses being fully utilised in the short-term.

IAS 12 Income Taxes

1AS 12 requires that a deferred tax liability should be recognized for all taxable temporary difference with minor exceptions (e.g. goodwill, which is not allowable for tax purposes).

Points for the auditor are:

(i) Confirm that the company's policy as regards deferred tax is in conformity with IAS 12 and is consistent with the previous year
(ii) Check the determination of and arithmetical accuracy of all temporary differences and the arithmetical accuracy of the deferred tax calculations
(iii) If deductible temporary differences exist (leading to deferred tax assets) confirm that the conditions for recognition have been met.
(iv) If a deferred tax asset has been recognized for unused tax losses being carried forward, confirm that the conditions allowing that recognition have been met.
Confirm that all disclosure requirements have been met.

5.16 SHARE CAPITAL

Share capital is a special type of liability and when it has been issued during the year then verification procedures are as follows:

1. Ensure that the issue is within the limits authorised by Memorandum and Articles of Association.
2. Checking the directors' minutes to ensure that the issue was authorised.
3. Vouch the correct recording of monies received.
4. Ensure the correct treatment of any share premium obtained in so doing remember that the share premium account can only be used to issue fully paid bonus shares, write off preliminary expenses, write off expenses of share or debenture issue, write off discounts on shares or debentures and to provide for a premium payable on the redemption of redeemable preference shares.
5. Examine the prospectus if there was one, applications, application and allotment sheets, the share register; the cash received records, share certificate counterfoils and repayment to unsuccessful applicants.

6. Vouch the payment of underwriting and other fees.
7. When the issue is not for cash but for other considerations e.g. the goodwill and other assets of a business, vouch the agreement and ensure that all entries are properly made.
8. If the issue was subject to approval from the Nairobi Stock Exchange, then ensure that approval has been obtained. If it has not been obtained all the money subscribed is returnable. Ensure that all the money was placed in a separate bank account until all conditions were satisfied. Ensure that the minimum subscription has been received because if there were not enough subscribers then the whole is returnable.

When there is no new issue of shares the audit work includes:

1. Determination of the total shares of each class as stated in the balance sheet and the obtaining of a list share holdings which in total should agree with the balance sheet total.
2. Testing the balances in the share register with the list and vice versa.
3. If the share register is maintained by an independent firm of registrars, the auditor should obtain a certificate that the above work has been done.
4. Vouch transfers to the share register and share transfer forms.

5.17 RESERVES

Movements in reserves require disclosure in the balance sheet, the profit and loss account, the directors reports or in the notes to the accounts. The auditors must ensure proper authorization has been given for these movements and they must vouch the recording of this movement. The auditors must ensure that material amounts of reserves are classified under appropriate headings. The capital redemption reserve fund and the share premium account require separate identification and the aggregate amount should also be shown. Provisions must be reviewed to ensure that they did not contain secret reserves.

5.18 LONG-TERM LIABILITIES

Long-term liabilities are usually evidenced by an agreement called a debenture. For this reason, long-term loans are often called debentures. They may be secured by a fixed charge over a specific asset or secured by a floating charge on all the assets or they may be unsecured in which case they are called naked debentures. Secured liabilities are sometimes referred to as mortgage debentures.

VERIFICATION PROCEDURES

a) Obtain a schedule detailing the sums due at the beginning of the year, additions and redemptions and the sum due at the year end.
b) Note or photocopy the terms and conditions of the loan as evidenced in the deed.
c) Agree the opening balances with last year's accounts and working papers.
d) If any new loans have been received, vouch to board minutes, memorandum and articles, register of debenture holders and charges etc.
e) Repayments made should be vouched with debenture deeds, the cash book and the register of debenture holders and charges.
f) Interest payments should be vouched with debenture deeds, cash books and any outstanding amounts should be correctly accounted for.
g) If the loans are secured, confirm that the charge is registered at the registrar of Companies.
h) Agree total amounts outstanding with the register of debenture holders.
i) Ensure disclosure is in accordance with Companies Acts requirements, clearly stating the date of redemption of the debentures.

5.19 PENDING LITIGATION

Because of the inherent uncertainty in estimating the outcome of legal actions, this is an especially difficult area for the auditor. Some actions are possible that assist in verifying the existence but not necessarily the amount of liabilities that will arise out of legal action.

These include:

a) Review of the client system for recording claims and disputes and the procedures for bringing this to the attention of the board.

b) Review of the arrangements for instructing solicitors.

c) Examination of the minutes of the board for references to and indications of possible claims.

d) Inspection of bills rendered by the solicitors.

e) Review of correspondence with solicitors and obtaining a list of all matters referred to solicitors with an estimate of the possible ultimate liability.

f) Written assurance in the form of a representation letter from an appropriate director that he is not aware of any other matters referred to the lawyers other than those disclosed. If the auditor is in doubt he should obtain a direct confirmation from the Company's lawyers. The request must be sent by the client not by the auditor.

5.20 CAPITAL COMMITMENTS

The Companies Act requires that capital commitments be disclosed by a way of note to the accounts. The auditor must therefore perform sufficient work to ensure that such amounts are fairly and completely stated. He may obtain this information from the directors in a letter of representation but work must be performed to confirm the amounts stated. The director's minutes should be reviewed for evidence of authority to place capital contracts. Examination of capital commitments must be carried out and discussions held with the appropriate management staff. Correspondence with lawyers should be perused to discover whether any instructions have been given for drawing up major contracts. The note must distinguish between expenditure authorised by the directors and the contracts which have already been entered into.

IAS 37 Provisions, Contingent Assets and Contingent Liabilities

IAS 37 was issued in order to deal with the subjective area of provision and to prevent the use of 'big bath provisioning' and the practice of profit smoothing.

IAS 37 requires that (in accordance with the definition of a liability) a provision should be made where the matter gives rise to a constructive or legal obligation and where there is a probability that there will be an outflow of economic benefits which can be reliably measured.

In addition IAS 37 gives examples of how specific situations should be dealt in terms of recognition, measurement and disclosure depending on the circumstances. These include onerous contracts, re-organizations and restructuring costs, and environmental contamination.

Contingent liabilities and contingent assets are also dealt with by IAS 37. Evidence is required to support their classification and disclosure is appropriate under the standard.

The auditor's task is to obtain sufficient evidence that the financial statements include only valid provisions and that they adequate but not excessive and that adequate disclosures have been made. (See below the sections dealing with accounting estimates and discounting operations below).

(a) Litigation and claims

ISA 501 *Audit Evidence – Additional Consideration for Specific Items* requires that auditors should carry our procedures to become aware of nay material litigation or claims involving the entity. Such procedures would include:

(i) Make appropriate enquiries of management including obtaining representations
(ii) Examine board or management minutes for indications of possible claims
(iii) Examine correspondence with lawyers including bills rendered
(iv) Examine legal expense account
(v) Obtain a list of matters refereed t lawyers with the company's estimates of possible liabilities

(vi) Review the client's system of recording claims including the procedure for bringing them to the attention of management.

When litigation or claims have been identified or where the auditor believes they may exist, the auditor should seek direct communication with the entity's lawyers.

The letter should be prepared by management and sent by the auditor. It should specify the litigation and management's assessment of the outcome, and request that the lawyer confirm directly to the auditor the reasonableness of the statement and to provide the auditor with further information if the list is incomplete. If the lawyer is likely to respond to a more general enquiry, then that would be better - lawyers are generally unwilling to do this unless there is nothing to report.

In complex situations the auditor may need to meet the lawyer, with the client's permission and preferably with the client in attendance.

Where permission to communicate with lawyers is refused, a qualified audit opinion will normally follow.

An extract from such a letter is set out below:

In connection with the presentation and audit of our financial statements for the year ended … the directors have made estimates of the ultimate liabilities (including costs) which might be incurred, and which are regarded as material, in relation to the following matters on which you have been consulted. We should be obliged if you would confirm directly to our auditors that in your opinion these estimates are reasonable.

Matter

Estimated liability including costs

Libel action against the company in Sh 250,000

Connection with statements

Appearing in newspaper

Signed ……………………………

Dated …………………………..

Etc

(b) Other Provisions and Contingencies

(i) Obtain the client's schedule of provisions and contingencies and seek supporting documentation in the form of legal opinions, correspondence with customers, environmental and technical reports.
(ii) Assess the basis of provisions for reasonableness and compliance with IAS 37
(iii) Ensure that correct calculations have been made
(iv) Physically inspect any sites in respect of which clean up restoration provisions have been made
(v) Consider the need for expert technical assistance
(vi) Assess the need for further similar provisions

(c) Standard Letter of request to the Bank

This is likely to provide the necessary evidence in respect of bills discounted and guarantees. This letter is considered in an earlier chapter as the primary method of verifying bank balances.

(d) Letter of Representation

This will be considered later as a form of audit evidence. It also acts to remind the directors to acknowledge their responsibilities.

The knowledge of contingent liabilities may very well be confined to management and is therefore a suitable matter for inclusion in such a letter. In addition it will remind the directors of their responsibility to disclose such matters to the auditor

5.21 AMOUNTS DERIVED FROM PRECEDING FINANCIAL STATEMENTS

Please note that the auditor is interested in preceding year's evidence because

1. The Companies Act states that corresponding amounts should be disclosed in respect of every item in a company's balance sheet and profit and loss account for the financial year preceding that to which the balance sheet and profit and loss account relate. IAS 7 requires similar information for the cash flow statement.
2. These figures form the opening position from which the present year's are derived. The auditor must be assured that the opening figures have been properly brought forward.
3. Accounting policies must be applied consistently from year to year.
4. Corresponding amounts must be shown and the auditor should seek evidence that they are properly shown.

The auditor is not required to express an opinion on the corresponding figures, but he is responsible for ensuring that they are:

a) The amounts which appear in the preceding year's accounts or;
b) They have been restated to achieve consistency and comparability or;
c) They have been restated due to a change in accounting policy or the correction of a fundamental error as required by IAS 8.

5.22 THE AUDIT OF ACCOUNTING ESTIMATES

An accounting estimate is defined in ISA 540 Audit of Accounting Estimates as 'an approximation of the amount of an item in the absence of a precise means of measurement'.

Estimates include amounts for accumulated depreciation, deferred tax; write downs to net realizable value, losses on long term contracts, legal claims against the company, other contingent liabilities and other areas which a significant element of judgment is required.

Such items are inherently more risky than non-judgmental items and control risk is usually higher as these are non-routine transactions. Management is responsible for making estimates.

The audit of accounting estimates under ISA 540 involves the following three steps:

- Review and testing of the process used by management to develop the estimate
  This will involve evaluation of the data and consideration of assumptions on which the estimate is based. Management's estimates as to warranty costs, for example should be based on past experience as to the level of claims and be in based. Management's estimates as to warranty costs, for example should be based on past experience as to the level of claims and be in line with the auditor's knowledge of the business. It will also involve checking of the mechanical calculations, comparison with estimates made in prior periods and consideration of management's approval procedures.

- Use an independent estimate (generated by the auditor) to compare with management's estimate

- Review subsequent events which confirm the estimate

Where in the case of contingent liabilities, subsequent events 'crystallize' the liability there will be no need to review management's processes or use independent estimates.

The auditor will normally test the calculations of the estimate, asses the assumptions made (e.g. the court is 90% likely to find in our favour) compare estimates with those made in previous periods and ensure that the estimate is in accordance with the auditor's knowledge of the business and the other audit evidence obtained.

IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations

A Discontinuing Operation is a component of an enterprise:

(a) That the enterprise, a pursuant to a single plan, is:

(i) Disposing of substantially in its entirety such as by selling the component in a single transaction, by de-merger or spin off of ownership of the component to the enterprise's shareholders.

(ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) Terminating through abandonment

(b) That represents a separate major line of business or geographical area of operations; and

(c) That can be distinguished operationally and for financial reporting purposes.

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* prescribes the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. The measurement provisions of IFRS 5 apply to all non-current assets and disposal groups, except for:

- Deferred tax assets (IAS 12 *Income Taxes*);
- Assets arising from employee benefits (IAS 19 *Employee Benefits*);
- Financial assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*;
- Non-current assets that are accounted for in accordance with the fair value model in IAS 40 *Investment Property*;
- Non-current assets that are measured at fair value less estimated point-of-sale costs in accordance with IAS 41 *Agriculture*; and
- Contractual rights under insurance contracts as defined in IFRS 4 *Insurance Contracts*.

Assets held for sale

A non-current asset (or disposal group) is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. That is, the asset (or disposal group) is available for immediate sale and its sale is highly probable.

A non-current asset (or disposal group) classified as held for sale is measured at the lower of fair value less costs to sell and its carrying amount.

Any impairment loss on write-down of the asset (or disposal group) to fair value less costs to sell is recognized in profit or loss. Any gain on subsequent increase in fair value less costs to sell is also recognized in profit or loss, but not in excess of the cumulative impairment loss already recognized on the asset either in accordance with IFRS 5 or IAS 36 *Impairment of Assets*.

Discontinued Operations

A discontinued operation is a component of an entity that either has been disposed of or is held for sale. It may be a subsidiary, or a major line of business or geographical area. It will have been a cash-generating unit (or group of cash-generating units) as defined in IAS 36 *Impairment of Assets*.

Disclosures of discontinued operations include:

- Analysis of the post-tax profit or loss into revenue, expenses, pre-tax profit or loss, and the related income tax expense;
- The gain or loss recognized on measurement to fair value less costs to sell or on disposal, and the related income tax expense;
- Net cash flows attributable to operating, investing and financing activities;
- Assets held for sale separately from all other assets; and
- Liabilities of a disposal group held for sale separately from all other liabilities.

As regards recognition and measurement, IFRS 5 does not establish any separate principles, but relies upon those of IAS 36 Impairment of Assets and IAS 37 Provisions, contingent Liabilities and Contingent Assets, and also on IAS 19 Employees Benefits and IAS 16 Property, Plant and Equipment.

IAS 37 explains when a provision should be recognized on discontinuance. In particular, a restructuring provision should only include the direct expenditure arising form the restructuring which are both;

(i) Necessarily entailed by the restructuring, and

(ii) Not associated with the ongoing activities of the enterprise

It may be necessary, on a discontinuance, to apply the provisions of IAS 36 in recognizing impairment losses.

Presentation and Disclosure

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure even occurs.

STUDY TEXT

(i) A description of the discontinuing operation

(ii) The business or geographical segment(s) in which it is reported in accordance with IAS 14

(iii) The date and nature of the initial disclosure event

(iv) The date or period in which the discontinuance is expected to be completed if known or determinable

(v) The carrying amounts as of the balance sheet date of the total assets and the total liabilities to be disposed of

(vi) The amounts of revenue, expenses, and pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense relating thereto.

(vii) The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

If the initial disclosure even occurs after the end of an enterprise's financial reporting period but before the financial statements or that period are approved by the board of directors or similar governing body, those financial statements should include the disclosures specified above for the period covered by those financial statements.

Separate disclosure is required for each material discontinuing operation.

When assets are sold or liabilities settled in discontinuance, the pre-tax gain or loss, and the income tax expense relating to it must be disclosed on the face of the income statement but not as an extraordinary item. (Disclosures (a) to (g) above may be disclosed by note or on the face of the income statement).

For assets not yet sold but for which a binding sale agreement exists, the net selling prices and the expected date of receipt must be disclosed by note.

Audit Approach

The accounting and auditing issues are mainly concerned with identifying the point in time at which the initial disclosure even occurs, and also ensuring that lonely appropriate costs are included in any provision for restructuring that is established. Appropriate formats must be used for the information to be disclosed.

The key auditing matters arising are that the auditors should confirm whether they agree with the company's view as to the need for disclosure of proposed or actual discontinuance, and that they agree that the company's disclosures are appropriate.

Typical procedures would include:

(i) Determine the client's policies and procedures in respect of discontinuing operations

(ii) Review board minutes and other relevant management documentation

(iii) Make enquiries of management into significant disposals of assets and investments

(iv) Examine after date information

(v) Verify the make up pf discontinuing operations by reference to supporting documentation.

CHAPTER SUMMARY

- IAS 2 inventories prescribes the accounting treatment for inventories, except:

(i) Work in progress arising under construction contracts (IAS 11 *Construction Contracts*);
(ii) Financial instruments (IAS 39 *Financial Instruments*); and
(iii) Biological assets related to agricultural activity and agricultural produce at the point of harvest (IAS 41 *Agriculture*).

- Sources of evidence are the accounting systems and the underlying documentation, the tangible assets, the management, the employees, customers, suppliers and other third parties who have dealings with or knowledge of the entity or its business.

- An intangible asset is initially recognized at cost if all of the following criteria are met:

i. The asset meets the definition of an intangible asset i.e. it is identifiable and controlled by the entity;
ii. It is probable that future economic benefits that are attributable to the asset will flow to the entity; and
iii. The cost of the asset can be measured reliably.

- Non current assets are generally classified as:

a) Intangible assets
b) Tangible Assets
c) Investments

- Evidence of existence of ownership can take the form of:

(i) Share certificates, correspondence with nominee etc
(ii) Payments for securities, brokers,' bought notes' or 'contract notes'
(iii) Dividends/interest from securities, dividends 'warrants'.
(iv) Internal control procedures.

- The basis of valuation should be cost plus attributable profit less foreseeable losses and progress payments both received and receivable

- The stock taking instructions should as a bare minimum contain:
  a) Identification of the articles and their ownership.
  b) Counting, weighing or measuring.
  c) Reporting of stocks which are damaged or otherwise defective.
  d) How the stock take is to be recorded.

CHAPTER QUIZ

1) Define current assets

2) What are the audit procedure as far as audit for goodwill is concerned

3) What is the typical approach in the audit of financial instruments

4) In work in progress, auditors should include

ANSWERS TO THE CHAPTER QUIZ

1) Those assets which are expected to be sold or consumed in the course of the operating cycle or assets which are held primarily for short term trading purposes and are expected to be realised with in 12 months of the reporting date or cash and cash equivalents

2)

- Vouching for details as per the purchase agreement of the values attributed to the assets purchased and whether the price obtained was reasonable considering similar businesses.
- Review of the accounts of the business concerned and determining whether the business is profitable and can therefore justify the continued recognition of goodwill as an asset.
- Consider impairment tests in accordance with IAS 36. (Top down and bottom up tests under IAS 36 Impairment of Assets)
- Consider the requirements of ISA 540 Auditing of accounting estimates, including fair value accounting estimates and related disclosures

3)

- Verification of the analysis between equity and debt and appropriate designation to capital and reserves or liabilities
- Performing tests for arithmetical accuracy
- Ensuring that the discount rates used are realistic
- Ensuring that other base data in the allocation is correct (e.g. the correct conversion date has been used)
- Ensuring that the detailed disclosures requirements are met.

4)

a) Enquiry into the costing system from which work in progress is ascertained.

b) Enquiry into how reliable the costing system is. A costing system integrated with the financial system will be more reliable because of the discipline of double entry and the inherent checks imposed by external data such as creditors statement.

c) Enquiry into checks that are made as part of the system on statistical data concerning inputs of materials and outputs of products and expectations.

d) Enquiry into the system of inspecting and reporting on work done so that allowance is made for scrapping and rectification work.

e) Determining the basis on which overheads are included in costs and ensuring that this is based on IAS 2.

f) Making enquiry into the basis on which any profit elements are dealt with. Profit should be eliminated from work in progress.

g) Where the organisation constructs internally some of its own fixed assets, the auditor must make sure that such items as are under construction at the year end are not accounted for twice i.e. in fixed assets and in work in progress.

PAST PAPER ANALYSIS

This a potential test area as most companies if not all have asserts and liabilities. Hence, its encouraged that student gets a great understanding of this chapter. Sittings in which this chapter have been testing include; 6/01 Question 2, 12/02 Question 1, 6/06 Question 3.

EXAM QUESTIONS

Question one

Your firm is responsible for auditing the financial statements of HK manufacturing Ltd., a privately owned incorporated business, for the year ended 31 May 2004. The company operates from a single site. Its sales are Sh.380 million and the profit before tax is Sh.8,360,000. There are no inventory records so the inventory counts at the year end will be used to value the inventory in the financial statements. As Monday 31 May 2004 is a normal working day, it has been decided that the inventory should take place on Sunday 30 May 2004 when there is no movement of inventory.

The company has produced the following schedule to determine the value of inventory at 31 May 2004 from that counted on 30 May 2004.

	Sh.	Sh.
Value of inventory – 30 May 2004		44,326,772
Add: Cost of goods received on 31 May 2004	833,644	
Production; labour on 31 May 2004	247,760	
Overheads relating to labour at 120%	297,312	
		1,378,716
Less: Cost of goods sold on 31 May 2004		2,792,240
Value of inventory at 31 May 2004		42,913,248

The company keeps basic accounting records on a microcomputer using a standard software package. The accounting procedures for sales, purchases and wages comprise:

STUDY TEXT

1. Dispatch notes are raised by the shipping department when the goods are sent to customers. Sales invoices are produced from dispatch notes. Sales invoices are input into the computer which posts them to the accounts receivable ledger and the general ledger.

2. When goods are received, a goods received note (GRN) is prepared, purchase invoices are matched with GRNs and purchase orders are authorized by the chief executive officer. After the purchase invoices have been authorized, they are input into the computer which posts them to the accounts payable ledger and the general ledger.

3. For the wages system, the hours worked by each employee are input into the computer which calculates the gross wage and deductions; PAYE, NSSF, NHIF and the net pay. All employees are paid weekly.

Required:

(a) The audit procedures you should perform to verify the accuracy of the inventorycount:

(i) Before the inventory count, and (5 marks)
(ii) On the day of the inventory count (5 marks)

Your answers to parts (i) and (ii) above should include details of the matter you should record in your working papers for follow-up at the final audit.

(b) The substantive procedures you should perform to check the company's schedule as shown above which adjusts the value of inventory at 30 May 2004 so that at the company's year end of 31 may 2004.

You are required to verify the total value of inventory of Sh.42,913,248 at 31 May 2004. You are not required to describe the procedures necessary to verify the accuracy of the individual values of raw materials, work in progress and finished goods, as required on IAS 2 – inventories. (6 marks)

(c) The substantive procedures you should perform to check the purchases cut off at the year end. (4 marks)

(**Total: 20 marks)**

Question two

Your firm is responsible for auditing the financial statements of HK manufacturing Ltd., a privately owned incorporated business, for the year ended 31 May 2004. The company operates from a single site. Its sales are Sh.380 million and the profit before tax is Sh.8,360,000. There are no inventory records so the inventory counts at the year end will be used to value the inventory in the financial statements. As Monday 31 May 2004 is a normal working day, it has been decided that the inventory should take place on Sunday 30 May 2004 when there is no movement of inventory.

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Required:

(a) The audit procedures you should perform to verify the accuracy of the inventory count:
   (i) Before the inventory count, and (5 marks)

   (ii) On the day of the inventory count (5 marks)

Your answers to parts (i) and (ii) above should include details of the matter you should record in your working papers for follow-up at the final audit.

(b) The substantive procedures you should perform to check the company's schedule as shown above which adjusts the value of inventory at 30 May 2004 so that at the company's year end of 31 may 2004.

   You are required to verify the total value of inventory of Sh.42,913,248 at 31 May 2004. You are not required to describe the procedures necessary to verify the accuracy of the individual values of raw materials, work in progress and finished goods, as required on IAS 2 – inventories. (6 marks)

(c) The substantive procedures you should perform to check the purchases cut off at the year end. (4 marks)

(Total: 20 marks)

Question three

You are the audit manager in Mwihaki Kang'ethe and Associates, a firm of Certified Public Accountants in Kenya. One of your clients, Kenya Mobile Communications (KMC) Ltd. whose year end is 31 October, provides computer and communication software in a rapidly growing economy.

In order to achieve horizontal integration, KMC Ltd. acquired 80% of the ordinary share capital in Future Computers (FC) Ltd., a Kenyan Company, on 1 May for Ksh. 170 million. KMC Ltd. expects to gain from he acquisition due to the increased market share and benefits of synergy arising from the acquisition.

On 1 October 2007, FC, Ltd. purchased 50% of the ordinary share capital of Uganda Communications (UC) Ltd, for Ush. 720 million.

The reporting currency of KMC Ltd. is the Kenya shilling (Ksh) while the reporting currency of UC Ltd is the Uganda Shilling (Ush.).

The auditors of FC Ltd. are Otieno Anyangu Company while those of UC Ltd. are Binaiza Odoi and Associates.

The directors of KMC Ltd. have presented the following draft consolidated income statement for the year ended 31 October 2007 and the comparative income statement for the previous financial period:

	2007	2006
	Ksh.000	Ksh. 000
Revenue	220,000	112,600
Cost of sales	(116,000)	(50,640)
Distribution costs	(58,800)	(45,750)
Administrative expenses	(45,300)	(30,700)
Finance costs	(350)	(200)
Loss before tax	(450)	(14,710)

Additional information:

1. The financial results of UC Lt. were not included in the group results for the year ended 31 October 2007.
2. Binaiza Odoi and Associates had given an adverse opinion in their audit report to the members of UC Ltd. for the year ended 31 October 2007.
3. The directors' report of KMC Ltd. indicates that the company intends to invest a huge cash outlay on expansion and upgrading of the current plant and equipment in order to be ahead of competition in the rapidly changing technological environment.

Required:

(a) Describe the principal business risk relating to the group that should be of concern to you as the audit manager of Mwihaki Kang'ethe and Associate.
(6 marks)

(b) Discuss the matters which will be taken into consideration by Mwihaki Kang'ethe and Associated, with respect to the acquisitions, during the planning stage of the audit of KMC Ltd.'s group financial statements for the year ended 31 October 2007.
(8 marks)

(c) Describe hoe analytical review procedures could be used in the various stages of the audit of KMC Ltd's group financial statements for the year ended 31 October 2007.

CHAPTER SIX

STUDY TEXT

THE AUDIT PROCESS: FINAL REVIEW OF AUDIT OF FINANCIAL STATEMENTS


CHAPTER SIX

THE AUDIT PROCESS: FINAL REVIEW OF AUDIT OF FINANCIAL STATEMENTS

▶ OBJECTIVES

When you have studied this chapter you should be able to:

- Explain the review procedures in relation to opening balances and comparative figures
- Review other information for its impact on the opinion on the financial statements
- Understand the impact of subsequent events on the view conveyed by the financial statements
- Critically evaluate issues surrounding the going concern basis

▶ INTRODUCTION

The work we have considered so far has shown that the auditor first gathers facts about the enterprise and the environment it operates in. The next stage was the gathering of audit evidence about individual items and groups of items which together form the accounts. In this chapter we shall find that the auditor is in a position of knowing that he has sufficient evidence to substantiate the detail of the accounts. He then needs to form an opinion as to whether the accounts as a whole contain certain qualities and this is when a final review is carried out.

▶ DEFINITION OF KEY TERMS

1. **Going concern** can be said to be that the financial statements assume that the enterprise will continue in operational existence for the foreseeable future, or put another way the financial statements assume no intention or necessity to liquidate or curtail significantly the scale of operation or put more simply that the enterprise can meet its financial obligations as they fall due

2. **Events after the balance sheet date** are those events that occur between the balance sheet date and the date when the financial statements are authorized for issue.

3. **Adjusting events** are those that provide evidence of conditions that existed at the balance sheet date

4. **Non-adjusting events** are those that are indicative of conditions that arose after the balance sheet date

EXAM CONTEXT

This paper may examinee scenario based questions requiring the to apply your audit knowledge assess whether financial statements have been prepared as per the IFRS standards , if they are error free, determine materiality and their use as audit evidence.

INDUSTRIAL CONTEXT

All companies prepare financial statements at the end of the financial year. During the conduct of an audit, the auditor must review the financial statement before writing his final report.

6.0 THE FINAL REVIEW OF THE FINANCIAL STATEMENTS

This is a stage of the audit carried out by senior members of the audit team using the financial statements. This is further to the analytical review procedures carried out as part of substantive tests. The aims of this review are:

i. To provide audit evidence by determining if the financial statements provide information that is internally consistent with other information in the possession of the auditor and

ii. Also to determine if the financial statements have been prepared using acceptable accounting policies, they comply with IFRS and other requirements and that there is adequate disclosure of all relevant matters.

I would stress however, the following two issues:

i. Qualities of the auditor who performs this review: this auditor must have:

a) An ability to distinguish between non-material, material and fundamental items;

b) An ability to assess the accuracy and completeness of information gathered in the audit;

c) Must possess skill, imagination and good judgement particularly on professional and economic issues;

d) An ability to recognise apparent inconsistencies and abnormalities which might indicate areas where errors, omissions, frauds, irregularities have occurred which might not have been revealed by the routine audit procedures and;

e) An ability to assess whether or not an audit opinion is possible.

ii. The qualities required of the final accounts: the final accounts must possess certain qualities and these are:

a) Use of acceptable accounting policies, appropriate to the business and consistently applied;

b) They must show the results of operations in the profit and loss account, state of affairs in the balance sheet, changes in the financial position in the statement of source and application of funds and all other information included in the financial statement should be compatible with each other and with the auditor's knowledge of the enterprise;

c) All appropriate matters should be adequately disclosed and information contained in the accounts should be suitably classified and presented;

d) There must be compliance with statutory requirements;

e) There must be compliance with other relevant regulations;

f) There must be compliance with Kenya Accounting Standards.

The final review may reveal:

a) All is well or
b) Further audit evidence is required in some areas or
c) That it may be desirable to make amendments to the accounts and
d) That a qualified report may be required.

The review stage is very important in modern auditing as current auditing opinion is moving more towards a consideration of the view given to users by financial statements. The detail is still important but the view given must be true in detail and fair in totality.

6.1 GOING CONCERN CONSIDERATIONS

IAS 1 Presentation of Financial Statements recognizes the going concern assumption as one of the fundamental assumptions that underlie the periodic financial statements of enterprises. The meaning of going concern can be said to be that the financial statements assume that the enterprise will continue in operational existence for the foreseeable future, or put another way the financial statements assume no intention or necessity to liquidate or curtail significantly the scale of operation or put more simply that the enterprise can meet its financial obligations as they fall due. The going concern idea is very well established in accounting and there is an authoritative document, ISA 570 Going Concern, The student is advised to read it in detail. The points to note however are:

i. The importance of the principle
ii. The auditor's duty
iii. Indications of the inapplicability of the principle
iv. Counter indications
v. Audit procedures
vi. The impact on audit reports in practice.

6.2 THE IMPORTANCE OF THE PRINCIPLE

We will probably understand better how important this principle is if we consider the implications of abandoning it. The effects of abandoning the principle include among others the following:

a) Fixed assets would need to be valued at realisable values and not depreciated cost.

b) Fixed assets would have to be classified as current assets as they would have no future benefits to the organization.

c) Stock would have to be regarded at lower of cost or forced sale net realisable value.

d) Prepayments and intangible assets may have no future benefits.

e) New liabilities may appear such as redundancy pay, leave pay and closure costs.

f) Long-term liabilities may crystallize and become immediately payable hence they cannot be classified as long-term liabilities.

g) The departure from the assumption, the reasons for this departure and its effect need to be explained in the accounts in accordance with IAS 1.

6.3 THE AUDITOR'S DUTY

The auditor has a duty to express an opinion on the truth and fairness and compliance with legislation, of the accounts. The valuation basis adopted in preparing the accounts assumes that the company is a going concern in accordance with IAS 1. Therefore, for the auditor to form an opinion he should consider whether he has reasonable grounds for accepting the applicability of the going concern assumption. It follows therefore; he must carry out sufficient work to ensure that this assumption is justified. He therefore looks for evidence that the company is likely to continue trading for at least the next 12 months from the balance sheet date or 6 months from the date of the audit report or more practically, he looks for evidence that there is no indication to the contrary. He must however take account of significant events which are likely to occur even later.

In the event that the auditor considers that the company is not a going concern, he should advise the directors accordingly and ensure that the accounts are prepared on a market value or a break-up basis. If the directors refuse to comply then the auditor will have to qualify the accounts as a whole to the effect they are not true and fair. It is not possible for the auditor to rely on an assessment of the going concern position at the balance sheet date alone because the accounts usually only become public knowledge much later after the balance sheet date. It therefore becomes necessary to take into account events taking place after the year end and before the AGM which may affect the company as a going concern.

6.4 INDICATIONS OF INAPPLICABILITY OF GOING CONCERN

Insolvency, unfortunately, is a growth industry as the economy suffers a down turn and therefore for a majority of enterprises in Kenya, the abandonment of the going concern assumption is no longer a remote possibility. Consequently, on all audits the auditor must consider whether or not his client is a going concern. ISA 570 gives numerous indications of going concern inapplicability.

6.5 COUNTER-INDICATIONS

That the auditor has found indications of going concern non-applicability does not of itself justify immediate conclusion that the entity is not a going concern. He must also seek for counter-indications or mitigating factors. This may include the following:

a) Ability to raise cash by selling assets

b) Ability to obtain new sources of finance for example leasing, factoring debts, hiring plant.

c) Opportunities of rearranging debt repayments or conversion of long term debt into equity.

d) The possibility of a rights issue.

e) Support from other group companies or from associated companies.

f) The possibility of making alternative trading arrangements.

6.6 AUDIT PROCEDURES

In forming an opinion on the going concern position of a company, the auditor should:

a) Investigate the company, its background, its plans for the future, review of cash flows and financing plans;

b) At every stage of the audit search for and evaluate evidence for and against the going concern applicability;

c) If he is in doubt, and the directors have formulated plans for the continuation of the company, he should evaluate these plans, ensuring that:

   1. All parts of the plan are consistent with each other;
   2. If the plans are contingent on the response of third parties then he should seek third parties written confirmations;
   3. Ascertain that the plans are specific rather than general;
   4. Review the supporting evidence for the plans if available for reasonableness;
   5. Seriously consider any professional advice obtained by the directors;
   6. Consider any potential support from other group companies by looking at any contractual obligations, directors intentions and the ability of the group company to give the support.

d) Consider whether he has sufficient evidence to form an opinion on the applicability of the going concern assumption.

6.7 AUDIT REPORTS

In the vast majority of cases, the going concern assumption is appropriate and if applied no mention need be made in the auditor's report.

In rare incidences, notes to the accounts may make reference to the going concern assumption. This may include references to continued favourable trading or availability of finance. It may be that the going concern assumption is not in doubt, but for a full understanding of the accounts there is need for amplification of these notes. In such cases, the auditor may use an emphasis of matter which is not a qualification and is allowed in ISA 700

When the auditor has complete doubt about the going concern assumption he may be required to qualify his report and this is a highly charged area for the auditor because an expression in his audit report that a company is not a going concern may in itself bring about the closure of the company. The auditor should therefore:

a) Not refrain from expressing a qualified opinion even though this may lead to receivership or liquidation;

b) The auditor should consider materiality, if the adjustments required on abandoning the going concern assumption are not material, then no qualification should be given;

c) If the auditor concludes that there is doubt then he should consider the consequences for the figures in the accounts. For example, he should obtain an estimate of the necessary provision against stock or the redundancy payments.

In practice because of the difficulties involved in making adjustments to the accounts and producing them on a break up basis, accounts in most cases in Kenya are produced on the going concern assumption and qualified by the auditor on the grounds that the going concern assumption may not be appropriate.

6.8 SUBSEQUENT EVENTS

Definition

IAS 10 *Events After the Balance Sheet Date* prescribes the accounting for, and disclosure of, events after the balance sheet date.

Events after the balance sheet date are those events that occur between the balance sheet date and the date when the financial statements are authorized for issue.

Events After the Balance Sheet Date may be classified into two categories:

- Adjusting events and
- Non-adjusting events.

An entity adjusts the amounts recognized in the financial statements to reflect adjusting events after the balance sheet date.

Adjusting events are those that provide evidence of conditions that existed at the balance sheet date (e.g. the settlement of a court case after the balance sheet date that confirms that the entity had a present obligation at the balance sheet date; the bankruptcy of a customer that occurs after the balance sheet date usually confirms that a loss existed at the balance sheet date on a receivable).

An entity does not adjust the amounts recognized in the financial statements to reflect non-adjusting events after the balance sheet date.

Non-adjusting events are those that are indicative of conditions that arose after the balance sheet date (e.g. a decline in the market value of investments between the balance sheet date and the date when the financial statements are authorized for issue).

For each material category of non adjusting event after the balance sheet date, an entity discloses the nature of the event and an estimate of its financial effect.

Dividends declared after the balance sheet dates are not recognized as a liability at the balance sheet date.

Financial statements are not prepared on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

The financial statements disclose the date when the financial statements were authorized for issue, and who gave that authorization.

6.9 AUDIT PROCEDURES

The relevant authority on post balance sheet events is ISA. The preparation of profit and loss account and balance sheet will always involve the consideration of events which have or will occur after the balance sheet date. The reason being there are numerous transactions in progress at the balance sheet date whose outcome is uncertain and therefore events subsequent to the balance sheet date which have occurred or are expected to occur need to be examined to determine the appropriate values of assets and liabilities. Examples abound such as the collectability of debts, the net realisable value of old stocks, the outcome of litigation. Even the value of fixed assets is a function of their expected future useful life.

Since the directors in preparing the accounts will invariably use post balance sheet events, the auditor must obtain evidence that all post balance sheet events have been considered and where appropriate used and balance sheet values correctly incorporate post balance sheet events.

- The questions that arise are concerned with what subsequent events should be taken into account and how should they be treated in the accounts

Principles

i. Financial statements should be prepared on the basis of conditions existing at the balance sheet date.

ii. A material post balance sheet event requires changes in the amounts to be included in the financial statements where:

a) It is an adjusting event or

b) It indicates that application of the going concern assumption to whole or a material part of the company is not appropriate.

iii. A material post balance sheet event should be disclosed where:

a) It is a non-adjusting event of such materiality and its non disclosure would affect the ability of the users of financial statements to reach a proper understanding of the financial position or

b) It is the reversal or maturity after the year end of a transaction entered into before the year end, the substance of which is primarily to alter the appearance of the company's balance sheet.

iv. In respect of each post balance sheet event which is required to be disclosed under paragraph (iii) above, the following information should be stated by way of note in the financial statement:

a) The nature of the event and

b) An estimate of the financial effect or a statement that is not practicable to make such as estimate.

v. The estimate of the financial effect should be disclosed before taking account of taxation and the taxation implication should be explained where necessary for a proper understanding of the financial position.

vi. The date on which the financial statement is approved by the board of directors should be disclosed in the financial statements.

Post balance sheet events occupy a very important place in auditing and therefore there is usually a program of work that is carried out in this area. This includes:

i. A routine examination of such events such as collection of debts, sale of stocks, payment of creditors, resolution of pending litigation;

ii. A comparison of significant ratios before and after the year end, seeking explanations for any material differences as they may indicate the presence of adjusting or non-adjusting events or have going concern implications.

iii. Examination of all material provisions and contingent liabilities at the latest feasible date prior to signing of the accounts to determine whether any additional evidence exists that may affect original estimates used.

iv. Review of director's minutes looking for any major new contract or losses of customers or losses of major contracts, capital expenditure commitments, and changes in accounting policy, new borrowing or share issues, extra-ordinary or abnormal transactions, changes in market conditions or products.

v. Discussions with the management, a review of management accounts, review of profit forecasts and cash flow projections, review of non-risk areas and

vi. Review of relevant external information e.g. reports in newspapers. This review must be as near as possible to the date of signing the audit report.

It should be noted that

i. The auditor must always date his audit report. This date should be as close as possible to the date of approval of the financial statement by the directors but must be after that date. ISA 700 requires that the date the directors approve their accounts must be disclosed.

ii. Special situation. These are relatively rare circumstances but possible:

a) If the auditor becomes aware between the date of his report and the AGM when the accounts will be presented, of information which would change his report then he should:

1. Discuss the matter with the directors who may wish to amend the accounts
2. Consider taking legal advice
3. Consider making a statement at the AGM as he is allowed to by the Companies Act.

b) If the directors wish to amend the accounts between the date of the report and the posting to the members, the auditor should

1. Consider if the proposed amendment requires a change in his report
2. Re date his report
3. Review post balance sheet events up to the re dating.

CHAPTER SUMMARY

- Events After the Balance Sheet Date may be classified into two categories:
  - Adjusting events and
  - Non-adjusting events.

- The aims of the financial statement review are:

  i. To provide audit evidence by determining if the financial statements provide information that is internally consistent with other information in the possession of the auditor

  ii. Also to determine if the financial statements have been prepared using acceptable accounting policies, they comply with IFRS and other requirements and that there is adequate disclosure of all relevant matters

CHAPTER QUIZ

1) Define going concern.

2) What are the qualities that final accountant contain?

ANSWERS TO THE CHAPTER QUIZ

1. this is the financial statements assumption that the enterprise will continue in operational existence for the foreseeable future, or put another way the financial statements assume no intention or necessity to liquidate or curtail significantly the scale of operation or put more simply that the enterprise can meet its financial obligations as they fall due

2.

a) Use of acceptable accounting policies, appropriate to the business and consistently applied;

b) They must show the results of operations in the profit and loss account, state of affairs in the balance sheet, changes in the financial position in the statement of source and application of funds and all other information included in the financial statement should be compatible with each other and with the auditor's knowledge of the enterprise;

c) All appropriate matters should be adequately disclosed and information contained in the accounts should be suitably classified and presented;

d) There must be compliance with statutory requirements;

e) There must be compliance with other relevant regulations;

f) There must be compliance with Kenya Accounting Standards.

PAST PAPER ANALYSIS

This is a potential examination area and in the recent past it has become popular with many examiners and students are highly encouraged to get its full understanding. Some areas that have been examined include;

6/00 Question 5, 12/00 Question 3, 12/07 Question 3 and question 4.

EXAM QUESTIONS

Question one

The International Auditing Practices Committee requires that doubts about the going concern presumption be detected and adequately disclosed in the financial statements and auditors' reports.

Required:

a) Explain the term "going concern" in relation to the preparation of financial statement. (4 marks)

b) Describe the audit procedures the auditor should undertake in order to obtain sufficient audit evidence to be able to form an opinion on the going concern status of the company. (6 marks)

c) List six factors which might cast doubt on the going concern status of a company. (6 marks)

d) Discuss briefly how the present responsibilities of the auditor regarding the going concern status of company could be extended. (4 marks)

(Total: 20 marks)

Question two

You are the audit manager at Zainabu and Associates responsible for the audit of the books of account of Ziwani Spares Ltd. in the course of the audit of the financial statements for the year ended 30 June 2004, your preliminary evaluation of the internal controls indicated that reliance could be placed on the system. However, compliance tests carried out during the audit disclosed that the system was not operating effectively. This situation has necessitated various amendments and additions to your original audit plan.

Required:

Describe the changes to be effected:

a) During the interim audit. (13 marks)

b) After the end of the financial year. (7 marks)

(Total: 20 marks)

CHAPTER SEVEN

SPECIALIZED AUDIT SITUATIONS

CHAPTER SEVEN

SPECIALIZED AUDIT SITUATIONS

▶ OBJECTIVES

Explain, discuss and carry out audits in specialised situations

▶ INTRODUCTION

Companies carry on thousands of different types of trade, business or professional activities. It is not possible in a manual on general auditing procedures to consider the special audit problems of each of them. In Kenya therefore, when we are talking of specialised audit situations, we would be talking about the financial sector, including institutions such as banks, financial institutions, building societies, insurance companies, hire purchase companies. In this chapter we are also concerned with charitable organisations, non-profit making organisations, lawyers practices and public entities such as cooperative societies, parastatals and local government authorities.

▶ DEFINITION OF KEY TERMS

An associate this is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in financial and operating policy decisions of the investee but is not control or joint control over those policies

▶ EXAM CONTEXT

This paper covers question relating to the distinct and unique auditing procedure that may be required to overcome the challenges facing in auditing specialised situations. It requires critical thinking and its highly practical

▶ INDUSTRIAL CONTEXT

In reality, companies carry on thousands of different types of trade, business or professional activities. It is not possible in a manual on general auditing procedures to consider the special audit problems of each of them. Hence the audit will use different approaches in auditing these specialised companies

7.1 FINANCIAL INSTITUTIONS

Due to the recent collapse of many financial institutions, this is now a heavily regulated area. The banks and financial institutions and building societies are now subject to close supervision by the Central Bank of Kenya and insurance companies are subject to strict control by the Commissioner of Insurance.

7.1.1 Banks

The Authoritative documents are:

- The Central Bank of Kenya Act,
- The Companies Act Cap 486
- IAS 30 Disclosure in the Financial statements of Banks and Similar financial Institutions
- IAPS 1000 Inter-bank confirmations procedures
  IAPS 1004 the Relationship between Supervisors of Banks and Banks External Auditors
- IAPS 1006 Audits of the Financial statements of Banks

Key audit points are

1. Internal control especially with regard to computerisation and internal audit.
2. Provision for doubtful debts on advances.
3. The manner of describing the profit figure and balance sheet items which include hidden inner results.
4. Critical review of the banks financial position and reserves

(a) **Profit and loss account:** When looking at a bank's profit and loss account the accountant should seek to discover what proportions of the bank's profits are derived from sustainable business and how much comes from sources of income that are speculative or uncertain. The three major sources of income that require examination are: the net interest between lending and borrowing, dealing profits derived from the banks investments portfolio and fees and commissions.

(b) **Current status**: Although he may be auditing a prior period the auditor should discuss with the management any current problems to discover whether profits are still being made in the current trading period.

(c) **Review of projected profits:** Enquiries should be made to ascertain whether projected profits take into account suspended interest, bad debts provision and any other decline in the realisable value of assets.

(d) **Frequency of reviews**: The auditor should enquire whether provisions are being reviewed on a regular basis.

(e) **Further enquiries:** Further enquiries are made in the following areas: investments, certificates of deposits, foreign exchange, land and property and loans. The fee earning activities of the bank are also investigated in the areas of loan commitment, acceptances, portfolio management and corporate advisory work.

Banks are incorporated under the Companies Act like any other business but are granted special privileges under the same Companies Act and subjected to very strict controls by the Central Bank of Kenya. Apart from frequent visits from the Central Bank and regular reports to the Central Bank on liquidity levels the auditor is also required to submit a copy of his audit report to the Central Bank. The auditor should review the reports submitted to the Central Bank and the reports submitted to the bank by the Central Bank as a result of the visits. The auditor is also concerned with enquiring into compliance with the Banking Act. In theory, banks are allowed to set up secret reserves by writing down assets or creating excessive provisions without disclosing that they have done so. The effect of this is:

(a) The real position may be better than that disclosed but never worse.

(b) In good years, secret reserves are created and in bad years they are run down. The effect of this is to even out the profits and the customers are not then tempted to withdraw their deposits if the bank has a bad year.

If the bank was to take advantage of these provisions then it would not be possible for the auditor to give a true and fair view report on the accounts. In practice banks in Kenya do not take advantage of the provisions and therefore the auditor carries out a normal audit and gives a report in true and fair terms.

7.1.2 Insurance Companies

Authoritative documents include:

- The Insurance Act
- The Companies Act
- IFRS 4 Insurance Contracts

The main legislation governing insurance companies and their conduct is the Insurance Act

Key audit areas: For an insurance company these are:

1. Investments,
2. unearned premiums, and
3. Expired risks, this is when a category of business has proved to be unprofitable provision is made for future losses on risks already accepted,
4. Outstanding claims,
5. Ascertainment of debtors and creditors,
6. Actuarial valuation re: life insurance.

Insurance companies like banks are also subject to special exempting provisions in the Companies Act and in the Insurance Act. Unlike banks, not only do they take advantage of the special provision but are in fact required by the Commissioner to take advantage of the provisions. The auditor therefore, in practice gives two audit reports for an insurance company and is also required to sign various reports that are submitted to the Commissioner of Insurance. The insurance company prepares statutory accounts which are audited in the normal way and a true and fair view report given and these are submitted to the members in the normal way and adopted and dividends paid on their strength. The Commissioner then requires accounts to be prepared in accordance with insurance regulations taking advantage of creating secret reserves. These are also audited and reported on accordingly by the auditor but not in true and fair view terms but rather by simply stating compliance with the insurance act.

Key audit areas in detail

(a) **Ascertainment of debtors and creditors.** Insurance companies do not maintain their personal ledgers in such a way as to produce directly a separate list of debtors and creditors. Their ledgers instead reflect the section of the market from which the business originates e.g. broker, re-insurer, direct policy holder etc, hence it is quite possible that both debtor and creditor balances will exist in one ledger sometimes for the same person. The legal position with regard to right of set off between debit and credit balances with the same person is not clear. From a professional point of view the auditor must ensure therefore that the company adopts a consistence approach in establishing the separate amounts of debtors and creditors.

(b) **Unearned premiums:** This represents the appropriate portion of a premium received during the year under review but is applicable to later accounting periods. Once again, a consistent approach should be adopted and the accounts should declare the basis selected by the insurance company under the heading of accounting policies. The most common basis adopted for annual premiums is the 24th basis.

(c) **Expired risks**: This represents the carry forward of provisions to the next accounting period in circumstances where it appears that insurance business undertaken in the period under review is unprofitable. This makes it similar to the provision on long term contracts in the construction industry. The audit difficulty is that a considerable element of adjustment enters the computation of such risks, the issue is for the auditor to form an opinion on the need for such a provision and if one exists whether the sum provided is adequate.

(d) Outstanding claims: We can classify these claims in the following three categories:

i. Those which have been notified and agreed but are still outstanding at the balance sheet date

ii. Those which have been notified before, but not yet agreed at the balance sheet date and

iii. Those which have arisen but have not yet been notified to the company by the balance sheet date.

A good deal of estimation is needed with regard to category (ii) and (iii) above. The audit procedures therefore would invariably include, review of the claims files in order to appraise the company's estimates. We must also compare the average cost of outstanding claims for each class of business with current experience and finally the auditor should examine statistical elements comparing past estimates with actual results.

7.1.3 Building Societies

Building Societies are organisations which exist to offer a savings and investment medium to the public and to lend to individuals money to enable them buy their own houses taking as security the deeds of the houses. They are not limited companies but are run by a board of directors elected by the investors and permanent staff. There are strong similarities in the legislation covering building societies and that covering companies.

There are additional control problems peculiar to building societies:

i. The large volume of deposits and withdrawals of small amounts of cash;
ii. The granting of loans on mortgage
iii. Control over documents of title
iv. Control over investments and their related income

It shall be the duty of the auditors of a building society to carry out such investigations as will enable them to form an opinion as to the following matter.

(a) Whether the society has kept proper books of account;

(b) Whether the society has maintained a satisfactory system of control over its transactions and records;

(c) Whether the balance sheets and revenue and appropriation account are in agreement with the books of account and records of the society and if the auditors are of the opinion that the society has failed to keep proper books of account or proper records or a proper system of control they should state that fact in their report.

Key Audit Areas

1. The auditor must examine the procedure for checking deeds on receipt from the lawyers to ensure that they are complete in accordance with the advance records properly executed and stamped;

2. Examine the maintenance of records that show the location of all deeds and the dates of any changes in the location of any of them.

3. Examine the procedure that ensures that the deeds are received from the society's lawyers without undue delay;

4. Examine the authority required for the release of deeds for a temporary period from their normal custody and the proper control for their prompt return;

5. Examine whether there is a continuous independent check of the deeds against the advance records or the borrowers ledger accounts;

6. Examine the necessity for satisfactory cross reference between the advance records, the cash book, the borrower's ledger account and the deed.

7. Examine the procedure for the release of deeds on redemption of the mortgage.

Other matters the auditor needs to be concerned with are:

Examination of deeds

- Ensure that the mortgage is in the name shown in the advance records;

- That there is a document of title to the property under mortgage and that the society's lawyers have been satisfied as to the borrower's title;

- The amount of the advance as stated in the mortgage deed is not less than that shown on the advance records;

- The mortgage deed is stamped, properly signed, witnessed and is prima facie in order;

- The property is adequately insured, the premium is paid up to date and the society's interest as mortgage is endorsed in the insurance policy.

Share and deposits

Shares may consist of subscription shares and paid up shares. Interest on shares may be credited to the accounts instead of being paid to ensure proper control the following should be covered by the system:


- There should be proper custody of unused share and deposit pass book, receipt forms and share certificates;
- There should be proper instructions to the staff as to the making of entries in the pass books and the issue of receipts;
- Withdrawal terms, notice and specimen signatures;
- Authorization of withdrawals by the ledger department or against the pass books;
- Records of deaths, marriages, powers of attorney and transmission of shares and deposits;
- The comparison of the balance shown in the pass book with that shown in the ledger.

Cash

Possibility of error and misappropriation always accompany the handling of cash. Building societies transactions to a large extent are in cash. This however does not involve audit considerations which differ in principle from those encountered in any other business. So there should be surprise cash counts and any discrepancies should be investigated in detail.

Window Dressing

Auditors should examine transactions which have the effect of showing as at the balance sheet date a state of affairs particularly the society's liquidity which is materially better than it was during the year and shortly after. Of particular attention are:

1. Large deposits received shortly before the year end and repaid shortly after;
2. Large mortgage repayments received shortly before the year end and re-advanced on the same property shortly after;
3. Unusual delay until after the year end in making payments in accordance with applications received for withdrawals of shares or deposits;
4. An abnormal year end accumulation of commitments for advances followed by the making of the advances shortly after the year end;
5. The significance of items in the bank reconciliation statements.

Not only does the auditor report to the members on the financial statements, he is also supposed to give a report to the registrar of societies to accompany the annual return.

7.1.5 Charities and Non Governmental Organizations

Key audit areas:

1. Income: donations are hard to verify therefore good internal control is needed particularly on the opening of mail. A published list of donors can be very helpful in verification;

2. Outgoings: Should be minuted and be subject to delegated authority;

3. Investments: Many charities have investments and these are verified in the normal way of verifying in investments.

The audit report is usually qualified on grounds that it is not possible because of the nature of the society to verify whether all the income receivable in the form of donations has been fully accounted for.

Control problems in charities

(a) Door to door collections: Volunteers should be issued with numbered boxes, the boxes should be sealed, the boxes should be opened and counted regularly preferably in the presence of the volunteer and one or more trustees. All contents should be promptly entered in a register kept for that purpose and banked. The entries in the book should be initialled by those counting.

(b) Donations received by post: Two people including a trustee should open the mail. Receipts should be entered in a register kept for the purpose and the entries initialled. Banking should be immediate.

(c) Deeds of covenant: A register of donors under deed should be kept. Checks should be made regularly to see that all amounts have been received or donors followed up.

(d) Harambee and other fund raising events: The plans for the events especially expenditure should be approved in advance by the trustees. Records should be kept of all details of these events. Individuals should be politely instructed in their financial duties. All cash and cheques should go to the society's bank account. All proceeds should be counted in the presence of a trustee and banked promptly. An account should be drawn up after the event approved by the trustee and publicised to all the members.

(e) Donations of equipment and materials: A full register of such donations should be maintained. An estimate should be made of the market value of all items. Maintenance materials should be properly stored.

(f) All cash payments should be made out of cash drawn from the bank, unless any donor objects the annual report should contain a full list of donors. The annual report and the accounts should be as detailed as possible.

7.1.6 Pension Funds

Pension funds are set up by companies or other organizations:

(a) To administer the pension payable to retired employees and

(b) Ensure that funds are available to pay pensions even if the sponsoring organization goes into liquidation. The auditors duties include:

i. Examining the trust deed that set up the fund and ensuring that its provisions have been correctly carried out;

ii. Verifying that there is proper control over the transactions of the fund;

iii. Verifying the portfolio of investments. All changes should be authorised by trustee minutes and all income must be received;

iv. Verify that the funds are sufficient to meet its future commitments. These are usually determined actuarially, preferably annually. Many schemes incorporate an undertaking by the sponsor to make good any deficiency.

7.1.7 Advocates

The statutory provision regulating the handling of client's monies is covered in the advocate's act.

Purpose of the rules:

- To require a lawyer to keep client's money separate from his own money;
- To ensure that a lawyer keeps adequate records of his transactions so that his books show money received and paid and balance held on account of each client;
- To ensure that one client's money is clearly distinguished from that of other clients and from any other money passing through the lawyer's accounts.

Broad effects of the rules:

- That money received by a lawyer which does not belong to him should be dealt with through the client account;
- That his own money is kept in an office account

The Accountant's Role

Every year a lawyer who handles client's money is required to produce to the Law Society of Kenya a report by a qualified accountant that he has complied with the rules in the advocate's act. This report is required once every year, however, a complete audit is not required nor is there a requirement for the preparation of the profit and loss account or balance sheet. For the purpose of giving his report the accountant must:

1. Ascertain from the lawyer particulars of all bank accounts kept or operated by the lawyer in connection with his practice.

2. Examine the book keeping system in every office of the lawyer to see that the system complies with the following requirements:

- That there is a ledger account for each client

- The ledger accounts show separately particulars of all client money received, held or paid on account of each client

- Transactions relating to clients money are recorded in the lawyers books so as to distinguish them from transactions relating to any other monies

- Test check postings to client's ledger accounts from records of receipts and payments of client's money

- Make test checks of casts of such accounts

- Compare a sample of lodgements and payments as shown in the bank statement with the lawyer's records of receipts and payments of client's monies

- Enquire into and test check the system of recording costs and of making withdrawals in respect of costs from the client account

- Satisfy himself by test examination that financial transactions are in accordance with the rules and that any entries in ledger accounts reflect the transaction in a manner which complies with the rules

- Extract all client's ledger balances at least two dates in the year and reconcile the cash book balance with that confirmed direct to the accountant by the bank

- Make test examination to ascertain whether payments from client account have been made on any individual account in excess of the money held on behalf of that client

- Peruse the office ledger, cash accounts and bank statements to see whether client money has not been paid into a client account

The accountant is not required

1. To extend his enquiries beyond the information contained in the relevant documents as supplemented by such information and explanations as he may obtain from the lawyer.

2. To enquire into stocks shares other securities or documents of title held by the lawyer on behalf of clients.

3. To consider whether the books of accounts of the lawyer were properly written up in accordance with the rules at any other time than at which his examination took place.

7.1.8 Co-operative Societies

An audit in this case is carried out as a normal audit except you should note that the auditor is appointed by the Commissioner of Co-operatives and although he reports to the members the accounts must be registered with the Commissioner. Of special note is that he is required to carry out special investigations on the bad debts provision to determine its adequacy and on the good debts he has to confirm their recoverability.

7.1.9 Public Sector Audits

7.2 PARASTATALS

These are subject to audits by the Auditor General .The audit is carried out as for any other company.

7.2.1 Central Government and Local Authorities

The audit of these accounts is governed again by the Audit and Exchequer Act and is carried out by the Controller and Auditor General who is accountable to the National Assembly.

7.3 AUDIT OF HOLDING COMPANIES AND GROUP ACCOUNTS

Authoritative documents are:

- The Companies Act Cap 486
- IAS 27
- IAS 28
- IAS 31
- IFRS 3
- ISA 620 Using the work of another auditor

The Companies Act requires that where a company at its year end has a subsidiary then the directors of that company called a holding company are required to produce consolidated accounts or group accounts which show a true and fair view of the state of affairs and the results of the company and its subsidiaries so far as they concern the members of the holding company.

Audit of Group Accounts

Definitions

- Principle auditor-means the auditor with the responsibility for reporting on the financial statements of an entity when these financial statements include financial information of one or more components audited by another auditor

- Other auditor means an auditor other than the principle auditor, with the responsibility for reporting on the financial information of a component which is include in the financial statements audited by the principle auditor. Other auditors include affiliated firms ,whether using the same name or not and correspondents as well as unrelated auditors

- Components mean a division, branch, subsidiary, joint venture, associated company or other entity whose financial information is included in financial statements audited by the principle auditor.

Factors to be considered before accepting a principal auditor

1) The materiality of the portion of financial statements which the principal auditor audits
2) The principal auditors' level of knowledge
3) The risk of material misstatements in the financial statements of the components to be audited by another


4) The performance of additional procedures regarding the components audited by the other auditor resulting in the principal auditor having significant participation in such audit.

Principal auditor's procedures

- **Professional competence-in assessing the professional competence of the other auditor in the context of the specific assignment the principal should consider membership or affiliation, make inquiries with other auditors ,bankers etc, have discussions with the other auditor .**

- **Sufficient appropriate audit evidence-to ensure that the work of the other auditor is for the principal auditor's purposes the principal auditor would advise the other auditor of**

1. The independence requirements regarding the entity and the component and obtain written representations to compliance with them

2. The use that is to be made of the other auditor's work and report and make sufficient arrangements for the co-ordination of their efforts at the initial planning stage

3. Matters requiring special consideration e.g. procedures for the identification of inter company transactions that may require disclosure

4. The timetable for completion of the audit

5. The accounting ,auditing and reporting requirements and obtain written representation as to compliance with them

- **Other procedures-discuss with the other auditor the audit procedures applied, review a written summary of the other auditor's procedures and review working papers of the other auditor**

Documentation - the principal auditor's working papers should include;

- **The components whose financial information was audited by other auditors**
- **The significance to the financial statements of the entity as a whole**
- **The names of the other auditors and any conclusions reached that individual components are immaterial**
- **Procedures performed and the conclusions reached**

Cooperation between auditors

The other auditor should cooperate with the principal auditor and bring to his attention any aspect of their work that cannot be carried out as requested

Reporting considerations

- ❖ Limitations of scope-a qualified opinion or disclaimer of opinion should be expressed when the principle auditor concludes that the work of the other auditor cannot beused an has not been able to perform sufficient additional information procedures regarding the financial information of the component audited by the other auditor

- ❖ Modified auditor's opinion-if the auditor issues or intends to issue a modified auditor's report the principal auditor considers whether the subject of the modification is of such nature and significance in relation to the financial statements of the entity on which the principal auditor is reporting that a modification of the principle auditor's report is required.

Division of responsibility-in some justifications a principal auditor is is permitted to base the audit opinion on the financial statements taken as a whole solely upon the report of another auditor the principal auditor should therefore clearly state this fact and indicate the magnitude of the portion of the financial statements audited by the other auditor

Using the work of other auditors

Other auditors may be involved in the audit of subsidiary and associated undertakings .Where there is no subsidiary right to request information and explanations from other auditorsthe client will be requested to arrange that the subsidiary instruct the other auditors to cooperate. If the other auditors of associated undertakings are unable or unwilling to co-perate the availability of alternative information should be considered.

Undertakings audited by other auditors

- ➢ Risk-to asses the risk of material misstatement in a subsidiary or associate it will be necessary to identify those most susceptible to material error

- ➢ Materiality-the materiality of each subsidiary or associate should be judged in relation to the group's total assets, results, account headings. As a guide>10% is material and<5% is immaterial. For all material group companies ,the other auditor should, be professionally competent, be independent of the group and complete all audit procedures considered necessary Audit approach to material undertakings

With the client's permission contact the other auditors and if appropriate arrange a meeting to ensure the adequacy of the other auditors work and review the overall audit plan. Confirm in writing the requirements of the other auditors.

☐ Instructions to other auditors

Contents maybe structured e.g.;

I. General
II. Specific procedures
III. Company
IV. Audit scope fees,scope and coverage
V. Critical and significant audit concerns
VI. Management letters
VII. New accounting standards

☐ Review of subsidiaries' report

In complex jobs a control sheet maybe maintained to record receipt of profomas from subsidiary auditors, agreements to consolidate schedules, whether auditors reports are modified

Preliminary review to check that all information included makes sense and adds up, exchange rates are confirmed and opening balances agreed with prior year's closing balances.

Significant matters review investigates eg a qualification in subsidiary's auditor's report or departments from group accounting policies

☐ Review of audit working papers

The purpose is to ensure a conclusion to be reached on whether the financial systems are acceptable for incorporation into the group financial statements. It is carried out by a partner or manager based on the firm's standard questionnaire

☐ Subsequent events

A review of events to the balance sheet date is required before signing the auditors report on group financial statements To some extent the review can be carried out centrally for the group as a whole particularly in respect of non-material subsidiaries. Other auditors and subsidiaries may be requested to provide necessary information up to the date of signing the auditor's report on the group's financial statements

Going concern

The consolidated financial statements will be prepared on a going concern basis when the group as a single entity is considered to be a going concern .However the going concern basis may only be appropriate for certain legal entities because the parent undertaking is willing and able to provide support.

Disclosure of information about companies audited by other auditors

Shareholders of the parent company are entitled to know that he financial statements of some of the group companies have been audited by other auditors and the materiality of those companies to the group This information maybe disclosed in a schedule of principal subsidiary and associate companies in the directors' report a note the financial statements. Disclosure of information relating to other auditors in the auditor's report on the group's financial statements not consistent with the responsibility of the principal auditor The omission of information regarding other auditors from the directors' report or group financial statements should not therefore be made good in the auditors report .

The major problems in this area can be split into three sections:

1. The audit of the holding company obtaining and confirming information about subsidiaries
2. Checking consolidation working papers and
3. Placing reliance on the work of other auditors

The audit of the accounts of a holding company follows the same lines as any company audit. However, special consideration has to be given to the dealings with and presentation of investments in subsidiary companies.

Audit work on the holding company

We will concentrate on the verification of investments in subsidiary companies.

1. Obtain a schedule which should contain the following information. All the data which the Companies Act requires to be disclosed in the holding company's own accounts, copies of the accounts of each subsidiary with a note who the auditor is, details of any qualifications in any of the audit reports, summary of movements in investments in subsidiary and on current and loan accounts with its subsidiary, reconciliations of intercompany balances.


2. Existence and ownership must be verified by examining the share certificates and ensuring that they are in the name of the holding company. If not, then blank signed transfer forms should be available from the nominees. If the share certificates are held by third parties, then an appropriate certificate must be obtained.

3. Current and loan accounts: Their verification is normally done by obtaining a certificate from its subsidiary confirming the balances. Also if the auditor of the holding company is the auditor of the subsidiary, he can reconcile entries in both sets of books himself. The auditor must satisfy himself that dealings between group companies are not used to cover up material errors.

4. Valuation: Valuation is verified as follows: If the shares were acquired in the year consider cost and authorization. Examine accounting treatment of any premium or discount on acquisition and any dividends received out of pre-acquisition profits. The balance sheet value of its subsidiary must be considered and this could include review of each individual subsidiary's account to confirm that it is still a going concern.

Checking consolidation papers

The auditor pays particular attention to the calculation of:

a) Goodwill arising on acquisition and consolidation
b) Pre-acquisition and post-acquisition profits
c) Minority interest
d) Treatment of intercompany profits in stocks
e) Agreements of intercompany indebtedness
f) Necessary cancellations in respect of intercompany cash in transit
g) Turnover, excluding group trading
h) Necessary adjustments in respect of group companies with different accounting period ends.
i) Taxation

The consolidated accounts must comply with all relevant accounting and legal requirements.

Reliance on the work of other auditors

The primary auditor or the principal auditor is solely responsible for the holding company's accounts. It is inevitable however that in large groups the holding company's auditor thus the principal auditor are not always the auditors of the subsidiary company, therefore, there is need for then to rely on the work of other auditors. The student must note that the principle auditors are fully responsible for their opinion on the group accounts and need not for this reason refer in their report to the fact that the accounts of some subsidiary or associated company have been audited by other firms. I refer you to the following important topics covered in the ISA 600 Using the work of another auditor. Accounting policies, availability of information, scope of work of the secondary auditors or other auditors, the materiality of the amounts involved. If the principal auditor is satisfied that the accounts present a true and fair view and comply with the Companies Act the auditor will be able to issue an unqualified audit report. However, qualification will be necessary in the following circumstances.

1. A material subsidiary if qualified then there may be need for this qualification to be noted in the holding company's report.

2. Failure by the principal auditor to obtain satisfactory information with regard to material subsidiary or material amounts that have been consolidated from an audited account.

3. Material disagreement with any of the consolidation calculations.

4. Non-compliance with legal or professional requirements as far as disclosure is concerned.

The student is strongly advised to read the ISA on reliance on the other auditors and keep in mind the following requirements:

1. A complete list of subsidiaries showing the share holdings of the holding company and other group members should be kept. He should have copies of the accounts of each subsidiary noting qualified audit reports, agreement of intercompany balances, division between pre and post acquisition profits, accounting policies adopted and ensure that each set of accounts is properly signed by directors and auditors.

2. Questionnaires used to determine the work undertaken by subsidiary company auditors.

3. Any letters of weakness sent by each subsidiary company auditor.

4. A checklist showing companies act requirements and IAS 27 and IAS 28.

Other matters to be covered are

1. Accounting policies: these should be uniform throughout the group and should be properly disclosed.

2. Consolidated adjustments should be carried out correctly both conceptually and mathematically.

3. He should ensure that all material subsidiaries have been audited.

4. He should investigate all known co-terminus accounts.

5. He should investigate for window dressing

6. He should consider foreign subsidiaries if any.

IAS 27

IAS 27 applies to the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. It also applies to accounting for investments in subsidiaries, jointly controlled entities and associates in the separate financial statements of a parent.

Summary of IAS 27

A parent presents consolidated financial statements in which it consolidates its investment in subsidiaries (those entities that it controls), unless certain conditions are met allowing it not to prepare consolidated financial statements. The consolidated financial statements are prepared using uniform accounting policies. The reporting date of the parent and its subsidiaries shall not be more than 3 months apart.

When separate financial statements are prepared, investment in subsidiaries, jointly controlled entities and associates should be accounted for either at cost or in accordance with IAS 39. The same accounting should be applied for each category of investments.

IAS 27 specifies disclosures to be made in consolidated and separate financial statements.

IAS 28 applies in accounting for investments in associates, except those held by:

- Venture capital organisations, or
- Mutual funds, unit trusts and similar entities including investment-linked insurance funds that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement.

Summary of IAS 28

An associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in financial and operating policy decisions of the investee but is not control or joint control over those policies. Such influence is presumed to exist if the investor owns 20 per cent or more of the voting power of the investee. An investment in an associate is accounted for using the equity method. The equity method is not used when:

- The investment is classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations; or

- The investor is itself a subsidiary, its owners do not object to the equity method not being applied, and its debt and equity securities are not publicly traded. In this case the investor's parent must present consolidated financial statements that comply with IFRSs.

The investor's financial statements are prepared using uniform accounting policies for like transactions and events in similar circumstances. Any difference between the reporting date of the investor and its associate must not be more than 3 months.

An investor discontinues the equity method from the date that it ceases to have significant influence over the associate. From that date it accounts for the investment in accordance with IAS 39, provided the associate does not become a subsidiary or a joint venture as defined in IAS 31.

IAS 28 specifies disclosures to be made in the investor's financial statements about associates.

Joint Audits

This arises where:

- The parent company auditors are appointed jointly with the existing auditors of a subsidiary; or
- A transitional arrangement is made for a newly-appointed firm to act jointly for say one year before the existing auditors resign.

Each auditor's responsibility remains the same as with a sole audit- they must complete the audit and evidence the work by appropriate files and appropriate reviews.

Separate working papers should be maintained by each auditor since each firm will form its own opinion.

CHAPTER SUMMARY

- There is a statutory provision regulating the handling of client’s monies which is covered in the advocate's act and it;

  i) Requires a lawyer to keep client's money separate from his own money;

  ii) Ensures that a lawyer keeps adequate records of his transactions so that his books show money received and paid and balance held on account of each client;

  iii) Ensures that one client's money is clearly distinguished from that of other clients and from any other money passing through the lawyer's accounts.

- Some Control problems experienced in auditing of charities include;

  (a) Door to door collections

  (b) Donations received by post

  (c) Deeds of covenant

  (d) Harambee and other fund raising events

  (e) Donations of equipment and materials

  (f) All cash payments should be made out of cash drawn from the bank.

CHAPTER QUIZ

1. Discuss the procedures usually followed in conducting an audit by more than one firm of accountants and the division of work between them.

2. Discuss the general advantages and disadvantages of joint audits.

3. What are some of the control problems experienced in auditing of charities?

ANSWERS TO THE CHAPTER QUIZ

1. All auditors may be liable to the consequences of loss arising from negligence. Each joint auditor accepts all the obligations of the office of auditor and this can mean that losses flowing from a wrong auditor's report may be recovered from either of both auditors. Thus a joint auditor might be financially responsible for losses arising as a consequence of the negligence or incompetence of his fellow auditor.

Before accepting a joint office, an auditor must:

i. Consider whether he is prepared to serve jointly with the other auditor. He may well ask himself if he would take him as a partner.

ii. Assure himself that adequate control and review of all aspects of the audit can be organised.

iii. Ensure that professional indemnity insurance cover can be obtained to cover the special situation.

Several possible arrangements could be made:

i. Each joint auditor could conduct its own audit with its own standard documentation and files. Leading schedules would need to be photocopied and exchanged.

ii. A unified set of documents and files could be produced by both firms. This may involve some modification of each firm's methods.

iii. Each firm could use one standard set of documents and files using the standards of the larger of the two firms.

Whatever the method is used, extensive discussion and planning must precede the commencement of any audit work.

The considerations which are **likely to dictate the division of work are**

i. Expertise: Each firm may have special expertise e.g. in certain types of client, computers etc.

ii. Geography: The particular location of the firms and their branches must be considered.

iii. Competence: One of the joint auditors may be especially competent with small clients, the other with large clients.

iv. Size and availability of staff.

v. Cost: Audit costs may be minimised by a particular division of work.

2. The general advantages and disadvantages of joint audits are

Advantages

i. All work and fees are welcome to audit firms.

ii. An opportunity to closely inspect the auditing methods of another firm.

iii. The other firm may have special expertise which might fit well in a joint business.

iv. The other firm may have geographical location possibilities which complement.

v. The other firm may be of such a size that a client company can be serviced which may otherwise be beyond available resources.

vi. Flexibility of working arrangements with another firm may avert bottlenecks owing to staff shortage at peak times.

Disadvantages

i. Shared legal responsibility. Liability for co-auditor's negligence.

ii. Lack of control. The other firm may have different audit standards which may be unsatisfactory.

iii. Any shared work or responsibility may lead to personality clashes.

3.

a) Door to door collections: Volunteers should be issued with numbered boxes, the boxes should be sealed, the boxes should be opened and counted regularly preferably in the presence of the volunteer and one or more trustees. All contents should be promptly entered in a register kept for that purpose and banked. The entries in the book should be initialled by those counting.

(b) Donations received by post: Two people including a trustee should open the mail. Receipts should be entered in a register kept for the purpose and the entries initialled. Banking should be immediate.

(c) Deeds of covenant: A register of donors under deed should be kept. Checks should be made regularly to see that all amounts have been received or donors followed up.

(d) Harambee and other fund raising events: The plans for the events especially expenditure should be approved in advance by the trustees. Records should be kept of all details of these events. Individuals should be politely instructed in their financial duties. All cash and cheques should go to the society's bank account. All proceeds should be counted in the presence of a trustee and banked promptly. An account should be drawn up after the event approved by the trustee and publicised to all the members.

(e) Donations of equipment and materials: A full register of such donations should be maintained. An estimate should be made of the market value of all items. Maintenance materials should be properly stored.

(f) All cash payments should be made out of cash drawn from the bank, unless any donor objects the annual report should contain a full list of donors. The annual report and the accounts should be as detailed as possible.

PAST PAPER ANALYSIS

This topic has not been very popular with examiners but student are advised not to ignore it. It has been tested in the following sittings; 12/00 Question 4, 6/06 Question 5.

EXAM QUESTION

Omega Furniture Ltd. is an audit client of Omega firm. It manufactures household furniture. It has a year-end of 31 December. On 13 June 2008, a fire destroyed the company's factory complex, which included the area used for storing raw materials. The fire was caused by an electrical fault. The factory has now been rebuilt and the company commenced trading again in November 2008.

The finance director of Omega Furniture Ltd. produces monthly management accounts; in these stocks and cost of sales are estimated, based on sales figures less assumed margins. On 321 March and 30 September, the company conducts full stock-takes for its own purposes in addition to is year end stock count. The results of these stock counts are compared with the management accounts for March and September and adjustments are made to reflect the physical stock quantities and their appropriate values.

The finance director has contacted your firm to provide a certificate in support of his claim for loss of profits and loss of stocks arising as a result of the fire.

Required:

a) State what information you would seek and what procedures you would perform to reach an opinion on the company's claim for loss of profits and loss of stocks.(12 marks)
b) Assuming you obtain all the information you require, draft your special report. Give brief reasons for the form of wording you have adopted. (8 marks)

(Total: 20 marks)

CHAPTER EIGHT

STUDY TEXT

EXTERNAL AUDITORS REPORTS AND OTHER REPORTS


CHAPTER EIGHT

EXTERNAL AUDITORS REPORTS AND OTHER REPORTS

▶ OBJECTIVES

When you have studied this CHAPTER you should be able to:

- Discuss and explain the concept of 'true and fair' and appreciate its relevance to the work of an auditor
- Prepare audit reports to meet different specified situations
- Prepare reports for management

▶ INTRODUCTION

The audit report is the final stage in the process of an audit. The terms 'true and fair' 'present fairly' have special significance in the audit report. In this chapter we will be required to draft unmodified and modified audit reports in accordance with ISA 700. *The auditor's report on a complete set of financial statements* taking into account a variety of circumstances which may affect the audit opinion. The CHAPTER also covers other reports or letters sent by the auditor to the client's directors and managers in accordance with ISA 260

*Communication with mana*gement. Finally, we consider some special purpose audit reports.

▶ DEFINITION OF KEYS TERMS

1. **A true and fair view** implies that all statutory and other information is not only available but is presented in a form in which it can be properly and readily appreciated. (Sir Russell Kettle).

2. **Substance over Form** Transaction should show the commercial reality rather than the legal form

3. **Materiality**. A matter generally is held to be material if its disclosure or non-disclosure would affect the view given by the accounts. Materiality may be considered in the context of the financial statement as a whole, the balance sheet, the profit and loss account, or individual items within the financial statement

4. **Fundamentality**. When a matter is fundamental then it is considered so crucial to the view given by the accounts that it can render them totally misleading or meaningless.

5. **A qualified opinion** expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.

6. **A disclaimer of opinion** is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

7. **An adverse opinion** is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

▶ EXAM CONTEXT

These questions tend to be challenging and needs lots of practice and a step to step approach to forming an opinion. Questions come in the form of mini scenarios, mostly requiring you to comment on the proposed audit report.

▶ INDUSTRIAL CONTEXT

At the end of each audit, an auditor is expected to write a report giving his opinion on the state of financial statements. His report is highly depended on by other stakeholders in their decision making.

8.1 TRUE AND FAIR

(a) History

International Standards on Auditing (ISAs) make it quite clear that the terms 'true and fair' and 'present fairly' which are used in audit reports in many other countries, mean the same thing. There is no definition of either term in legislation or standards anywhere. Although both have existed for a long time.

IAS 1 (revised) *Presentation of Financial Statements* states that financial statements should 'present fairly' the financial position, performance and cash flows of and enterprise and goes on to state that financial statements prepared in accordance with IASs (with additional disclosures if necessary) will generally result in fair presentation. The 'true and fair' override, as used in the UK, that allows any accounting standard to be departed from, in the interest of giving a true and fair view, is only to be applied on 'extremely rare circumstances'.

The term *true and fair* was first used in the UK, where it originates, in legislation of 1948. However, prior legislation had used similar phrases.

Companies legislation dated 1844 required UK companies to *present a full and fair balance sheet*, though the meaning of this phrase was never defined. A company was required to keep *full and true accounts*. By 1900 the auditor was required to state whether the balance sheet was *properly drawn up so as to exhibit a true and correct view.* This phrase was retained until 1948.

The Kenya Companies Act Cap 486 is based on the UK Companies Act of 1948

At no stage has any legal definition of the meaning of these terms been provided. ISA does not set out what is meant by either 'true or fair' or 'present fairly'.

(b) Attempts at definition of the 'true and fair' view

The following quotations represent authoritative views on the meaning of true and fair view.

A true and fair view implies that all statutory and other information is not only available but is presented in a form in which it can be properly and readily appreciated. (Sir Russell Kettle).

A true and fair view implies appropriate classification and grouping of items.. (And) consistent application of generally accepted principles. (The Institute of Chartered Accountants in Australia – Recommended on Accounting Principles 1964).

> the meaning attached to (the words true and fair) has been built up over the years by standards of presentation specifically required by the Act; established accounting techniques; case law decisions; the natural desire of responsible directors of companies and auditors to ensure that the facts and figures which are presented in the public properly reflect the position; and last but not least common sense. (Sir Henry Benson 1962).

For an auditor to be able to say that a financial statement is true and fair it must be:

(a) Relevant to the business transactions etc it purports to describe

(b) Objective, being free from any bias … and being based on unprejudiced and verifiable evidence which us capable of supporting it (Lee).

STUDY TEXT

True and fair has become a term of art. It is generally understood to mean a presentation of accounts drawn up according to accepted accounting principles using accurate figures as far as possible and reasonable estimates otherwise, and arranging them so as to be show within the limits of current accounting practice as objective a picture as possible free from willful bias, distortion, manipulation or concealment of material facts. (Lee).

It must be concluded that there has been little attempt precisely to define true and fair.

The Companies Act requires an auditor to report in true and fair view terms as regards the balance sheet and the profit and loss account. The Companies Act however, does not define what constitutes a true and fair view. We have no decided case in Kenya or anywhere in the world that has given a definition of true and fair view.

It has therefore been left to the profession to try to define the meaning of true and fair view or at least to determine what not a true and fair view is. The Companies Act in the 6th Schedule gives the minimum disclosure requirements of items in the balance sheet and profit and loss account. It would therefore seem to follow that compliance with the requirements of the 6th Schedule, would result in the accounts giving a true and fair view.

Professional thinking has tried to put a meaning to this expression by analysing the two words separately. If we took this approach we would come up with the following decision:

(c) True

Meaning of 'true and fair'/present fairly'

Truth in accounting is quite different form scientific truth. Accounting does not deal with that type of truth which has a fixed and unchanging quality. Costs and revenues for any accounting period which is less than the full life of each venture involved cannot be determined with precision. In accounting only cash draws close to the concept of scientific truth, but since the value of cash changes with time, it lacks total correspondence with the precision of scientific truth.

The auditor should attempt to ensure that the accounts which are subject of his audit present clearly and equitably the financial state of affairs of the enterprise. This suggests that in order to achieve the statutory true and fair view it is necessary not only to present certain information impartially but also that this data is shown in such a way that it is clearly understood by the user.

A dictionary definition of true includes such words as:

- In accordance with reality;

- In accordance with reason, or correct numbers or perceived standard;
- We can also think of truth as meaning: not false, or not fictitious and in accordance with facts.

We can clearly identify that accounts contain elements of truth in that if the balance sheet states that the company has got land and buildings valued at 10 million shillings then it is either true or not true that the company owns the land. Therefore statements made in the accounts can be tested to prove whether they are true of false. In this case, we are concerned with ownership of assets and liabilities, we are concerned with their existence and we are concerned with their proper definition or description and classification. Hence the auditor looks for evidence to confirm stated and implied assertions in the accounts. True does not relate to value because value is dependent on many factors.

(d) Fairness

The word *fair* can have the following meanings: on the one hand *clear, distinct* and *plain* and on the other *impartial, just* and *equitable*. All can be considered relevant when fair is used in an accounting text.

We ask ourselves the questions—fair to whom? And it seems that we should be fair to the user of the accounts in that the user of the accounts has certain expectations. He expects that accounts will comply with the Companies Act requirements and he also expects that the accounts will conform to generally accepted accounting principles and the IAS, hence if we can satisfy the expectations of the user it can be felt that we have been fair. This therefore leads us to relevance, in other words, the accounts must give a view that is relevant to the needs of the user. It will therefore be expected that the accounts will show the resources employed in the company, claims against those resources, the changes in the resources and claims over a period of time. The accounts also report on historical events. They are therefore not intended to be used for decision making although they are regularly used for this purpose.

Objectivity

Most accounting figures are subjective and contain substantial elements of subjective judgement. Many business transactions have financial effects that spread over many years. Decisions are therefore to be made, as to the extent to which expenditure incurred in one year can reasonably be expected to produce benefits in the form of revenue in other years. Objectivity therefore requires that accounts state externally verifiable changes rather than subjectively considered opinions. The accounts must therefore be free from bias, thus the producer of the accounts should not allow personal preferences to enter into their accounts preparation work. In practice, all activities are influenced by personal experience and prejudice. An important thing is for the auditor to be aware of this and also for him to be aware of the tendency to bias in all financial reporting.

Conformity

Although the user of the accounts expects the accounts to conform to general accepted accounting principles and the IFRSs, simple rigid conformity can lead to a misleading view. Thus if we simply included profits from overseas branches and those profits are not available to shareholders because of exchange control restrictions, then the accounts would be misleading.

Conservatism

The concept of prudence is highly esteemed in the accounting profession. However, taken to extremes it could result in accounts not giving a true and fair view as in the case of long term construction contracts, contingent liabilities and in substance over form transactions. The accountant is a pessimist by nature but the auditor must guard against over conservatism.

Accounting Principles and Policies

The user of the accounts expects that the accounting principles and policies used will be in conformity with IAS, be generally accepted, be widely recognised and supported and be appropriate and applicable in the particular circumstances. It is crucial for the auditor to get evidence that the accounting policies used are appropriate in the circumstances, not only acceptable.

Substance over Form

Transaction should show the commercial reality rather than the legal form. These would require therefore that the accounts should show all the assets and liabilities of the organization even though legally the assets or liabilities do not relate to the organization.

Presentation and Disclosure

The overall result and final position can only be appreciated by aggregating transactions and balances into suitable classes and categories. The description given to these classes and categories must show their true nature.

Materiality

An item is material if its disclosure or non-disclosure would make any difference to the view received by the user of the accounts. Fairness is therefore a function of materiality. The accounts must not be cluttered with trivialities or amounts and statements that are insignificant to the overall view given by the accounts. The auditor has to keep the concept of materiality in mind at all times.

8.2 REGULATIONS GOVERNING AUDIT REPORTS IN KENYA

- The requirements of the Companies Act Cap 486
- International Financial Standards (IFRSs)
- International Standards on Auditing (ISAs)

8.2.1 The Requirements of the Companies Act

The seventh schedule to the Companies Act gives the matters which must be expressly stated in the AUDITOR'S REPORT

1. Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examinations of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

3. i. Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.

   ii. Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by this Act in the manner so required and give a true and fair view:

      a) In the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

      b) In the case of the profit and loss account, of the profit or loss for its financial year, or as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.

4. In the case of a holding company submitting group accounts whether in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.

The Meaning of Proper Books of Accounts

S.147 of the Companies Act requires every company to keep in the English language proper books of accounts with respect to:

a) All sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place. Hence, most companies will have a cash book to comply with this requirement but note that the Companies Act does not specifically call for a cash book nor does it lay down any hard rules on what form these records should take.

b) All sales and purchases of goods by the company: Most companies comply with this requirement by maintaining sales and purchases journals or day books. Again, the Companies Act does not specify the form which these records should take.

c) Assets and Liabilities: Most companies comply with this requirement by maintaining personal and general ledgers with regard to assets and liabilities of the company and changes therein.

The books of accounts generally speaking can be kept anywhere the directors deem fit and are open to inspection by the directors at any time. The Companies Act also requires that a company keeps the following statutory books.

1. A register of directors and secretaries
2. A register of charges, fixed and floating
3. Minute Book of meetings of the company, meeting of its directors
4. An indexed register of accounts
5. An indexed register of each director's shareholding

It also requires that public companies must keep a register of major shareholders, thus an interest of 5% or more in the nominal value of the voting share capital is a major holding.
Proper books of accounts are such books that are necessary to give a true and fair view of the state of affairs and to explain its transactions. The auditor's interest in the statutory books is:

a) They are usually concerned with accounts;

b) They are audit evidence in their findings and details of items in the accounts;

c) Failure to maintain proper books of accounts casts doubt upon the accuracy and reliability of the books generally.

The Companies Act principles require that where a company has branches, then returns must be received from those branches that can explain its transactions as for the main company.

8.2.2 The Auditor's Report to Shareholders

The Content and Meaning of Unqualified and Modified Audit Repots

The **audit report** is usually the only channel of communication between the auditor and the shareholders of the company whose financial statements have been subject to audit. As such the report acts as a bridge taking the large volume of information possessed by the auditors and conveying it to the shareholders in a much abbreviated form.

In order to convey information in a succinct from the audit report has become extremely formalized group of phrases, each of which has special significance. Any deviation from the standard format is regarded by an accountant as being significant and may provide important extra data.

The possibilities are as follows:

(a) An unqualified audit report

(b) A modified audit report which required an audit qualification

(c) A modified audit report which, although the opinion is unqualified, may require additional detail emphasizing particular matters contained within the financial statements.

IFAC has issued ISA 700 *The Auditor's Report on a complete set of general Financial Statements* in order to reduce the differences which previously existed in the method of reporting so that shareholders and other users of financial statements could grasp more easily the standardized message which the auditor is intending to convey.

It is important that you recall from your earlier studies that auditors do not 'guarantee' or 'certify' that financial statements are 'correct', they express opinions on the matters required by ISA 700 i.e.

(a) Whether they give a true and fair view

(b) Whether they are properly prepared in accordance with the financial reporting framework.

Where appropriate, the auditor will also report whether the financial statements comply with relevant local statutory requirements such as the companies Act Cap 486.

As an alternative to the phrase 'true and fair view' the auditor may report that the financial statements are 'presented fairly in all material respects'. These two expressions are equivalent and emphasize that the auditor is only concerned with material items.

The content of the auditor's report is governed by the Companies Act, Seventh Schedule to the Companies Act and the ISA 700, The Auditor's Report on Financial Statements

The Companies Act lays down no specific requirements as to the wording to be used in the audit report so long as all the matters as mentioned in the Seventh Schedule are specifically mentioned in the auditor's report. The auditing standard seeks to provide guidance on the form of wording that is acceptable.

The auditing standard requires the auditor to:

a) Identify those to whom his report is addressed i.e. the members of the company;

b) The auditor should identify the financial statements on which he is reporting, this is done by numbering the pages of the accounts;

c) The auditor should refer expressly to whether the financial statements have been audited in accordance with the approved auditing standards;

d) The auditors must state expressly whether in their opinion the financial statements give a true and fair view of the state of affairs, profit and loss, and where applicable source and application of funds;

e) The auditor should refer expressly to any matters described by relevant legislation or any other requirements.

8.2.3 Circumstances in Which Qualification Is Necessary

When the auditor has no reservations on the matters required by the Seventh Schedule, he issues a clean report. If he has any reservations, he may issue a qualified report. The circumstances which cause auditors to introduce qualifying statements into their reports where the matters at issue are material include the following

a) If the auditors are unable to obtain all the information and explanations they consider necessary for the purposes of their audit, for example, if they are unable to obtain satisfactory evidence:

   i. of the existence of ownership of material assets or of the amounts at which they have been stated on the basis adopted;

   ii. of the validity of payments;

   iii. That the records properly reflect all transactions of the business because the evidence has been lost or destroyed or is otherwise not forthcoming or has never existed.

b) If in the opinion of the auditors:

   i. Proper books of accounts have not been kept in accordance with the Companies Act;

ii. Proper returns adequate for their audit have not been received from branches nor visited by them;

iii. The balance sheet and the profit and loss account are not in agreement with the accounting books and returns.

c) If in the opinion of the auditors the accounts though based on proper books of account fail to give the information required by the act for example, a failure to comply with specific disclosure requirements of the Companies Act in material respects.

d) If in the opinion of the auditors the accounts though otherwise complying with the disclosure requirements fail to disclose a true and fair view for example:

i. Because in the auditor's opinion the underlying accounting policies do not conform to accounting principles appropriate to the circumstances and nature of the business;

ii. Because they are prepared on principles inconsistent with those previously adopted and without adequate explanation and disclosure of the effects of the change;

iii. Because the auditors are unable to agree with the amounts at which an asset or a liability is stated;

iv. Because the auditors are unable to agree with the amount at which income or expenditure or profit is stated;

v. Because the accounts do not disclose information though not specifically required by the companies act, is necessary for the presentation of a true and fair view;

vi. Because additional information given in a note or in the director's report materially alters the view otherwise given by the accounts.

e) If in the case of a holding company submitting group accounts it is the opinion of the auditors that the group accounts have not been properly prepared in accordance with the provisions of the act so as to give a true and fair view of the profit and loss of the company and its subsidiaries so far as it concerns the members of the company.

More than one of the circumstances in which qualification is necessary may be present in any particular case. Where the auditor has these reservations, he must inform the shareholders in his audit report.

8.2.4 Principles of Qualifying Reports

A qualified report is not necessary unless the amounts at issue are material. If a qualified report is called for the auditors must decide:

a) To which specific matters their reservations apply;

b) Whether they actively disagree or on the other hand lack sufficient evidence to enable them form an opinion as regards material items in the accounts;

c) Whether in either event the matters in question are so material as to affect the presentation of a true and fair view.

If for instance the items in doubt or disagreement are limited and therefore not so material as to cast doubt on the views shown by the accounts as a whole, the auditors will be able to report that in their opinion subject to specific reservations or with specific exemptions the accounts present a true and fair view. There may however be cases where the substantial items or those in disagreement are so material that the audits must report stating their reason either:

i. that they are unable to form an opinion whether the accounts present a true and fair view or;

ii. that in their opinion the accounts do not present a true and fair view. A qualification in this extreme term is only made in rare circumstances.

The Companies Act lays down no specific requirements as to the manner in which auditors should when they judge it necessary, qualify their report. This can only be decided in the circumstances of each particular case. It would be undesirable to suggest standard forms of working that might be appropriate to the variety of circumstances in which it may be necessary for auditors to give a qualifying report. The guiding principle is that it is the duty of an auditor to convey information not merely to arouse inquiry.

Before qualifying their report, auditors should discuss the accounts with the company's management and make their views clear. This enables the directors to examine the matter at issue and as far as they judge it practical and appropriate they may take steps to provide the missing information or to amend the accounts in such a way as to enable the auditors give a report without qualification. A qualifying statement should be direct and informative. It should be phrased as to leave the reader in no doubt as to its meaning. Therefore, it should:

a) Be as concise as is consistent with clarity;

b) Be specific as to the items and facts as far as possible the amounts involved;

c) Within the limits of the information available to the auditors make clear its effects on the accounts and;

d) Express the auditor's opinion without the possibility of misinterpretation.

The object is to give in clear and unequivocal terms so far as circumstances permit such information in augmentation of that provided by the accounts and notes thereto as will in the auditor's opinion provide the information required by the acts and ensure that the accounts will then give a true and fair view. It must be emphasised that the fact that the auditors judge it necessary to include qualifying statements in their report does not necessarily impute the financial integrity of a company's directors who are ultimately responsible for the form and presentation of the accounts and the information they contain. It is the duty of the auditors to exercise their judgement and express their opinion, their obligation is inescapable. It would be wholly inappropriate for instance for auditors to seek to avoid qualifying their reports by resigning before the expiry of their term of office simply because they are dissatisfied with the position disclosed by their audit.

It identifies the nature of circumstances and recognises only two which are uncertainty and disagreement.

Uncertainty

The auditor may be unable to express an opinion on a set of accounts as a result of uncertainty. This would seem to imply that to some extent he has been unable to obtain all the information and explanation which he deemed necessary for the purposes of the audit. These can be as a direct intervention or lack of cooperation by the management or the management can give him all the help he needs but he is still unable to express an opinion due to circumstances beyond a management's control and limitations from the available information. The standard recognizes that uncertainty can arise as a result of limitations in the scope of the audit and as a result of inherent uncertainties.

Uncertainty can be of two levels, material and not fundamental and fundamental. An uncertainty is material but not fundamental if the auditor has reservations on only a particular aspect of the accounts and not on the accounts as a whole. In this situation the auditor is able to form an opinion on the accounts as a whole with particular reservations on a specific matter. He therefore disclaims opinion on only an aspect of the accounts and not the accounts taken as a whole.

An uncertainty becomes fundamental when its impact on the accounts taken as a whole is to make them meaningless for any decision making purposes and to reduce their informational value. In this situation, the auditor is unable to form an opinion on the accounts taken as a whole and he therefore disclaims his opinion altogether by stating that he is unable to form an opinion as to whether the financial statement gives a true and fair view.

Disagreement

The ISA gives circumstances in which disagreement could arise between the auditor and the management.

These are:

- Departures from accepted accounting practices where (i) there has been failure to comply with the relevant IAS and the auditor does not concur (ii) an accounting policy not the subject of a IAS is adopted which in the opinion of the auditor is not appropriate to the circumstances of the business or (iii) exceptionally a IAS has been followed with the result that the financial statements do not present a true and fair view.

- Disagreement as to the facts or amounts included in the financial statement.
- Disagreement as to the manner or extent of disclosure of facts or amounts in the financial statements.
- Failure to comply with the relevant legislation or other requirements.

Where the auditor disagrees with the management on just an aspect of the accounts, he will indicate in his report that he has exceptions as against reservations noted under uncertainty and he will mention in his report that to the extent of the exceptions the accounts do not give a true and fair view. This is where the disagreement is material but not fundamental. A disagreement becomes fundamental where its impact on the financial statements is to make them misleading as a whole. In this situation the auditor will state that the accounts taken as a whole do not give a true and fair view.

i. Materiality

The auditors will not clutter their opinion with trivial matters and therefore their audit is carried out with emphasis on matters that could have material impact on the report. A matter generally is held to be material if its disclosure or non-disclosure would affect the view given by the accounts. Materiality may be considered in the context of the financial statement as a whole, the balance sheet, the profit and loss account, or individual items within the financial statement. In addition, depending upon the nature of the matter materiality may be considered in relative or absolute terms. If therefore the auditor concludes that, judged against criteria he believes to be most appropriate in the circumstances, the matter does not materially affect the view given by the financial statements he should not qualify his opinion.

Materiality is essentially a matter of professional judgement and therefore an individual item can be judged material if knowledge of that item could reasonably be deemed to have influence on the users of the financial statement. The issue of materiality arises in two situations:

(i) Determining the extent to which detailed audit work should be performed in specific areas and

(ii) Determining whether errors or other mis-statements have affected the true and fair view.

An amount is not material solely by reason of its size. Other factors including those set out below must be considered in making decisions as to materiality: (a) the nature of the item i.e. whether it is a factor entering into the determination of net income, unusual or extra-ordinary, contingent upon an event or condition, determinable based upon existing facts and circumstances and required by statute or regulation (b) the amount itself in relation to the financial statements taken as a whole, the total of the amount of which it forms or should form a part, related items (e.g. if the figure under review is the doubtful debt provision then debtors would be related items), the corresponding amounts in previous years or the expected amounts in future years. It has been found that it is possible to have quantitative guidelines as to materiality and these ranges between

5 and 10 percent when compared to an appropriate base. Below 5% would not normally be material unless it is one of those transactions which must be disclosed by statute e.g. directors emoluments.

☐ ii. Fundamentality

When a matter is fundamental then it is considered so crucial to the view given by the accounts that it can render them totally misleading or meaningless. This usually arises in very rare circumstances. Remember that an uncertainty ceases to be just material and becomes fundamental when its impact on the financial statements is to make them meaningless. A disagreement ceases to be just material and becomes fundamental if its impact on the financial statements taken as a whole is so great as to make them totally misleading. It would appear that failure to comply with IAS and the requirements of legislation would automatically make a disagreement fundamental because compliance with the IAS and Companies Act is necessary for accounts to give a true and fair view.

When the auditor is faced with a situation of uncertainty whether it is limitation of scope or inherent but it is only restricted to an item in the accounts and not the accounts as a whole then he should use a “subject to” form of report.

Where the uncertainty is considered fundamental then the auditor should use a disclaimer of opinion.

When it is a situation of disagreement on an aspect of the accounts then the auditor uses an “except for” opinion.

When the disagreement is fundamental, then he gives an adverse opinion.

Emphasis of matter

The standard states as a general principle, the auditor issuing an unqualified opinion should not make reference to specific aspects of the financial statements in the body of his report as such a reference may be misconstrued as being a qualification. In rare circumstances the reader will obtain a better understanding of the financial statements if his attention is drawn to important matters. These situations arise when there is an unusual event, an unusual accounting policy, or an unusual condition and it is felt that awareness of such a situation is fundamental to the understanding of the financial statement, therefore to avoid being misconstrued as being a qualification reference which are intended to be of emphasis of matter should be minimal and should be made not in the opinion paragraph of the report but in a separate and subsequent paragraph introduced with the phrase “Without qualifying our opinion above, we draw attention to....”,

8.2.6 Basic Elements of the Auditor's Report

The auditor's report includes the following basic elements, ordinarily in the following layout:

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph
  (i) Identification of the financial statements audited;

  (ii) A statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph (describing the nature of an audit)

  (i) A reference to the ISAs or relevant national standards or practices;

  (ii) A description of the work the auditor performed;

(e) Opinion paragraph containing:

  (i) A reference to the financial reporting framework used to prepare the financial statements (including identifying the country of origin3 of the financial reporting framework when the framework used is not International Accounting Standards); and
  (ii) An expression of opinion on the financial statements;

(f) Date of the report;

(g) Auditor's address; and

(h) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding and to identify unusual circumstances when they occur.

(a) Title

The auditor's report should have an appropriate title. It may be appropriate to use the term "Independent Auditor" in the title to distinguish the auditor's report from reports that might be issued by others, such as by officers of the entity, the board of directors, or from the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor.

(b) Addressee

The auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations. The report is ordinarily addressed either to the shareholders or the board of directors of the entity whose financial statements are being audited.

(c) Opening or Introductory Paragraph

The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.

The report should include a statement that the financial statements are the responsibility of the entity's management4 and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. This determination will be made in the context of the financial reporting framework that management chooses, or is required, to use. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

(d) Scope Paragraph

The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with ISAs or in accordance with relevant national standards or practices as appropriate. "Scope" refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. The reader needs this as an assurance that the audit has been accordance with established standards or practices. Unless otherwise stated, the auditing standards or practices followed are presumed to be those of the country indicated by the auditor's address.

The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement.

(e) The auditor's report should describe the audit as including:

(a) Examining, on a test basis, evidence to support the financial statement amounts and disclosures;

(b) Assessing the accounting principles used in the preparation of the financial statements;

(c) Assessing the significant estimates made by management in the preparation of the financial statements; and

(d) Evaluating the overall financial statement presentation.

(f) The report should include a statement by the auditor that the audit provides a reasonable basis for the opinion.

An illustration of these matters in a scope paragraph is:

> "We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, 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. We believe that our audit provides a reasonable basis for our opinion."

(g) Opinion Paragraph

The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards) and state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.

The financial reporting framework is determined by IASs, rules issued by recognized standard setting bodies, and the development of general practice within a country, with an appropriate consideration of fairness and with due regard to local legislation. To advise the reader of the context in which the auditor's opinion is expressed, the auditor's opinion indicates the framework upon which the financial statements are based. The auditor refers to the financial reporting framework in such terms as: "… in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin]) …."

In addition to an opinion on the true and fair view (or fair presentation, in all material respects), the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law.

An illustration of these matters in an opinion paragraph is:

"In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 2OO7, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin]) (and comply with ...)."

(h) Date of Report

The auditor should date the report as of the completion date of the audit. This informs the reader that the auditor has considered the effect on the financial statements and on the report of events and transactions of which the auditor became aware and that occurred up to that date.

Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

(i) Auditor's Address

The report should name a specific location, which is ordinarily the city where the auditor maintains the office that has responsibility for the audit.

(j) Auditor's Signature

The report should be signed in the name of the audit firm, the personal name of the auditor or both, as appropriate. The auditor's report is ordinarily signed in the name of the firm because the firm assumes responsibility for the audit.

The format of the unqualified audit report

Here is the illustrative unqualified report from ISA 700

Auditor's Report

(APPROPRIATE ADDRESSEE)

We have audited the accompanying balance sheet of the ABC Company as of December 31, 2OO7, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the account principles used in significant estimates made by the management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 2OO7 and of results of its operations and its cash flows for the year then ended in accordance with … (and comply with ….)

AUDITOR

Date

Address'

Footnotes:

1. Reference may be by page numbers
2. Indicate IASs or relevant national standards
3. Refer to relevant statues or law

8.2.7 Modified Reports

There are four situations in which the auditor will depart from the form of report given above.

Matters that do not affect the auditor's opinion

(a) Emphasis of a matter

Matters that do affect the auditor's opinion

(a) Qualified opinion

(b) Disclaimer of opinion

(c) Adverse opinion

(a) Emphasis of Matter

An emphasis of matter is an extra paragraph inserted in the report to draw attention to a significant matter affecting the financial statements which is explained more fully in a note to the financial statements.

An emphasis of the matter paragraph should follow the opinion paragraph and will normally refer to the fact that the auditor's opinion is not qualified.

(b) Going Concern

The auditor should modify the auditor's report by adding a paragraph to highlight a matter regarding a going concern problem.

(c) Significant Uncertainty

The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the finical statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

>>> Illustration

An emphasis of matter paragraph relating to a pending lawsuit might take the following form:

'Without qualifying our opinion we draw attention to Note X to the financial statements. The company is the defendant in a law suit alleging infringement of certain patent rights and claiming royalties and punitive damages. The company has field a counter action, and preliminary hearings

STUDY TEXT

and discovery proceedings on both actions are in progress. The ultimate outcome to the matter cannot presently be determined and no provision for any liability that may result has been made in the financial statements.

It is important to realize that an emphasis of matter does not affect the audit opinion; it merely draws attention to nay significant matters so that the reader is able to obtain a full understanding of the finical statements.

8.2.8 The qualified opinion, disclaimer or opinion and adverse opinion

These three modifications to the auditor's report are used when there is either:

(a) A limitation on the scope of the auditor's work or;

(b) Disagreement with management regarding the acceptability of the accounting policies selected the method of their application or the adequacy of financial statement disclosures.

The effect of these circumstances can be material or fundamental. The qualified report is used for material problems.

If a limitation on scope or a disagreement is so material and pervasive tat a simple qualification is not sufficient, one of the two stronger forms are used.

(a) A **qualified opinion** should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed to being 'except for' the effects of the matter to which the qualification relates.

(b) A **disclaimer of opinion** should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

(c) An **adverse opinion** should be expressed whet the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and unless impracticable, a quantification of the possible effect(s) on the financial statements. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer or opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

>>> Examples of modified reports

(a) Limitation on scope

(i) Limitation on scope – qualified person

'We have audited … (remaining words are the same as illustrated in the introductory paragraph of the unqualified above).

Except as discussed in the following paragraph, we conducted our audit in accordance with ….(remaining words are the same as illustrated in the scope paragraph of the unqualified report above).

We did not observe the counting of the physical inventories as of December 31, 2OO7, since that date was prior to the time we were initially engaged as auditors fir the company. Owing to the nature of the company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and (remaining words are the same as illustrated in the opinion paragraph of the unqualified report above).'

(ii) Limitation on scope – disclaimer of opinion

'We are engaged to audit the accompanying balance sheet of the ABC Company as of December 31 2OO7 and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitations as follows :)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the company.

Because of the significance of the matters discussed in the preceding paragraph we do not express an opinion on the financial statements.

(b) Disagreement

(i) Disagreement on Accounting Policies- Inappropriate Accounting method – Qualified Opinion

'We have audited ….(remaining words are the same as illustrated in the introductory paragraph of the unqualified report above.)

We conducted our audit in accordance with … (remaining words are the same as illustrated in the scope paragraph of the unqualified report above).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, isn't in accordance with International Accounting Standards. The provision for the year ended December 31, 2OO7 should be based on the straight line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly the non current assets should be reduced by the accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx respectively.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and …. (Remaining words are the same as illustrated in the opinion paragraph of the unqualified report above).

(ii) Disagreement on Accounting Policies – inadequate disclosure – qualified opinion

'We have audited … (remaining words are the same as illustrated in the introductory paragraph of the unqualified report above).

We conducted our audit in accordance with.. (Remaining words are the same as illustrated in the scope paragraph of the unqualified report above.

On January 15, 2OO8, the company issued debentures in the amount of xx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 2OO7. In our opinion, disclosure of this information is required by …. (Insert reference to statutory or regulatory requirement).

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and … (remaining words are the same as illustrated in the opinion paragraph of the unqualified report above).

(iii) Disagreement on Accounting Policies – inadequate disclosure – adverse opinion

We have audited … (remaining words are the same as illustrated in the introductory paragraph of the unqualified report above).

We conducted our audit in accordance with.. (Remaining words are the same as illustrated in the scope paragraph of the unqualified report above.

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair of (or do not 'present fairly') the financial position of the company as at December 31, 2OO7, and of result of its operations and its cash flows for the year then ended in accordance with (insert relevant IASs or national standards).. And do not comply with …… (Insert relevant statutes or law).

The extent to which users understand the audit report

Users of accounts have information needs, and the auditor's report as an independent attestation lends credibility to the accounting information. However there has been the tendency for users to place far more reliance on the audit report than its actual function merits.

Typical, and erroneous, beliefs of users have included the following:

(a) Auditors are the persons responsible for ensuring the accounts show a true and fair view

(b) Auditors are responsible for preventing and/or detecting fraud.

(c) Auditors guarantee that the company is going concern.

How qualification may be avoided by negotiation with management

Before deciding on the nature of the audit opinion, the auditor should review the impact of the Summary of Audit Differences. A meeting between the auditor and the directors should be held to discuss the issues which may affect the opinion and review the audit differences. In practice, after negotiation, it is often the case that a compromise will be reached with the client such that some audit differences are adjusted whilst those that do not materially affect the view given by the financial statements are left as they are.

Management is generally keen to avoid qualifications in the audit report because:

(a) Adverse publicity may arise from the media

(b) If the qualification concerns a matter of statutory accounting policy, the powers of the courts may result in the preparation of revised accounts.

(c) Loan/debenture deed may refer to an audit qualification as giving rise to a breach of a covenant, thus giving loan note holders an immediate right to repayment or the right to appoint a receiver.

Therefore if the auditors have a contentious issue, the directors will often reconsider their decision on a particular policy provided that the auditors present the matter in an effective way with management. Thus can sometimes be a difficult and sensitive area because the auditor would normally want to avoid antagonizing or losing the client, although of courts, the need for 'truth and fairness' must prevail.

8.3 AUDIT REPORTING IMPLICATIONS OF OPENING BALANCES AND COMPARATIVES

8.31 Opening balances

ISA 510 *Initial Engagements – Opening Balances* requires that when auditors take on a new client, they must ensure that:

(a) *Opening balances* do not contain misstatements that materially affect the current period financial statements.

(b) Prior period closing balances have been correctly brought forward or restated

(c) Appropriate accounting policies have been consistently applied, or changes adequately disclosed.

Where the prior period was audited by another auditor the current auditor may be able to gain sufficient appropriate evidence from a review of his working papers.

He should obviously consider the professional competence and independence of the predecessor auditor. The predecessor may or may not be willing to cooperate in practice and is under no ethical obligation to open his file to another auditor. If the prior period audit report was modified with an emphasis of matter or a qualification, particular attention should be paid to the modification.

Where the prior period was not audited or was not adequately audited, some evidence can be obtained from current audit procedures such as the checking of receipts and payments of cash to substantiate receivables and payable figures. Inventories are more difficult, additional procedures maybe necessary. These may include the observation of current physical inventory taking and reconciliation back to opening quantities testing of opening figures and the review of gross margins. For non current assets and liabilities, underlying documentation can be checked.

Where there is insufficient evidence, the auditor issues an 'except for' or disclaimer of opinion similar to the following:

> 'We did not observe the counting of the physical inventory stated at XXX as at December 31, 2OO7 since that date was prior to our appointments as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.
>
> In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary has we been able to observe the continuing of physical inventory and satisfy ourselves as to the opening balance of inventory, the financial statements give a true and fair view of (or 'present fairly, in all material respects.') the financial position of …. As at December 31, 2OO8 and the results of its operations and its cash flows for the year then ended in accordance with …'.

Where misstatements on opening balances are not properly accounted for or adequately disclosed, and where accounting polices have not been consistently applied or restated an 'except for' or adverse opinion is issued.

8.3.2 Comparatives

ISA 710 *Comparatives* requires that comparatives comply in all material respects with the identified financial reporting framework. The IASB's *Framework for the Preparation and Presentation of Financial Statements and IAS 1 Presentation of Financial Statements* both require that financial statements show comparatives.

Two categories of comparatives exist:

(a) **Corresponding figures** – which are an integral part of the current period's financial statements and are not intended to standalone. The audit report in this case only refers to the financial statements of the current period which encompasses the prior period figure, and does not refer specifically to corresponding figures.

Audit work in respect of corresponding figures is significantly less than that required for the current period. It is limited to ensuring that corresponding figures have been correctly reported or restated and appropriately classified.

If a matter in respect of which the prior period audit report was qualified is unresolved, the current report should also be qualified in respect of corresponding figures. Where the matter is resolved, an emphasis of matter paragraph may still be appropriate.

If prior period financial statements turn out to be materially misstated, and the corresponding figures are property restated in the current period, an 'emphasis matter' paragraph may also be appropriate.

Local regulations sometimes permit a reference to the fact that the prior period was audited by another auditor. If prior period financial statements were not audited at all, the audit report should state that fact.

If the corresponding figures are materially misstated, a qualified audit report should be given.

(b) **Comparative financial statements** – which are included for comparison with the current period but do not form part of the current period's financial statements. The audit report here refers specifically to each period presented (as is in the US, three years for the income statement and two years for the balance sheet.)

The auditors assess whether the accounting polices are consistent with the prior period or have been properly adjusted and disclosed. They also ensure that prior period figures agree with prior period financial statements or have been properly adjusted.

It is perfectly possible for the opinion on one set of financial statements to be different from that on the others. If an opinion different to one previously issued is given in any year, an 'emphasis of matter' paragraph should be given.

When prior periods were audited by another auditor, the predecessor auditor may reissue the audit report on the prior year in the current year, or the incoming auditor should indicate that the prior period was audited by another auditor and give details of the report issued.

Where prior period financial statements audited by another auditor require restatement, either the predecessor auditor issues a report on the revised financial statements, or, the incoming auditor state in his report that adjustments to the prior period financial statements have been made and that they have been audited.

Where prior financial statements have not been audited the audit repot should state that fact.

8.4 COMMUNICATIONS ON INTERNAL CONTROL

Introduction

It should be normal practice at the end of an audit to send a letter to the client setting out weaknesses in the system of internal control. Certain rules should be observed when preparing such a letter (known as the management letter, the letter of weakness, the internal control memorandum, the letter of recommendations or the constructive service letter).

General points of good practice are as follows:

(a) It should make clear that the object of the audit is not to discover fraud, but to report on the financial statements. The matters referred to have been discovered incidentally to the main objective.

(b) The points should be listed logically.

(c) There is no point in drawing attention to a weakness which is inherent in the nature or size of the business, or it's totally trivial.

(d) Only the weakness should be noted. It should not be implied that no fraud is taking place although the possible consequences of the weaknesses can be expanded upon.

(e) Recommendations for improvements should be made in respect of each weakness.

(f) Communications in respect of recommendations should be made on a timely basis.

The management letter will normally be a natural by-product of the audit, and the auditor should incorporate the need to issue the letter in the planning of the audit. The letter should be sent as soon as possible after completion of the audit procedures giving rise to the need to comment. Where audit work is carried out in more than one stage it may be appropriate to issue a letter at the interim audit stage as well as the final audit stage.

It is important that the management letter is sent and responded to on a timely basis (at the audit completion stage) in order to have impact, be effective and acted upon by the client. It is important to discuss all the points in the letter with management before the letter is issued. Any significant matters should be brought to management's attention immediately first verbally followed up in writing. It is essential that the contents of the letter are considered by the management. A copy of the letter with replies should be kept on the file. Significant matters should be followed up after the client's response by way of discussion or the performance of system tests. Normally, it is usual for the auditor to review points made in previous years at the first subsequent audit visit.

When a group of companies is involved, the management of the holding company may want to be informed of significant points arising in the reports o the management f the subsidiaries. The auditor must obtain permission from the management of the subsidiary before releasing such information.

Any report made to management should be regarded as confidential communication. The auditor should therefore not normally reveal the contents of the report to any third party without the prior written consent of the management of the company.

In practice, the auditor has little control over what happens to the report once it has been dispatched. Occasionally, management may provide third parties e.g. their bankers, with copies of the report.

The auditor can use a disclaimer of liability against foreseen liability to third parties but this may not give full protection from liability where the auditor knows or ought to know that a report to management may be passed to a third party who would rely on it.

Example of a management letter

There are other acceptable layouts which you may have seen in practice; columnar formats with the headings 'weakness', 'implication' and 'recommendation' are common. Again it is not necessary to learn this example, as the points would not be appropriate for all enterprises. Note however the type pf points made.

PRIVATE AND CONFIDENTIAL

The Directors

Jaribu Ltd.
Nairobi

Morovia
15th May 20x8

Dear Sirs

Jaribu Ltd.

Audit for the year ended 31 December 2OO7

In accordance with our normal practice, we are writing toe you with regard to matters arising out of our audit for the year ended 31 December 2OO7 which we consider should be brought to your attention.

Our responsibilities as auditors are governed by the (IASs/ national laws) and principally require us to report on the accounts laid before the company in general meeting.
This report has been prepared for the sole use of the directors of Upper plc. None of its contents may be disclosed to third parties without our written consent. Swift and Co assumes no liability to nay other persons.

The matters detailed in this report reflect matters coning to our attention during the course of our audit. They are not intended to be a comprehensive statement of all weaknesses that may exist or of all improvements that could be made. We set out below those matters which we consider to be of fundamental importance. Other matters of lesser significance, but which nevertheless require your attention, are dealt with in note form in the attached appendix.

(a) Management reporting

A fundamental requirement to allow proper control over your business is the regular and timely preparation of accurate management accounts. Preferably those should be prepared monthly, compared with budgets and submitted for formal consideration and adoption by the full board of directors. At the moment no such system exists.

(b) Internal control – accounting system

(i) The company exercises no control over the input, processing or output of information processed by the computer bureau. Reliance is placed on the computer bureau to ensure complete processing of accounting information. In our opinion the directors should ensure that the company effects proper control over the completeness and accuracy of information processed.

(ii) There are other areas covering aspects of inventory, non-curent assets and receivables where control is lacking or inadequate which are dealt with in the appendix attached.

(iii) Our audit work was made considerably more difficult by the absence of care in filing supporting documentation which was therefore difficult to trace. The proper maintenance of records is not only a requirement of the (national laws/IASs but is also necessary for the efficient running of your business.

(c) Preparation of accounts

The quality of the draft financial statements submitted to us for audit was poor.

(i) The financial statements were produced late without proper support. When support was provided in some cases it failed to agree with the amounts stated in the draft financial statements.

(ii) A number of items required to be disclosed under the (IAS/national laws) was omitted. Extensive discussions were necessary with you to ascertain the information to be disclosed in respect of director's interests and capital expenditure.

To reduce the time spent on the audit, and thus the cost to you, all supporting documentation should agree with the financial statements and statutory disclosure information would be assembled prior to our examination.

We would be pleased to discuss these points with you at your convenience.

Yours faithfully

Swift & Co

Appendix

Jaribu Ltd. – year ended 31 December 2OO7

(a) computer processing

Weaknesses:

Lack of control exercised over computer processing.

Implications

The completeness, accuracy and validity of the accounting records may be undermined.

Recommendations:

(i) Authorization of input especially journals not arising from books of prime entry.
(ii) Batch controls using registers over all input in terms of value and number of documents/transactions processed.
(iii) Use of hash totals
(iv) Management control over master file amendments
(v) Reconciliation to control accounts
(vi) Clear audit trial for the correction and resubmission of nay rejected
(vii) All financial information processed at one location
(viii) A back up system should be available if the bureau is unable to process the input.

(b) Payroll

Weaknesses

No evidence of approval

Implications

Unauthorized changes may occur

Recommendations

Management should evidence their approval of the payroll, changes in rates of pay and the employment of new staff.

(c) Inventory

Weaknesses

- Lack of physical and financial control over times of inventory

- Cut off errors were discovered for widgets dispatched prior to the year end but un invoiced

- Overhead allocation in valuation of widgets lacked support

Implications

- Inventory could be misappropriated
- The year end inventory figure could be misstated

Recommendations

(i) A simple system of perpetual inventory should be implemented at each location. This should be used to check for the dispatch and receipt of inventory and would provide good overall control to enable a comparison of:
- Expected use to actual by comparison with orders, and
- Book inventory to actual after regular inventory checks

(ii) Improvements should be made to the system of control to facilitate a review of the dispatches at the year end to ensure that a proper cutoff is achieved.

(iii) The valuation of widgets depends on the estimated throughout during the year. It is important that the number of widgets produced is properly recorded and that consideration is given to normal production levels to allow compliance with accounting standards.

(d) Non-current assets

Weaknesses

- Lack of physical control
- Lack of clear capitalization policy
- Assets will nil net book vale subject to depreciation charge.

Implications

- Portable assets could be misappropriated.
- Items could be incorrectly capitalized
- The depreciation figures in the accounts could be overstated.

Recommendations

(i) A register should be introduced to record all assets at cost together with associated depreciation

(ii) In previous year's capital additions, notably the improvements to the leasehold premises, have been written off. Also, assets scrapped have not been written off. The effect of this cancel out and therefore we have not proposed an adjustment to opening figures. A capitalization should be laid down and adhered to.

(iii) A register would enable the identification of fully depreciated assets and allow them to be excluded from the deprecation calculations.

(e) Purchases of payments

Weaknesses

- Lack of proper allocation of costs
- Lack of supporting documents
- Lack of control over cheque books
- Unauthorized charges
- Poor control over unrecorded liabilities

Implications

- Purchases in the accounts may be misstated
- Payables may be understated if unrecorded liabilities are not controlled

Recommendations

(i) All charges incurred should be allocated to the relevant cost centre to promote accountability of these centers.

(ii) Proper supporting documents for all payments must be retained and property filed for easy retrieval.

(iii) Control over payments would be improved if only one cheque book was in sue at any one time.

(iv) Documents supporting charges should be authorized by an appropriate level of management

(v) A purchases journal should be introduced. Payments should be marked off. This would provide control over unpaid invoices and a means for regular control account reconciliation.

8.5 COMMUNICATIONS OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

ISA 260 Communications of Audit Matters with Those Charged with Governance. The standard requires auditors to communicate, on a timely basis, matters of governance interest to those with the governance of an entity.

This rather obscure form of words means that auditors should communicate to management matters such as the following:

(a) The general approach and overall scope of audit, including any expected limitations thereon, or any additional requirements.

(b) The selection of, or changes in, significant accounting polices and practices that have, or could have, a material effect on the entity's financial statements.

(c) The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements.

(d) Audit adjustments, whether or not recorded by the entity that have or could have significant effect on the entity's ability to continue as a going concern.

(e) Material uncertainties related to events and conditions that may cast sufficient doubt on the entity's ability to continue as a going concern.

(f) Disagreement with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. This communication includes consideration of whether the matter has, or has not, been resolved, and the significance of the matter.

(g) Expected modifications to the auditor's report.

(h) Other matters, such as material weakness in internal control, questions regarding management integrity and fraud involving management.

(i) Any other matters agreed upon in the terms of the engagement.

8.6 RECENT DEVELOPMENTS

8.6.1 Electronic Communications

An increasing number of companies are posting financial statements, including the auditor's report onto their websites or allowing shareholders to receive the annual report in electronic from in place of a hard copy version. In these circumstances auditors check that the electronic version of the financial statements is identical in content to the manually signed accounts. (In the UK guidance for auditors to perform procedures as suggested above has been issued in this matter.)

8.6.2 Disclaimer

Some of the major firms are now including a disclaimer paragraph in an attempt to restrict liability to third parties. An example of such paragraph (shown after the opinion paragraph) based on PricewaterhouseCoopers audit report is as follows:

'We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or in whose hands it may come, save where expressly agreed by our prior consent in writing.'

IAPS 1014 Reporting on Compliance with International Financial Reporting Standards

The purpose of this IAPS is to clarify when financial statements are in full compliance with IAS/IFRS and proposes additional guidance when the auditor expresses an opinion on financial statement prepared in accordance with:

- IAS/IFRS
- Both IAS/IFRS and national standards
- Relevant national standards but disclosure notes in the financial statements which explain the extent of compliance with IAS/IFRS.

The issue is of increasing relevance as more countries become required to comply with IAS/IFRS and claim compliance. (E.g. Australia and the EU as from January 2005).


8.7 SPECIAL PURPOSE AUDIT REPORTS

8.7.1 Reports on Summarized Financial Statements

An entity may prepare financial statements summarizing its annual audited financial statements for the purpose of informing user group interested in the highlights only of the entity's financial position and the result of its operations. Unless the auditor has expressed an audit opinion on the financial statements from which the summarized financial statements were derived, the auditor should not report on summarized financial statements.

Summarized financial statements are presented in considerably less detail than annual audited financial statements. Therefore, such financial statements need to clearly indicate the summarized nature of the information and caution the reader that for a better understanding of an entity's financial position and the results of its operations, summarized financial statements are to be read in conjunction with the entity's mist recent audited financial statements which include all disclosures required by the relevant financial reporting framework.

Summarized financial statements need to be appropriately titled to identify the audited financial statements from which they have been derived, for example, 'Summarized Financial Information prepared from the Audited Financial Statements for the Year Ended December 31, 2OO7

Summarized financial statements do not contain all the information required by the financial reporting framework used for the annual audited financial statements. *Consequently, wording such as 'true and fair' or 'present fairly' in all material respects' is not used by the auditor when expressing an opinion on summarized financial statements.*

The auditor's report on summarized financial statement should include the following basic elements ordinarily in the following layout:

(a) Title

(b) Addressee

(c) An identification of the audited financial statements from which the summarized financial statements were derived

(d) A reference to the date of the audit report on the unabridged financial statements and the type of opinion given in that report

(e) An opinion as to whether the information in the summarized financial statements is consistent with the audited financial statements from which it was derived. When the auditor ahs issued a modified opinion on the unabridged financial statements yet is satisfied with the presentation of the summarized financial statements, the audit report should state that although consistent with the unabridged financial statements, the summarized financial statements were derived from financial statements on which a modified audit report was issued.

(f) A statement, or reference to the note within the summarized financial statements, which indicates that for a better understanding of an entity's financial performance and position and of scope of the audit performed, the summarized financial statements should be read in conjunction with the unabridged financial statements and the audit report thereon.

(g) Date of the report

(h) Auditor's address, and

(i) Auditor's signature

Examples of Reports on Summarized Financial Statements

When an Unqualified Opinion was expressed on the Annual Audited Financial Statements

AUDITOR'S REPORT TO ………………

We have audited the financial statements of ABC Company for the year ended December 31 20x, from which the summarized financial statements were derived, in accordance with International Standards on Auditing (or refer to relevant national standards or practices). In our report dated March 10 2OO7 we expressed an unqualified opinion on the financial statements from which the summarized financial statements were derived.

In our opinion the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized statements were derived and our audit report thereon.

Date AUDITOR

Address

When a Qualified Opinion was expressed on the Annual Audited Financial Statements

AUDITOR'S REPORT TO ………….

We have audited the financial statements of ABC Company for the year ended December 31 20x, from which the summarized financial statements were derived, in accordance with International Standards on Auditing (or refer to relevant national standards or practices).
In our report dated March 10 2OO7 we expressed an unqualified opinion on the financial statements from which the summarized financial statements were derived gave a true and fair view of (or 'presented fairly, in all material respects') … except that inventory had been overstated by ……..

In our opinion the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived and on which we expressed a qualified opinion.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized statements were derived and our audit report thereon.

Date AUDITOR

8.8 REVISED ACCOUNTS

It may be discovered after the audited financial statements have been presented to members and/or filed that they are defective. This is a relatively rare event.

Depending on the particular national requirements such as 'defective' accounts must be, may be or may not be, revised. Where revision is required or permitted the revisions should relate only to matters arising before the original accounts were approved and in respect of fundamental errors of fact (and not for changes in accounting policies).

Revision of accounts may be by way of:

- Revision by replacement (in which case the original version is withdrawn) or
- Revision by supplementary note.

The main duties of the auditor are to cover the following points:

(a) Ensure that revisions are properly prepared in accordance with the applicable reporting framework

(b) The revised accounts show a 'true and fair view'/'are presented fairly', as seen at the date when the original accounts were approved.

(c) Ensure that the original accounts failed to comply with the local or national requirements/ applicable accounting standards. A company cannot revise accounts without good reasons.

Typical audit procedures should include

- Review the original audit plan and consider what further audit evidence may be required
- Reassess the matters of judgment involved
- Obtain specific evidence in respect of the adjustments required to the original accounts
- Extend the post balance sheet review period (from the date on which the original accounts were approved)
- Perform a 'final review' on the revised accounts
- Consider any legal or regulatory consequence of the version.

An example of an opinion paragraph included in the auditor's report revised accounts is as follows:

'In our opinion, the revised financial statements give a true and fair view (or 'present fairly, in all material respects') as at the date the original financial statements were approved, of the financial position of the Company as of December 31 2OO7 and of the results of its operations and its cash flows for the year then ended in accordance with (national legislation).

Or

In our opinion, the original financial statements for the year ended December 31 2OO7 failed to comply with (relevant national standards or legislation).

8.8.1 Distributions following an audit qualification

A company is limited in the amount of dividends it can pay to its shareholders by the total distributable profits available. These can be defined as:

Accumulated realized profits, so far as not previously utilized by distributor or capitalization, less accumulated realized losses.

In some countries there are additional restrictions for public companies.

In order to determine the amount of distributable profits, reference is made to the latest audited accounts. If those accounts have been qualified, and directors want to pay a dividend, auditors are normally required (under national legislation) to state in writing whether in their opinion the qualification is material for determining whether the proposed distribution is legal.

8.9 IAS 14 SEGMENT REPORTING

IAS 14 is mandatory for enterprise whose equity or debt is publicly quoted or about to be publicly quoted. IAS 14 encourages other enterprise to provide segmental information, and if they do they should comply with the provisions of IAS 14.

When consolidated financial statements are presented as well as those of the parent, the segmental analysis need only be disclosed on a group basis.

8.9.1 Definitions

IAS 14 contains the following definitions:

(i) Business Segment

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

(ii) Geographical Segment

A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

(iii) Reportable Segment

A reportable segment is a business segment or a geographical segment identified based on the foregoing definitions for which segment information is required to be disclosed buy this standard.

(iv) Segment revenue

Segment revenue is revenue reported in the enterprise's income statement that is directly attributable to a segment and the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, whether from sales to external customers or from transactions with other segments of the same enterprise.

Segment revenue includes a joint venture's share of the revenue of a jointly controlled entity that us accounted for by proportionate consolidation in accordance with IAS 31 Financial reporting of Interests in Joint Ventures.

(v) Segment expense

Segment expense is expense resulting from the operating activities of a segment that is directly attributable to the segment and the relevant portion of an expense that can be allocated on a reasonable basis to the segment, including expenses relating to sales to external customers and expenses relating to transactions the other segments of the same enterprise.

Segment expense includes a joint venture's share of the expense of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IAS 31.

8.9.2 Extent of Segmental Analysis

In view of these definitions, it may be seen that segmental analysis of the income statement is only required as far as operating profit, presumably because allocations of finance costs would be likely to be arbitrary. Even general administrative costs are excluded.

Segmental analysis of assets and liabilities must be consistent with that for revenue and expenses.

8.9.3 Reportable Segments

In determining whether a segment is a reportable segment, a 10 per cent rule is adopted. A segment is a reportable segment if most of its sales are to external customers and it has at least 10 per cent of:

(i) Total sales, including sales to other segments, or

(ii) Total profit of all profit making segments, or total loss of all loss making segments or

(iii) Total assets of all segments

A segment which is below these levels may still be designated as a reportable segment.

A segment below the 10 per cent thresholds and not designated as a reportable segment may be combined with another similar segment. If this is not possible, it is included as an unallocated reconciling item.

8.9.4 Identifying Reportable Segments

The main choice in identifying segments is between business segments and geographical segments. In fact, IAS 14 require some segmental analysis for both of these, but the IAS 14 disclosure requirements are based on the idea of ‘primary’ and ‘secondary’ segment reporting formats. If classification by business is the primary format, a full segmental analysis is required on this basis, with limited disclosure in the secondary geographical format, and vice versa if the geographical format is chosen as primary.

Most businesses will probably choose analysis by business as their primary format. One could also envisage a single product enterprise which produced geographical analysis only.

The geographical analysis may be done in two ways – by location of assets and by location of customers. There are thus three possible choices for the primary format:

- Business (analysis by different product or services)
- Geographical by location of assets
- Geographical by location of customers

8.9.5 Implication of IAS 14 for Auditors

There is significant amount of discretion allowed to the directors in applying IAS 14. The auditor will need to establish the basis for the analysis provided by the directors and check whether they have followed the guidance given in IAS 14 regarding significant segments. The segments need to be consistent with previous periods but there can be valid reasons for changes as the relative importance of different sectors changes.

Test checks to source documentation will need to be made of the analyses supplied and then reconciled to the aggregate figures in the financial statements.

8.9.6 IAS 7 Statement of Cash flows

The amounts appearing in the cash flow statement are derived mainly from the balance sheet and the income statement particularly where the indirect method has been used and verified accordingly. Where the direct method has been used the amounts should be verified by reference to the source accounting records (for example the cash book). The auditor should also ensure that the items have been properly classified and that cash and cash equivalents fall within the definition in the standard. Arithmetical tests should be performed on the cash flow statement and it should be reviewed for compliance with the disclosure requirements of IAS 7.

Thus if the auditor has qualified because of a disagreement over the accounting treatment, the auditor will adjust the accounts for his own preferred accounting treatment and compute whether the proposed dividend would be affected.

An example of a report (based on UK legislation) is as follows:

AUDITORS' STATEMENT TO THE MEMBERS OF XYZ PLC (OR LTD)

We have audited the financial statements of XYZ plc for the year ended 31 December 20.. in accordance with Auditing Standards issued by the Auditing Practices Board and have expressed a qualified opinion thereon in our report dated …..

Basis of opinion

We have carried out such procedures as we considered necessary to evaluate the effect qualified opinion has for the determination of profits available for distribution.

Opinion

In our opinion, this qualification is not material for the purpose of determining whether the distribution of £….. Proposed by the company is permitted under section 263 of the Companies Act 1985.

Certified Accountants and
Registered Auditor
Date

Address

CHAPTER SUMMARY

- Materiality is essentially a matter of professional judgement and therefore an individual item can be judged material if knowledge of that item could reasonably be deemed to have influence on the users of the financial statement. The issue of materiality arises in two situations:

(i) Determining the extent to which detailed audit work should be performed in specific areas and

(ii) Determining whether errors or other mis-statements have affected the true and fair view.

- The Basic Elements of the Auditor's Report are;

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph

(d) Scope paragraph

(e) Opinion paragraph containing:

(f) Date of the report;

(g) Auditor's address; and

(h) Auditor's signature.

- An auditor can express either of the three opinions

(a) A **qualified opinion** should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.

(b) A **disclaimer of opinion** should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

(c) An **adverse opinion** should be expressed whet the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

- Management are generally keen to avoid qualifications in the audit report because:

1) Adverse publicity may arise from the media

2) If the qualification concerns a matter of statutory accounting policy, the powers of the courts may result in the preparation of revised accounts.

3) Loan/debenture deed may refer to an audit qualification as giving rise to a breach of a covenant, thus giving loan note holders an immediate right to repayment or the right to appoint a receiver.

- In determining whether a segment is a reportable segment, a 10 per cent rule is adopted. A segment is a reportable segment if most of its sales are to external customers and it has at least 10 per cent of:

(i) Total sales, including sales to other segments, or

(ii) Total profit of all profit making segments, or total loss of all loss making segments or

(iii) Total assets of all segments

QUIZ

1. What should financial statements contain for them to be termed true and fair
2. For auditing purpose, the companies act requires a company to keep books that detail?
3. Give some situation when qualification of financial statements is necessary.
4. Highlight the two situations under which materiality arises.
5. What are the basic elements of an auditors report?

ANSWERS TO THE CHAPTER QUIZ

1.

(a) Relevant to the business transactions etc it purports to describe

(b) Objective, being free from any bias … and being based on unprejudiced and verifiable evidence which us capable of supporting it (Lee).

2.

a) All sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place. Hence, most companies will have a cash book to comply with this requirement but note that the Companies Act does not specifically call for a cash book nor does it lay down any hard rules on what form these records should take.

b) All sales and purchases of goods by the company: Most companies comply with this requirement by maintaining sales and purchases journals or day books. Again, the Companies Act does not specify the form which these records should take.

c) Assets and Liabilities: Most companies comply with this requirement by maintaining personal and general ledgers with regard to assets and liabilities of the company and changes therein.

3.

a) If the auditors are unable to obtain all the information and explanations they consider necessary for the purposes of their audit, for example, if they are unable to obtain satisfactory evidence:

i. of the existence of ownership of material assets or of the amounts at which they have been stated on the basis adopted;

ii. of the validity of payments;

iii. That the records properly reflect all transactions of the business because the evidence has been lost or destroyed or is otherwise not forthcoming or has never existed.

b) If in the opinion of the auditors:

i. Proper books of accounts have not been kept in accordance with the Companies Act;

ii. Proper returns adequate for their audit have not been received from branches nor visited by them;

iii. The balance sheet and the profit and loss account are not in agreement with the accounting books and returns.

c) If in the opinion of the auditors the accounts though based on proper books of account fail to give the information required by the act for example, a failure to comply with specific disclosure requirements of the Companies Act in material respects.

d) If in the opinion of the auditors the accounts though otherwise complying with the disclosure requirements fail to disclose a true and fair view for example:

i. Because in the auditor's opinion the underlying accounting policies do not conform to accounting principles appropriate to the circumstances and nature of the business;

ii. Because they are prepared on principles inconsistent with those previously adopted and without adequate explanation and disclosure of the effects of the change;

iii. Because the auditors are unable to agree with the amounts at which an asset or a liability is stated;

iv. Because the auditors are unable to agree with the amount at which income or expenditure or profit is stated;

v. Because the accounts do not disclose information though not specifically required by the companies act, is necessary for the presentation of a true and fair view;

vi. Because additional information given in a note or in the director's report materially alters the view otherwise given by the accounts.

e) If in the case of a holding company submitting group accounts it is the opinion of the auditors that the group accounts have not been properly prepared in accordance with the provisions of the act so as to give a true and fair view of the profit and loss of the company and its subsidiaries so far as it concerns the members of the company.

4.

i. Determining the extent to which detailed audit work should be performed in specific areas and

ii. Determining whether errors or other mis-statements have affected the true and fair view.

5.

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph

(i) Identification of the financial statements audited;

(ii) A statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph (describing the nature of an audit)

(i) A reference to the ISAs or relevant national standards or practices;
(ii) A description of the work the auditor performed;

(e) Opinion paragraph containing:

(i) A reference to the financial reporting framework used to prepare the financial statements (including identifying the country of origin3 of the financial reporting framework when the framework used is not International Accounting Standards);
and

(ii) An expression of opinion on the financial statements;

(f) Date of the report;

(g) Auditor's address; and

(h) Auditor's signature.

PAST PAPER ANALYSIS

This also another examiners favourite although its usually combined with other chapters during its testing. Among the sittings which it has been tested include; 12/00 Question 5, 6/03 Question 5, 12/05 Question 3, 6/06 Question 1, 12/07 Question 4.

EXAM QUESTIONS

Question one

The information below relates to three different situations that have arisen during the audit of A Ltd., B Ltd. and C Ltd. who are clients of your audit firm.

1. **A Ltd**.
   A Ltd's turnover for the year ended 30 June 2007 was Sh. 20 billion and net profit was Sh 1.7 billion. Kenya Revenue Authority (KRA) has launched an inquiry that is still under way. It is not possible to ascertain at this stage if a tax liability will arise as a result of this inquiry. The directors have disclosed the inquiry in a note to the accounts. They have also indicated a willingness to make any further disclosures that you recommend to the management.
   A tax specialist has advised you that the possible range of outcomes in respect of additional tax liabilities ranges between a zero liability and a Sh. 2 billion liability, but because of the complexity of the issues, she is unable to forecast the outcome.

2. **B Ltd**
   B Ltd., a charity registered as `a company limited by guarantee', has accrued Sh.17 million for the purchase of freehold property and recorded this liability within accruals in creditors falling due within one year and a corresponding expense in building costs in the income statement. The charity has not yet identified a property to purchase and has not entered into a contract to purchase a property. The draft financial statements for the year ended 30 September 2007 currently shoe an excess of income over expenditure of Sh.70, 000. The trustees of the charity have refused to adjust the financial statements because the believe disclosure of a large surplus would inhibit their ability to raise funds in the future.

3. **C Ltd.**
   C Ltd. exports a significant amount of its products and has major distribution centre in an overseas country, which is at war with a neighbouring country. Due to the imposition of travel restrictions, it was not possible for your audit firm to attend the year-end stock count. The stock at the overseas distribution centre ads at 30 September 2007 represents 60% C Ltd.'s stocks.

Required:

(a) Explain the reasons and benefits of:

(i) Completing a discloser checklist (3 marks)

(ii) Carrying out a final analytical review when the auditors are conducting final checks on the financial statements. (2 marks)

(b) In respect of A Ltd., set out the matters you would consider as part of a going concern review. (6 marks)

(c)

(i) Giving supporting reasons, explain the audit opinion you would give in the audit report for each of the three companies. (6 marks)

(ii) Explain the effect of the conclusions reached in c (i) above on each audit report. (3 marks)

(Total 20 marks)

Question two

(a) With reference to International Standard on Auditing 550 (Related Parties), discuss the responsibility of an auditor with regard to related party transactions.

(b) You are a partner in ABC Associates, a firm of Certified Public Accountants (CPAs) specializing in the audit of group accounts. One of your clients, Excel Ltd., is the parent company of a number of subsidiary companies. Some of these subsidiary companies are audited by other audit firms.

Your firm is in the process of determining the extent to which the work of these subsidiary company auditors can be relied upon in the audit of the accounts of the parent company.

Required:

i. Explain the factors you would consider in deciding on the extent to which you could rely on the work of the auditor of a subsidiary company. Your answer should include a consideration of the size of the subsidiary. (6 marks)

ii. Analyse the matters you would consider in deciding whether you should qualify your audit report on the parent company's accounts given that the audit report on the accounts of a subsidiary company is qualified. (6 marks)

(**Total: 20 marks**)

CHAPTER NINE

STUDY TEXT

AUDIT INVESTIGATIONS, RECEIVERSHIPS, LIQUIDATIONS AND CURRENT ISSUES IN AUDITING

CHAPTER NINE

AUDIT INVESTIGATIONS, RECEIVERSHIPS, LIQUIDATIONS AND CURRENT ISSUES IN AUDITING

▶ OBJECTIVES

When you have studied this chapter you should be able to:

- Explain and carry out audit investigation
- Prepare various accountants reports
- Explain and discuss the main principles of independence
- Discuss the role of audit committees
- Discuss the advantages and disadvantages of carrying out non audit work for an audit client
- Explain and discuss the fundamental principles of professional ethics
- Discuss the forms of organizations available to professional firms

▶ INTRODUCTION

An investigation can be defined as an enquiry commissioned by a client for some purpose of his. In this chapter, we will focus on the scope of enquiry, the range of possible clients and the number of purposes can be very large. We shall therefore confine ourselves to the most common types of investigations that the professional accountant may be called upon to do.

▶ DEFINITION OF KEY TERMS

1. **Back duty investigation** Occurs where the income tax authorities have reason to suspect that a resident individual subject to taxation has not made complete and accurate return of income for taxation purposes, they may require an investigation to determine the correct position.

2. **Prospective financial information** (PFI) means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment and can be in the form of forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection.

3. **A forecast** a prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best –estimate assumptions).

4. **Bankruptcy** a legal status which a person (not a company) acquires when the court makes an adjudication order against him. The order effectively deprives him of the ownership of all his property (with certain exceptions) and subjects him to certain disabilities.

5. **Insolvency** refers to the inability of a person (including a company) to pay debts as and when they fall due. However, although a debtor may be insolvent, he is not a bankrupt until and unless the court adjudges him to be so.

EXAM CONTEXT

This question mostly audit procedure you would apply in the audit of companies under receivership or liquation. They may also ask you to discuss on he current audit developments while arguing for or against the developments. The question usually requires critical thinking.

INDUSTRIAL CONTEXT

In real life, companies all into financial difficult and may be placed under receivership or liquidation. Although this is a rare occurrence, auditors should be well equipped to handle such sceneries. Auditors should also constantly update themselves on the current issues affecting the profession.

9.1 COMMON TYPES OF INVESTIGATIONS

a) Acquisition of companies;

b) Purchase of business;

c) Prospective investments;

d) Admission of new partners;

e) Prospective lending;

f) Fraud;

g) Systems breakdown;

h) Company Acts investigations;

Under this heading we shall also consider, prospectuses and profit forecasts.

Investigations may be needed whenever facts are in doubt or in dispute or where knowledge is required. Anybody can commission an investigation and you will find that companies, individuals, financial institutions and banks, local authorities, the tax authorities can all commission various investigations.

9.2 INVESTIGATIONS: THE STAGES

All investigations are carried out in the same way, therefore the student must remember this section of this chapter.

Stage 1:

You must always obtain precise written instructions from the client. This must incorporate a very clear view of the aims of the investigation, the scope of the investigation, the degree of the detail required, the degree of secrecy to be observed, the person to whom the accountant must address his report. At this level, consideration must be given to the resources the client is ready to utilise and the cost of the job, both in terms of money and time.

Stage 2: Professional courtesies

Professional etiquette requires that if investigations are carried out in the affairs of organizations to which the accountant is not the auditor then the auditors must be communicated with. This is to observe the usual courtesies and to obtain their cooperation.

Stage 3: Organization of the investigations

This involves the accountant assessing the aims of the investigation, estimating the time to be taken and the likely costs and ensuring that the appropriate staff will be available.

Stage 4: Obtaining the background information

This is particularly important in investigations in acquisition of business. It involves gathering as much background information as possible about the object of the investigation, the size of the industry and its structure, history since commencement, the future prospects, the relevant legislation affecting that industry, investment information and relevant accounting ratios. This information is usually available from published sources such as government statistics, trade associations and the financial statements.

Stage 5: Gathering preliminary information

This information has to be gathered on the subject to be investigated. This information includes the location of the subject, its products, its range of services and its share of the market, key personnel, major accounting control systems and past reports.

Stage 6: Preparing the report outline

A report that meets the needs of many accounting investigations is as follows:

Part A: Introduction whereby we have references to the instructions given. The object of the investigation must be apparent from the introduction.

Part B: A summary of the instructions must be given.

Part C: A statement of the precise objectives of the investigation and the report.

Part D: A statement of the scope of investigation stating the time period and the area covered.

Part E: A statement of the documents used. If it is necessary to reproduce any of these documents this is usually done in an appendix.

Part F: An outline of the work actually done, again it may be necessary to put some of this material in an appendix.

Part G: A summary of the information obtained.

Part H: Further information which could be of use to the client but does not flow from the investigation proper.

Stage I: Recommendations of the accountant. In giving recommendations, the accountant must always ensure that:

a) He gives information from which the client can draw his own conclusions

b) Avoid presenting information in such a way that the clients' judgement is influenced

c) If information is based upon assumptions, then the accountant must state the assumptions in full and substantiate them if possible

d) Make no forecasts

e) If you are giving opinions, estimates or forecasts, then the accountant must state who made them and what qualifications they had to making them

f) The recommendations are practical

g) The investigation has been comprehensively completed.

h) The report is drafted and discussed with the client

i) The final report is submitted

9.3 SPECIFIC INVESTIGATIONS

9.3.1 Acquisitions (Interest Acquisition Audits)

These are agreed procedures engagements.

Accountants are frequently requested by individuals or companies to investigate a business or a company of which the client is contemplating purchase. What the accountant is being asked to do is to help his client make up his mind on whether to buy or not and if to buy at what price and for what consideration. The accountant's approach will depend on his instructions. An investigation of this nature might be carried along the following lines:

i. Obtain written instructions. This is to determine the purpose of the investigation and any particular criteria the client may wish to apply. So, we must know the cash availability, the consideration to be offered, the minimum return on the investment, the scope and cost of the investigation.

ii. Establish contacts. The accountant must open up a relationship with his client, the subject of the investigation, its professional advices particularly accountants and auditors.

iii. Examine and redraft the accounts for a period of years. This is usually taken to be 3 years, one year being considered too short because there are no comparatives, two years being considered too short because there is no trend, three years being considered optimum because you have a comparative and trend. More than three years is considered to be purely of historical value. Under this stage, we eliminate all the non-recurring items and all items which will not apply after the change of ownership and we include notional amounts for items that will become applicable after the change of ownership. These may involve redrafting of the accounts using different accounting policies.

iv. Establishing the reliability of the accounts: If they have been audited by a well recognized firm, then little verification is required apart from considering any qualifications in the auditors reports and the appropriateness of the accounting policies used. If the accounts have not been audited, then you require some more information in the following areas:

a) Sales: You have to investigate for inclusion of fictitious sales or sales from other businesses;

b) Purchases: Look out for exclusions;

c) Cut off: This is important as potential sellers are well known for switching sales into final periods to boost turnover and profits;

d) Work in progress and stock: It is important to check the quantity and value sometimes an independent stock take should be arranged at the take over date;

e) Gross profit ratios: This should be consistent year to year and with the industry average;

f) Asset valuations: Adequacy of depreciation and the value of debtors need to be looked at critically. Look out to see whether necessary repairs and renewals of assets have been ignored;

g) Undisclosed liabilities: Items may include pension obligations compensation for redundancies and taxation liabilities.

v. Commercial considerations: The various factors to be considered include:

a) Requiring knowledge of the spread of customers and products;
b) Knowing the development plans for the district;
c) Length of leases of premises and the possibilities of renewal;
d) The continuity of trading arrangements;
e) The personal connections of the vendors will the customers continue to patronise the business after change in ownership;
f) Personnel considerations;
g) The need for an agreement that the vendor will fill in from original.

vi. Future prospects: The important factors here are:

a) The future of the industry;
b) The future of the enterprise within the industry;
c) The capital working needs and the fixed assets investment needs, you may find cash flow forecasts essential;

d) Miscellaneous issues: Your client will be interested in being given facts upon which he can form an opinion. He would also like to know the reason for the sale of the business and he may be interested in working methods that are ordinarily used for valuing businesses.

9.3.2 Requests for Loans

The bank in wishing to give loans requires certain information from the applicant. The bank wants to know:

a) The purpose for which the loan is required

b) The adequacy for that purpose of the amount being sought

c) The nature and adequacy of the underlying security and the ease with which it may be realised if necessary

d) The proposed arrangement for the payment of interest and the period over which repayment of the principal sum will be completed

So, to carry out an investigation the following procedures are generally adopted:

General

a) The background and professional standing of the promoters of the company;

b) The viability of the concern in the light of current and probable future requirements in the area of operation;

c) The size of the existing market and the likelihood of success for a new venture;

d) The quality of the goods and services to be offered must be compared with what is already available including comparison of price;

e) The availability of suitably located premises at an economic rent possessing permission for the use intended.

Financial

a) The bank wants to know the extent which the promoters can match the requested finance with their own resources;

b) Their personal financial status, the possibility of providing personal guarantees as security for the loan sought;

c) Their past success or failure in business ventures;

d) Their ability to provide references as to their commercial acumen, honesty and integrity in business dealings.

Schedules included in the presentation

a) The cash flow budgets of the proposed concern for the first two years of operation (usually the most difficult for new businesses). At this stage cash budgets are far more significant than profitability, although the bank will obviously wish to be satisfied as to potential future profitability;

b) Estimates, set out month by month, of income from sales/services, net of direct (i.e. variable) expenditure incurred in earning that revenue;

c) Estimates, once again set out monthly, of the fixed and set up costs likely to be incurred from the inception of the enterprise. Such expenses would cover:

i. Administrative salaries including directors drawings;

ii. Establishment expenses e.g. rent and rates, premiums on leases, installation of telephones, light and heat;

iii. Refurbishing and decorating costs to meet the company's initial requirements;

iv. Cost of acquiring furniture, typewriters etc.;

v. Initial and regular advertising direct mail, stationery;

vi. Repairs and maintenance;

vii. Interest charges on the finance which it is hoped the bank will extend as a result of the presentation;
d) A duplicate set of estimates and under (a - c) above except that they should be prepared on the basis of a worst position.

9.3.3 Fraud Investigations

The nature and scope of a fraud investigation are dependent on the instructions given. The main problems usually are:

a) The past time period that needs to be investigated. This could be a few days or many years.

b) The scope of the investigation. We have to determine whether we are investigating an individual, a whole company, a whole department or a group of companies.

c) The questioning of individuals. This can be a very painful exercise and the following general rules can be helpful:

i. The questioner should have a colleague present;

ii. The person being interviewed should be allowed to have a friend present;

iii. Accusations should not be made but evidence should be presented and explanations requested;

iv. The questioning should be in private;

v. If necessary, judges' rules should be observed. This means that a person being questioned understands the nature of the question and should not unwittingly incriminate himself;

There are two broad categories of fraud

a) Fraud involving the manipulation of the records and the accounts usually by the company's senior officer with a view to benefiting in some way from the false picture which they convey.

b) Frauds usually by employees involving the theft, misappropriation or embezzlement of the company's funds usually in the form of cash or other assets.

Below is a summary of procedures the investigating accountant will be required to follow in arriving at estimates of losses from case (b), assuming that it is already known that a defaulting employee has been at work.

i. He has to ascertain the level of authority and the nature of duties of the defaulting employee;
ii. Cast and vouch the cash book and obtain certificates of opening and closing balances from the bank;
iii. Check the cash book against bank statements paying particular attention to the dates of lodgement to ascertain whether receipts were banked promptly;
iv. Examine pay-in-slips at the bank and compare with counterfoils as these may reveal teeming and lading;
v. Carry out a positive circularisation of debtors;
vi. Scan the cash book for any apparently irregular payments;
vii. Examine returned cheques comparing names or payees with the details in the cash book and invoices;
viii. Obtain duplicates of missing expenditure vouchers;
ix. Vouch all amounts shown as partners or directors drawings or loans;
x. Vouch and cast the petty cash book;
xi. Confirm names of all employees shown on payroll with the chief accountant and the personnel manager and confirm amounts payable to them;

xii. If the defrauder has access to all books then all postings should be checked and a trial balance extracted;
xiii. Confirm all bad debts written off, discounts allowed and returns of goods;
xiv. Check the order book against the sales day book, or copy sales invoices in order to detect any unrecorded sales;
xv. Vouch purchase invoices with purchases day book and see that none of them has been processed twice;
xvi. Obtain duplicates of all missing purchase vouchers;
xvii. Compare the creditor's statements against purchase ledger balances;
xviii. Check goods inwards book or order against invoices to ensure that the latter relate to genuine purchases.

9.3.4 Back Duty Investigations

Where the income tax authorities have reason to suspect that a resident individual subject to taxation has not made complete and accurate return of income for taxation purposes, they may require an investigation to determine the correct position. This investigation is ordinarily called a back duty investigation. The victim is required to appoint his own accountant to carry out the investigation at his own cost. The appointment has to be approved by the income tax department. A statement known as a capital statement is usually the form in which the results of this investigation are summarised. The purpose of the statement is to attempt a reconciliation of net worth at the opening and at the close of the period respectively by reference to known and estimated sources of income and expenditure. The final discrepancy that is revealed being the closest possible approximation of the undisclosed income which gave rise to the investigation in the first place.

The following procedural points should be noted: The investigation relates to the income and expenditure of the tax payer in his private as well as business capacity. The enquiries must therefore extend to his wife and children and other dependants. All sources of potential information must be tapped such as: bank statement, deposit receipts, brokers' notes, insurance policies, interest and dividend counterfoils etc. Receipts and payments have to be traced through to source and destination respectively. Do not ignore small items since they may indicate the existence of assets previously undisclosed. The amount of insurance covered should be ascertained since it may indicate the approximate value of the underlying assets. The final report should refer to the deficiencies in the information provided as well as the assumptions and estimates which it has therefore been necessary to make.

Special points which arise in this investigation are: the period to be covered which could be many years, the apparent cash available for living compared with the taxpayers' actual standard of living, the accumulation of capital compared with known sources of such accumulation, the existence of other sources of income and capital must be investigated. This will include: gambling wins, gifts and legacies. The result of the investigation may be that undeclared income comes to life. This will involve the payment of tax on the income, interest thereon, and a negotiated penalty in some cases strangely very rare, the tax payer may be jailed. The statement of capital may look like this (opposite page).

Taxpayer..

Period covered by this investigation..

STATEMENT OF NET WEALTH AT OPENING AND CLOSING DATES

		Kshs.	Kshs.	
Total wealth of taxpayer, wife and dependants at the commencement of the investigation period			xx,xxx	
Add:	Known sources of earned income declared		xx,xxx	
	Known sources of unearned income declared		xx,xxx	
	Profits on sales of:			
	— Investments		xx,xxx	
	— Rights issues	xx,xxx		
	— Other issues (specified in detail)		xx,xxx	
	Capital increases from:			
	— Gifts		xx,xxx	
	— Legacies		xx,xxx	
	— Life policies matured		xx,xxx	
	— Life policies surrendered		xx,xxx	
	— Windfall gains		xx,xxx	
	— Other items (specified in detail)		xx,xxx	
			xx,xxx	
Less:	Known expenditure accounted for and, acknowledged to be consistent with the taxpayer's standard of living	xx,xxx		
	Losses on sales of:			
	— Investments	xx,xxx		
	— Other assets (specified in detail)	xx,xxx		
	Capital decreased:			
	— Gambling losses	xx,xxx		
	— Gifts	xx,xxx		
	— Other losses, including assets worn out/scrapped (specified in detail)	xx,xxx		
			xx,xxx	
				xx,xxx
Surplus/Deficiency:				
"Notional" Total Wealth at the close of the period				xx,xxx
Actual Total Wealth at the close of the period (as admitted)				xx,xxx
Discrepancy due to undisclosed source of income				xx,xxx

9.3.5 The Accountants Report on Prospectuses

a) The contents of the Accountants Report for the purposes of a prospectus are:

i. Title of report and identification of the reporting accountants, with details of their address.

ii. Addressee - usually the Director of the company.

iii. Report with the following information:

a) Examination of audited accounts of the company for the years required, Report on proposed issue stating number of shares and nominal value.

b) The accounts have been prepared in accordance with generally accepted accounting practices. The accounting policies used disclosed.

c) Whether reporting accountants have also been auditors of the company, if not the auditors are mentioned.

d) Whether any accounts have been made up for submission to the members subsequent to previous balance sheet.

e) Opinion on truth and fairness of the accounts;

f) Significant accounting policies that have been used in preparation of the accounts;

g) Profit and Loss Accounts for the last five years that must show earnings per share, profit before taxation, taxation and extra-ordinary items, directors emoluments.

h) Latest balance sheet.

i) Capital commitments and contingencies not provided for.

j) Date of report, signed.

b) Provision is made for disclosure of the adjustments made by reporting accountants in arriving at the information included in the report. The purpose of these adjustments is to reflect past results in future conditions so far as these are known. This is a reasonable principle acceptable under the third schedule provisions. As a result of these adjustments it may be difficult to reconcile reported figures with those in the past published accounts of the company.

The published stewardship accounts are prepared by a company's directors for presentation to committed shareholders in order to acquaint them with the result of the company's activities during the last complete year of stewardship. There is no over-riding need for the accounts to be comparable and consistent with each other. In a prospectus, the information is addressed to potential investors in such a way as to enable them to form an opinion on the likely prospects of the company under future trading conditions so far as they can be assessed. The purpose must be met, consistency and comparability must be achieved but also future conditions must be taken into consideration.

Examples of situations in which adjustments would be appropriate are:

i. Income and/or expenditure which has arisen in the past, but which it is known will not arise in the future may be eliminated, e.g. nationalised subsidiaries, uninsured losses, extra-ordinary items etc.

ii. Revaluation of assets causing a change in depreciation charges. This should be adjusted only if revised figures can be produced with reasonable certainty otherwise it may be preferable to explain the position in a note to the accounts.

iii. A significant change in accounting policies at any point during the period reported on, in which event the accounts for all affected periods should be adjusted to reflect the accounting policies which are known to be applicable in the future.

9.3.6 The Accountants Report on Prospective financial information

Auditing procedures for historical financial information are well established. However companies often prepare and publish prospective financial information such as profit forecasts. In order that the forecasts should have credibility the company may ask the auditor to examine and express an opinion on the prospective financial information. This examination does not amount to an audit. However, users of the prospective financial information do get some assurance from an examination of the prospective financial information by the auditor.

According to International standard on Assurance engagements No. 3400 *The Examination of Prospective Financial Information,* 'Prospective financial information' (PFI) means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection.

The purpose of the ISAE 3400 is to establish standards and provide guidance on engagement to examine and report on prospective financial information including examination procedures for best –estimate and hypothetical assumptions. This ISAE does not a apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management' s discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination.

ISAE 3400 defines a '**forecast**' as prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best –estimate assumptions).

A '**projection**' is defined as prospective financial information prepared on the basis of:

(a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start –up phase or are considering a major change in the nature of operations, or

(b) A mixture of best-estimate and hypothetical assumptions

PFI can include financial statements or one or more elements of financial Statements.

In effect a forecast is an informed opinion on what will happen and a projection is an opinion on what might happen in certain circumstances. Often a one-year forecast is given together with a five year projection.

Acceptance of engagement

Before accepting an engagement to examine prospective financial information, the auditor would consider, among other things:

- The intended use of the information.
- Whether the information will be for general or limited distribution
- The nature of the assumptions, that is, whether they are best –estimate or hypothetical assumptions
- The elements to be included in the information; and
- The period covered by the information.

Purposes of Prospective Financial Information

Prospective financial information can be issued:

(a) As an internal management tool e.g. to support a possible capital investment

(b) Or distribution to third parties, for example

- In a prospectus
- In an annual report
- To inform lenders or to support an application for finance.

The preparation of PFI involves the following steps:

- Make best estimate assumptions about the future e.g. sales will rise by 4%, interest rates will remain stable and exchange rates will fluctuate.

- Determine the accounting policies used in the past which must be used in preparing the PFI.

- Issue the PFI with the material assumptions clearly disclosed, including an indication as to whether they are best estimate assumptions or hypothetical assumptions.

- Prepare the PFI on the basis of the assumptions and accounting policies.

Assurance Procedures

An auditor may be engaged to report on the PFI. The auditor will normally carry out the following procedures:

- Agree a letter of engagement

- Obtain a sufficient knowledge of the business – the auditor should have the knowledge

- Consider the period to be covered – in the case of a forecast this cannot be very long, normally not more than a year.

- Assess the source and reliability of the evidence supporting management's best estimate assumptions. Evidence can be obtained from internal sources (e.g. past financial statements) and external sources (e.g. the auditor's knowledge of current economic circumstances). Any plans should be within the client's capacity.

- The auditor should consider, when hypothetical assumptions are used, whether all implications of such assumptions have been taken into account. Forecasts should consider the capital spending needs, productive capacity, staff recruitment, working capital, cash flow and all other aspects of a proposed plan. Any hypothetical assumptions should be realistic.

- The auditor should make arithmetical checks on the forecasts and supporting schedules (budgeted financial statements). The whole set should be internally consistent and in accordance with proposed management actions and with assumptions.

- The auditor should focus on areas which are particularly sensitive to variation.

- When part of the period, which is the subject of the forecast, has already elapsed, the auditor should examine evidence for the financial results already achieved. If the client's year end is 31 December, a forecast for the year ending 31 December 20x3 may be made in say May 20x3 when four months or so have already elapsed.

S T U D Y T E X T

- The auditor should obtain written representations from management on the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information.

- The auditor should assess the presentation and disclosure of the prospective financial information.

- Finally the auditor should issue a report.

Consistency

The PFI should be based on budgeted financial statements. It should take into account the assumptions and ensure that all items are consistent with each other and that accounting policies normally adopted by the company have been used.

Disclosure

The prospective financial information must be properly and comprehensively disclosed and presented, which means that:

- The information is not misleading

- The accounting policies used are clearly disclosed in the notes to the prospective financial information

- The assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether the assumptions represent management's best-estimates (e.g. inflation will be at 3% which agree with government forecasts) or hypothetical (let us assume that our market share increase to 46% from 43%, which may be unrealistic). If the assumptions are material and subject to a high degree of uncertainty, the sensitivity of the forecast to these assumptions must be adequately disclosed.

- The date when the forecast was prepared must be disclosed

- Sometimes the forecast is in the form of a range, and the basis of selection of the points on the range must be unbiased and disclosed

- Any change in accounting policy since the last set of financial statements must be disclosed together with the reason for the change and the effect on the prospective financial information.

Reporting On Prospective Financial Information

Contents of the Report

The report by the auditor should contain the following:

1) Title
2) Addressee
3) Identification of the prospective financial information
4) A reference to the auditing standard applied (e.g. ISA 810), if any
5) A statement that the management is responsible for the prospective financial information including the assumptions on which it is based
6) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information
7) A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information
8) An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework
9) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information
10) Date of the report, which should be the date procedures have been completed
11) Auditor’s address
12) Signature

Reports on profit forecasts

An example of such a report is set out below:

Auditors' report on the profit forecast issued by the Directors of B Limited and covering the twelve months ending 31 December 20x3

To the Board of Directors of B Limited

We have examined the profit forecast covering the twelve months ending on 31 December 20x3 set out on earlier.

We carried out our examination in accordance with International standard On Assurance Engagements (ISAE) 3400: The examination of prospective financial information.

Management is responsible for the forecast including the assumptions set out on pages XX and XX on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions.

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

ABC&CO

Nairobi

13 April 20x3

Note the following points:

- The negative assurance given (nothing has come…..)
- If the forecast is presented in accordance with a relevant reporting framework (e.g. the national legislation of ISAEs or an IERS), that fact should be stated.
- A statement that the forecast may turn out to be wrong
- Management responsibility

Reports on Projections

The following is an example of a report on a projection

We have examined the projection of the profits to be earned by C Ltd. in the five years ending 31 December 20x5 set out on pages XX to XX of this document in accordance with International Standards on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the projection including the assumptions set out in Note X on which it is based.

This projection has been prepared for the purpose of the offer for sale of 10% convertible debentures.

As the entity is in a start up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that sales growth of 10% annually is achieved. Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with generally accepted accounting principles.

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated event frequently do not occur as expected and the variation may be material.

ABC & Co

Nairobi

13 April 20X5

Inadequate Disclosures

The auditor may form a conclusion that the presentation and disclosure of the prospective financial information is not adequate. This may arise because the financial information fails to disclose adequately the consequences of any assumptions that are highly sensitive. In such cases the auditor may:

- Express a qualified opinion
- Express an adverse opinion
- Withdraw from the engagement

In practice the auditor would discuss the issue with management and persuade them to change the forecast.

Quiz

Hopeful

As a response to a falling share price, Hopeful, listed companies, who are magazine printers, have issued a profit forecast with the annual accounts for the year ending 31 December 20x8. The annual accounts were signed off on 24 April 20x9. The forecast is for profits in 20x9 of $26 million which contrasts with the current profit of $21.5 million. This depends on increasing turnover by 7% and reducing overheads by 4%.

To give assurance to shareholder and other investors, the company has asked Swallow and Co, the auditors, to report upon the forecast.

Required

(a) Explain the term 'prospective financial information' and identify the principal problem which reporting on such information raises for auditors. (10 marks)

(b) Summarize the procedures that Swallow should carry out in order to be in a position to report on the forecast. (15 marks)

(Total: 25 marks)

Summary of the Auditors Responsibility

a) Preliminary considerations:

i. The accountant must have sufficient time to carry out his review. In tense and fast moving takeover situations the accountant may be asked to conduct a review, literally overnight. They must not allow themselves to conduct a review at a faster pace than the problem merits.

ii. It must be clearly established and made clear to all parties that the accountants are reporting only on accounting bases and the calculations as distinct from the assumptions including commercial assumptions.

iii. The accountant should only review the current period, and if a significant part of that has elapsed, then the next following period.

iv. Reporting accountants cannot relieve the directors of their responsibility for profit forecasts which may be used and relied upon by outsiders.

v. The accountant must establish the purposes for which the forecasts have been prepared.

vi. The accountant must be sure that the directors assume full responsibility for the forecasts by:

a) A minuted board resolution;
b) A statement to that effect in the document containing the forecast.

vii. The accountant must take note of the other advisers acting in the matter.

b) The main points to be considered in conducting the review:

i. Nature and background of the company's business. Establish its activities, products, customers, markets, labour force, prospectus, and the trends of its financial results.

ii. Accounting policies. Establish the accounting policies adopted for interim and final accounts and forecasts. Ensure that they are acceptable and consistently followed especially in the forecasts. Special areas to be watched include stock and work in progress valuations, depreciation, the method of taking profit on long term contracts, exceptional and extraordinary items, and deferred tax.

iii. The assumptions:

a) These should be stated;

b) The forecast should be consistent with the assumptions which may be economic (e.g. growth in G.N.P), financial (e.g. interest rate movement, marketing (e.g. market share), (e.g. output potential), labour relations (e.g. strike free periods) etc.

The accountant is not concerned with the correctness of these assumptions although he should be sure the directors are responsible for them and that they are reported on by the advisers.

iv. The procedures adopted by the company to prepare the forecasts: the accountant should investigate:

a) Whether forecasts are regularly prepared for management or prepared only for this occasion.

b) If they are regularly prepared, the degree of accuracy and reliability achieved.

c) Whether the forecasts are best estimates, honestly believed to be achievable, or simply targets.

d) The extent to which forecasts for wholly or partly expired periods are covered by reliable interim accounts.

e) The extent to which the forecasts are built up from detailed divisional or activity based sectional accounts, distinguishing those with steady performance from those with more volatile results.

f) The treatment of material, extraordinary, and exceptional items.

g) The adequacy of provisions for future losses and contingencies.

h) The adequacy of working capital. If finance will be required to fulfil the forecast, this should have been arranged and confirmed.

c) The report:

This will be addressed to the directors and will contain:

i. A statement that the reporting accountants have carried out a review of the accounting bases and calculations on which the profit forecasts have been based.

ii. Specific identification of the forecasts and documents to which the report refers.

iii. If, as is likely, the accountants have not carried out an audit of estimated results of expired periods, a statement to that effect.

iv. Whether in the opinion of the reporting accountants the forecasts have been properly compiled on the basis of the assumptions made by the Board of Directors, as set out in the prospectus or circular, and are presented on a basis consistent with the accounting practices normally adopted by the company.

v. If the accountants have material reservations about any part of the forecast, they should qualify their report.

9.3.7 Letters of Consent

If a prospectus contains any statement purporting to be made by an expert (e.g. the reporting accountant), then the expert must have given and not withdrawn his consent to the issue of the prospectus with the statement in the form and context in which it is included.

A statement that consent has been given and not withdrawn must be included in the prospectus.

An example of a letter of consent is

We hereby consent to the issue of the prospectus dated 14th May 2004 issued in connection with the offer for sale of ten million shares of Going Places Group Ltd with the inclusion therein of our report dated 14th May 2004 and the references thereto, and the references to our name. In the form and context in which they appear. We attach a copy of the document initialled by us for the purposes of identification.

The letter of consent should be available for public inspection and except for quoted companies, be filed with the Registrar of Companies.

Before signing a letter of consent, the reporting accountant should review the whole prospectus to ensure that the information in it is not inconsistent with anything in his report. He is none-the-less not responsible for anything except his own report.

9.3.8 Comfort Letter

The reporting accountant may be asked by the director or by the sponsor to prepare reports on other matters. These letters are not for publication and are not required by statute or other regulations. The reason for them is that the directors must make statements in the prospectus on such matters as:

a) The adequacy of working capital

b) The aggregate of borrowings at the latest practicable date

c) Any pro-forma financial statement shown in the prospectus to indicate the effect of a major acquisition or re-organisation

d) Taxation clearances and indemnities

e) Any other financial information anywhere in the prospectus.

Clearly the directors or sponsor must be sure these matters are correctly stated and thus ask the reporting accountant to investigate and give a comfort letter that all is well.

Example of a Comfort letter

Directors
Harbridge Ltd
Gentlemen

We refer to the document dated 2nd January 2003 issued by your company in connection with a placing by ourselves of 1,000,000 shares of 20/= each. The document contains a forecast (for which you as directors are solely responsible) of the company's profits to the year ending 30th June 2003. We have discussed with you the bases and assumption upon which the forecast has been made and have considered the letter dated 2nd January 2003 addressed to you from Wahasibu & Co, regarding the accounting bases and calculations for the forecast.

In our opinion, the profit forecast for the year ending 30th June 2003 has been prepared after due and careful enquiry.

Yours faithfully
GOLDFINGER & Co
Member of the Nairobi Stock Exchange

Examples of the assumptions and letters associated with a forecast are

Assumptions

In arriving at the profit forecast by the directors for the year ending 30th June 2004 the principal assumptions made are that:

a) Group turnover of Kshs20 million will be achieved

b) Overhead costs will have increased at a rate of 5% since 30th June 2003

c) Interest rates will not vary significantly from those ruling at 31st December 2003

d) No further claims will be received by the directors relating to the profit forecast for the financial year ending 30th June 2004

The Directors
Harbridge Limited

Gentlemen

We have reviewed the accounting bases and calculations for the profit forecast of Harbridge Limited (for which the directors are solely responsible), for the year ending 30th June 2004 as set out in the document dated 2nd January 2004 issued by your company in connection with a placing of 1,000,000 ordinary shares of Kshs10/- each.

In our opinion the forecast so far as the accounting bases and calculations are concerned has been properly compiled (on the footing of the assumptions made by the directors set out in the document) and is presented on a basis consistent with the accounting practices normally adopted by the company.

Yours faithfully
XYZ
Certified Public Accountants

Directors
Harbridge Ltd

Gentlemen

We refer to the document dated 2nd January 19X9 issued by your company in connection with a placing by ourselves of 1,000,000 ordinary shares of 10/= each. The document contains a forecast (for which you as directors are solely responsible) of the company's profits to the year ending 30th June 19X9. We have discussed with you the bases and assumption upon which the forecast has been made and have considered the letter dated 2nd January 19X9, addressed to you from XYZ, regarding the accounting bases and calculations for the forecast.

In our opinion, the profit forecast for the year ending 30th June 19X9 has been prepared after due and careful enquiry.

Yours faithfully
S.B. ROBERT
Nairobi Stock Exchange

9.3.9 Investigations by the Registrar of Companies

Section 164 to 175 of the Kenya Companies Act provides for the inspection of a companies affairs by the Registrar of Companies.

Section 164, the Registrar may appoint inspectors on the application of either not less than 200 members or of members holding not less than one tenth of the issued shares of the company.

Section 165, the Registrar must appoint inspectors if:

a) The company by special resolution or

b) By court order

Declare that the company's affairs should be investigated.

Section 166 empowers the High court to appoint inspectors if it appears that there are circumstances suggesting that:

a) The business is being run with intent to defraud creditors or in a manner oppressing to any part of its members or for any fraudulent or unlawful purpose, or

b) That persons concerned with the company's formation for the management of its affairs have in connection therewith been guilty of fraud or other misconduct towards it or its members, or

c) That its members have not been given all the information with respect to its affairs which they might reasonably expect, or

d) That it is desirable to do so.

Section 166: This section gives inspectors power to investigate affairs of investigated company's holding or subsidiary companies if they consider it relevant to their enquiries.

A team of inspectors usually consists of one accountant, and one advocate. Investigations usually take the form of a very extensive audit involving much use of verification, analytical review and detailed tests. The work can often take many years so it is usual for the inspectors to issue interim reports.

9.4 RECEIVERSHIP AND LIQUIDATIONS

Remedies of Debenture Holders

A debenture holder who wishes to release his security and recover his money may make use of all or any of the following remedies:

a) He may sue on behalf of himself and all other debenture holders to obtain payment or to enforce his security by sale. The Courts will appoint a Receiver and a manager for the company's business, if necessary, and declare the debentures to be a charge on the assets of the company, and order the sale of the property.

b) He may appoint a Receiver, if the conditions of the issue of the debentures give him the power to do so. The Receiver will sell the property and the sale proceeds will be utilised for the payment of the principal sum, interest, and costs due to debenture holders.

c) He may apply to the Courts for the foreclosure of the company's rights to redeem the debentures. This remedy is not common, as it is necessary for all the debenture holders of every class to be parties to the court action.
d) He may as a creditor for the principal and interest thereon, present a petition for the winding up of the company, or if there be a winding up in progress, he can prove in the winding up for the amount due to him, but not having any security, he ranks merely with the ordinary creditors.

e) He may have the property sold by the trustees if the debenture trust deed permits the sale.

f) If the company is being wound up and his security is insufficient he may value his security and prove for the whole debt.

Appointment of a Receiver

A debenture holder can appoint a receiver under the express power in his debenture, or he can apply to the Courts. Under Section 347 the Courts have power to appoint a receiver on the application of the debenture holder or other creditors. A receiver will be appointed by the Courts.

a) If the principal sum becomes due

b) If default is made in the payment of principal or interest

c) If the company is being wound up, or the winding up is imminent

d) If the company is disposing of its undertaking in violation of the terms of the security

e) If there are judgements against the company

f) If the security is in jeopardy, i.e. in danger of loss or serious deterioration in value. The question whether the security is in danger is one of fact in each case.

Although the courts will be willing to appoint a receiver whenever the security of a debenture holder is in jeopardy, they will not do so:

a) If the company is not in fault; and

b) If the assets of the company realised would be insufficient to pay the debenture holders in full.

Notice of Appointment

Section 103 provides that any person obtaining a Court order for the appointment of a receiver or manager, or appointing a receiver or manager under a power contained in the debenture or trust deed must:

a) Give notice of receiver's appointment to the Registrar within seven days after the order of appointment; and

b) If such a person ceases to act as a receiver, he must within seven days give the Registrar notice to that effect.

Section 351(1) imposes an obligation on a receiver so appointed, that he must forthwith give notice of his appointment to the company.

Position of Receiver

A receiver appointed by the Courts, being an officer of the court is not a mere agent but becomes personally liable on all contracts which he makes. In his capacity as a receiver he takes the custody of the property into his own hands for the benefit of the parties interested in it. Where he sustains any personal losses as a result of performing his duty as a receiver, he is entitled to be indemnified out of the assets of the company to the extent of its assets, and beyond this he has no right of indemnity.

A receiver may borrow money to carry on the business or to preserve the company with the sanction of the Court but not for speculative business. The sum borrowed will rank in priority to the debentures. A receiver appointed by the Courts is not bound by the company's contracts unless he accepts liability by means of a contract of novation.

A receiver appointed by the debenture holders under power in the debenture is their agent, and they are therefore liable on his contracts, unless the document conferring the power to appoint a receiver expressly states that he is to be the agent of the company.

Remuneration of Receiver

The remuneration of a receiver may be by the terms of the debentures or by the debenture holders in accordance with its terms. But a receiver appointed by the Courts has the amount of his remuneration fixed by the Courts. Although a receiver appointed by the debenture holders under power in the debentures has his remuneration fixed by agreement, the Courts may, on the application of the liquidator, fix the amount to be paid by way of remuneration to the receiver. Section 350(1).

Delivery of Accounts

Where a receiver or manager of all (or substantially all) the property of the company is appointed either under the power of the debentures or the Courts on behalf of the holders of debentures secured by a floating charge, the Receiver must send to the company notice of his appointment forthwith, and the company within fourteen days makes out and submits to him (i.e. the Receiver) a statement of its affairs.

Within two months after receiving this statement, the receiver must send to the Registrar and to the Courts (if he was appointed by the Courts) a copy of the statement and any comments he sees fit to make and must send to the Registrar a summary of the statement and of his comments, and must send to the company a copy of his comments, and to the trustees and all debenture holders a copy of the summary. Section 351.

The receiver must also within two months after the end of each year and within two months after he ceases to act as a receiver or manager, send to the Registrar and to the trustees (if any) and the company and the debenture holders any abstract of his receipts and payments during the relevant period.

Contravention of the aforesaid requirements renders the receiver liable to a fine of one hundred shillings for every day during which the default continues.

9.5 BANKRUPTCY AND INSOLVENCY

a) Bankruptcy is a legal status which a person (not a company) acquires when the court makes an adjudication order against him. The order effectively deprives him of the ownership of all his property (with certain exceptions) and subjects him to certain disabilities.

b) Insolvency refers to the inability of a person (including a company) to pay debts as and when they fall due. However, although a debtor may be insolvent, he is not a bankrupt until and unless the court adjudges him to be so.

Objects of bankruptcy laws

The principal objects of the law relating to bankruptcy are as follows:

a) To ensure that the debtor's property is distributed equitably among his creditors. (In this context equitable is not the same as equal; certain creditors are entitled to be paid in full before the other creditors receive anything from the state).

b) If the court agrees, to grant the bankrupt a discharge, thereby freeing him from any further liability for past debts. (Note, Section 7 of the Bankruptcy Act provides for the automatic discharge of a bankrupt, at the end of five years from the day he was first adjudged bankrupt, if he has not obtained his release before then.

c) To examine the debtor in order to see if he has committed any offence, and to punish him in appropriate cases. This procedure is therefore a protection for creditors and other members of the public who might subsequently have become creditors.

Who can be made bankrupt?

A debtor who:

a) Has committed or suffered an act of bankruptcy within the three months immediately preceding the presentation of a petition seeking to have him made bankrupt;

b) Owes liquidated debt (or debts) of at least Shs. 1,000/= to the presenter(s) of the petition, such (debts) being due both at the relevant act of bankruptcy and at the date of the petition's presentation; and

c) Is domiciled in Kenya or, within the year prior to the petition, was resident or carried on a business (personally or through an agent) in Kenya.

Procedures in Bankruptcy

Procedure in Outline

The following are the summarised steps in a typical bankruptcy:

A) An act of bankruptcy committed or suffered by the debtor;
b) Lodgement of a petition (by a creditor or by the debtor itself);
c) The issue of a receiving order against the debtor by the court;
d) The appointment of the official receiver;
e) The private examination of the debtor;
f) Preparation of a statement of affairs and deficiency account by or on behalf of the debtor;
g) The first meeting of creditors;
h) (Occasionally) a scheme of arrangement or composition prepared by the debtor;
i) The public examination of the debtor (unless excused by the court);
j) An adjudication order against the debtor (making him a bankrupt);
k) The appointment of a trustee in bankruptcy to deal with bankrupt's property;
l) The trustee's duties, powers and responsibilities;
m) Proofs and proxies;
n) The realisation of assets by the trustee;
o) Payments to creditors;
p) The discharge of the bankrupt;

The Official Receiver

a) The official receiver is appointed, removed and controlled by the Court and is an officer of the court to which he is attached.

b) He becomes receiver of the debtor's property when the receiving order is made. He also acts as trustee in bankruptcy:

i. In small bankruptcy (unless the creditors want someone else as trustee);
ii. during a vacancy in the office of trustee;
iii. When a trustee is released;
iv. In bankruptcy proceedings under penal code;
v. in the administration of the estate of a deceased insolvent (unless and until creditors appoint their own trustee;
vi. In a composition or scheme or arrangement until a trustee is appointed (and during any vacancy).

Duties of the official receiver

a) Regarding the debtor's conduct. As and when required by the court:

i. To investigate and report to the court on the debtor's conduct (in order to determine whether a discharge should be granted);

ii. To take part in the debtor's public examination (where required);

iii. To take part in the prosecution of a debtor accused of fraud.

b) Regarding the debtor's estate:

i. To act as receiver, temporary trustee or special manager (where one is needed but no one is acting as such);

ii. To authorise the special manager to raise moneys or to make advances, where necessary;

iii. To summon and to chair the first meeting of creditors;

iv. To issue and process forms of proxy for use at meetings of creditors;

v. to report to creditors on any proposal for a composition or scheme of arrangement;

vi. To arrange for advertisements in the Kenya Gazette and local papers, as and when necessary (e.g. in respect of the receiving order, the first meeting of creditors, and the public examination);

vii. To act as trustee (where necessary to protect assets);

viii. To authorise, on occasion, the employment of an accountant (e.g. to prepare the debtor's statement of affairs).

STUDY TEXT

Special Manager

a) A special manager may be appointed:

   i. if the debtor's business needs a manager;

   ii. at the request of a creditor;

   iii. by the official receiver (at his discretion).

b) The debtor himself may be the special manager, if the official receiver considers it in order for him to act;

c) The special manager must give security as directed by the court;

d) The special manager must submit accounts (verified by affidavit) to the official receiver who, after approving them, adds them to his own accounts;

e) The special manager's remuneration is fixed by the creditors in general meeting, or by the court;

f) The official receiver can remove the special manager, if he considers he is no longer needed. The official receiver must remove the special manager if the creditors so resolve (by special resolution).

Company Liquidations

The life of a company may be terminated as follows:

a) Compulsory liquidations commenced by petition to the court;

b) Voluntary liquidations commenced by resolution of the members;

c) Voluntary liquidations subject to the courts supervision order. Shares are virtually absolute;

d) Company transferring its undertaking to another company under a scheme of reconstruction or amalgamation may be dissolved by court order without winding up Sec.209.

e) A defunct company may be struck off the register by the Registrar and so dissolved without winding up.

Liquidation and winding up mean the same thing. A company cannot be made bankrupt.

Powers of the Liquidator

These powers fall into two categories:

Those which he may exercise without sanction and those which require sanction.

With the consent of C of I, the liquidator may:-

a) Bring or defend any legal proceedings in the name and on behalf of the company;

b) Carry on the company's business so far as may be necessary for its beneficial winding-up;

c) Appoint a lawyer to assist him;

d) Pay any class of creditors in full;

e) Make compromise claims arrangements with creditors;

f) Compromise claims against contributions for unpaid capital by the company against any person.

Without consent of C of I, the liquidator may:-

a) Sell and transfer the company's property;

b) Do all acts and execute all documents in the name of and on behalf of the company;

c) Prove in the bankruptcy of any contributory;

d) Sign bills of exchange or promissory notes in the name and on behalf of the company;

e) Raise money on the security of the company's assets;

f) Appoint an agent to do business which the liquidator cannot do himself;

g) To do all things necessary to wind-up the company affairs and distribute the assets.

Duties of the Liquidator under the Act and Winding-up Rules

The liquidator must:-

a) Take all the company's property into his custody or control as soon as possible;

STUDY TEXT

b) Settle a list of contributories, discharge its liabilities and distribute any surplus amongst the members;

c) Have regard to any directions given by resolution of creditors or contributories at a meeting or by C of I. Directors of the creditors or contributories override those of the C of I. He must summon meetings of creditors or contributories at such times as they, by resolution, direct or when requested in writing to do so by ten or more of the creditors or contributories;

d) Keep the prescribed books and subject to the control of the court, allow any contributory or creditor to suspect them;

e) Send an account in the prescribed form of his receipts and payments to registrar;

f) Pay all money received by him during the liquidation into the company's liquidation insolvency services account;

g) If the winding-up is not completed within a year after its commencement, send to the Registrar at the end of that year, a statement in the prescribed form concerning the progress of the liquidation;

h) Pay into Insolvency Services Account all money representing unclaimed or undistributed assets which have remained unclaimed or undistributed for six months. Thereafter, any person claiming any part of such moneys may apply to the Registrar for an order for such payment.

FORENSIC AUDITS

This is the process of gathering ,analysing and reporting ondata, in a pre-defined context for the purpose of finding facts and/or evidence in the context of financial /legal disputes /or irregularities and giving preventive advice in this area.

There are two types of forensic investigation;

- Those relating to civil disputes
- Those relating to criminal matters

Civil disputes-may fall into several categories

- Calculating and quantifying losses and economic damages ,whether suffered through tort or breach of contract
- Disagreements relating to company acquisitions and business valuation

Criminal matters-engagements frequently involve the assessment of accounting systems and accounts presentation

There are two main aspects of forensic investigations;

a. Determining the loss

b. Reporting the findings

Applications of forensic audits

- Fraud investigation-where evidence of fraud is gathered it could be presented in court of law so as to;

    1. To prove or disapprove the suspicious

    2. To identify persons involved

    3. To provide evidence for appropriate action possibly criminal proceedings

- Negligence-this covers personal injuries, fatal accidents, medical negligence, professional negligence, fires and other forms of damage caused by negligence. The measure of damage is to put the injured person back in the financial position they would have been but for the negligence

- Insurance claims-these are claims for such things as business interruption under insurance policies .The loss will be quantified in accordance with the terms of the policy

- Others include contract disputes ,copyright and royalty audits, matrimonial and asset tracing

Expert witness-these are generally forensic accountants. The require a recognised accountancy qualification .The work of a forensic accountant is subject to scrutiny by both sides and ,if it is wrong ,the court can make cost orders against him.

Reporting unethical behaviour-the report contains

❖ An appropriate declaration that the expert understands his duty to the court and has complied with that duty

❖ A statement of truth relevant curriculum vitae detailing qualifications and experience appropriate to the opinion expressed

- ❖ The substance of all material instructions summarising the facts and instructions which are material to the opinions
- ❖ Where there is a range of opinion on a matter a summary of the range and reasons for the expert 's own opinion

The report should be;

- Clear and easy to read
- Have minimal errors
- Show that the forensic accountant is protecting independence of the investigation
- Should show the competence of the forensic accountant

ENVIRONMENTAL AND SOCAL AUDITING

A growing number of companies are devising processes and non-financial indicators for measuring social and environmental performance.

Annual surveys of global companies regularly find an increasing percentage producing annual 'sustainability reports"

Environmental audit

This is where organisations introduce business ethics policies to govern the behaviour of the organization and its employees and their relationship with the environment. Environmental performance might include;

- Compliance
- Air emissions
- Environmental impact potentials e.g. global warming and acidification.
- Recyclable materials
- Waste water
- Stockpiling of ozone layer degrading substances

Environmental audit may be performed by external or internal experts at the discretion of the entity's management. Work is often performed by a multi-disciplinary team at the request of the management and for internal use The findings of an environmental audit may provide appropriate audit evidence for the auditor of the financial statements .Important criteria to be considered are;

- The impact of the results on the financial statements
- The competency and skill of the audit team and their objectivity
- The scope of the environmental audit
- Management's response to recommendations and how this is evidenced
- The due professional care exercised b y the team in the performance of the environmental audit
- The proper direction, supervision and review of the audit.

Social responsibility audit

The purpose of this is to systematically examine on an organizational wide basis the existing policies and practices relating to social responsibility, both internal and external to the organization

Social policies - internal environment

- Physical environment
- Working conditions minority groups organization structure and management style
- Communications
- Industrial relations
- Education and training

External environment

- Social responsibility and new opportunities
- Community relations
- Consumer relations
- Pollution

- Packaging
- Investment relations
- Shareholder relations

CORPORATE GOVERNANCE

This is the means by which a company is operated and controlled. It concerns such matters as;

- The responsibilities of directors
- The appropriate composition of the board of directors
- The necessity for good internal control –the necessity for an audit committee
- Relationships with external auditors

The key to good corporate governance is to ensure that talented individuals are rewarded at appropriate levels for their effort and skill whilst ensuring that they act in the best interest of the company and its stakeholders

Auditors' responsibility for reporting in corporate governance

- Listed companies must include a corporate governance statement in the annual report
- The auditors are not required to audit this statement but must review it for inconsistencies with other information contained within the annual report.
- Inconsistencies may impact on an audit in that if they highlight an error in the financial statements and the directors refuse to amend the error the auditor will issue a qualified report. If the inconsistency highlights an error or misleading information the auditor will add an emphasis of matter paragraph to their report .This is not a qualification, it is included to bring readers' attention to the mater.

Audit committees

These are committees consisting of non-executive directors which is able to view a company's affairs in a detached and independent way and liaise effectively between the main board of directors and the external auditors.

Objectives of an audit committee

- Increasing public confidence in the credibility and objectivity of published financial information
- Assisting directors in meeting the responsibilities in respect of financial reporting.
- Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

Functions of the audit committee

- Monitoring the integrity of financial statements
- Reviewing the company's internal financial controls
- Monitoring and reviewing the effectiveness of the internal audit function making recommendation in relation to the appointment and removal of the external auditor and their remuneration
- Reviewing and monitoring the external auditors independence and objectivity and the effectiveness of the audit process
- Developing and implementing policy on the engagement of the external auditor to supply non-audit services
- Reviewing arrangements for confidential reporting by employees and investigation of possible improprieties

Advantages of audit committees

- It may improve the quality of management accounting as it is well placed to criticise internal functions
- It should lead to better communication between directors, external auditors and management.

Disadvantages - they may lead to

- Fear that their purpose is to catch management out
- Non-executive directors being over-burdened with detail a "two-tier" board of directors
- Additional costs in terms of ,atleast, of time involved

Internal audit and corporate governance

The need for internal audit will depend on;

- Scale, diversity and complexity of activities
- Number of employees
- Cost/benefit consideration
- The desire of senior management to have assurance and advice on risk and control

Internal auditors provide assurance to the company's management that;

- Systems are operating effectively
- Internal controls are effective
- Laid down procedures are being followed
- Financial and other information being produced is sound and reliable

Limitations of internal audit function

- Lack of independence-can internal audit be truly independent of the organization of which it is part?
- Variation of standards-not uniform across the profession
- Relatively new profession-still evolving
- Expectation gap-problem of what the internal auditor's role is perceived to be
- Understanding internal audit-negative view by some –perhaps seen as "checking up" on the employee on behalf of the bosses

Internal audit report

It should be customer focused, meeting organizational needs .The internal auditor should always be conscious of the organizational philosophy, management styles and reporting objectives.

Purpose and structure of the report

The purpose is to summarise the results of the work undertaken, so that lessons can be learned and appropriate action taken. The report should be;

- Short and sweet-clear, concise, easy to read format will mean it is more likely to be read and understood.
- Measurable outcome-it is easy to recommend in a report that something should be improved.
- Priotisation-the important content should be readily accessible, not buried in the back of an appendix somewhere.
- Avoid surprises-discuss with management as points arise .This will mean less argument over facts or detail when the drat report is issued and will allow management to take steps promptly
- Fairness-balanced and constructive reporting will be welcomed by management and the organization

Types of reports provided in an internal audit

- **Formal reports-is a traditional outcome from an internal audit assignment**

Structure of the report is as follows;

Shorter memorandum reports-these are for;

- For smaller scale assignments
- Assignments where less depth is required
- Assignments where results are needed urgently
- A shorter less formal report maybe required

Nevertheless the same care needs to be taken with the contents of the report ie

1. Addresses-make sure it goes to the right people
2. Subject matter-make sure the purpose of the report is clear and that the objective is addressed by the content of the report
3. Structure-make sure the report is laid out well so that its message is communicated efficiently.

Presentations

i. An oral presentation can have a greater impact than a written document.

ii. Usually, however, a presentation will be delivered as well as the main report and used to highlight the full findings.

iii. Although the delivery methods are clearly different, the structure of a presentation has much in common with the structure of a formal written report

Cover of report-it should contain;

a) Subject

b) Distribution list

c) Date of issue

d) Any rating/evaluation

The cover of the report makes sure that the report goes to the right people and it can also make the difference between the report being reward or not

9.6 CURRENT DEVELOPMENTS IN AUDITING

9.6.1 Auditor Independence

There has been much debate recently about the issue of auditor independence. In particular the US Securities and Exchange Commission (SEC) which regulates investment, proposes to make auditor's independence a large issue.

Independence is something that is both a mater of fact and a matter of appearance. It is important to be independent but it is also important to appear to be independent.

In recent years auditing firms have seen auditing almost as a loss leader, giving access to a client so that the client can be sold all manner of additional services, all of which are the really lucrative ones for the audit firm as a whole. Financial disasters of Enron and WorldCom have concentrated the collective professional minds on how to deal with the issues which have been highlighted by these cases.

9.6.2 What is independence?

The SEC has suggested four principles of independence:

- An auditor may not have a mutual or conflicting interest with the client
- An auditor may not audit his own firm's work
- An auditor may not function as management or as an employee of the audit client
- An auditor may not act as an advocate for the audit client

9.6.3 Rules

To ensure both independence and the appearance of independence, rules have been set out in the professional bodies' ethical codes. Included in the codes are the following matters which impair independence.

- Undue dependence on an audit client as a proportion of fee income
- Actual or threatened litigation
- Family or other personal relationship
- Beneficial interest in shares and other investments
- Beneficial interest in trusts
- Loans to or from client
- The provision of goods and services or hospitality
- The provision of other services

9.6.4 Provision of Non Audit Services (other services)

The provision of other services, has proved particularly contentious, and this is what concerns us here:-

- Book keeping or other services related to accounting records
- Preparation of financial statements
- Financial information systems design and implementation
- Appraisal or valuation services
- Internal audit services
- Management functions
- Obtaining or advising on human resources
- Broker/dealer services
- Contingency fee arrangements

Advantages of auditors taking on non-audit work

- In economics terms, an extensive knowledge of the client will enable the auditor to offer his or her services to his or her client in context which he/she already understands.
- The auditor will not need to obtain large amount of background knowledge before conducting the other work.

Disadvantages of auditors taking on non-audit work

- The auditor will be perceived as not being fully independent
- The auditor will in many cases be auditing his or her own work
- Effectively much of this kind of other work involves management functions
- Some of the work may effectively involve acting as and advocate for the client.

Should an auditor act as a tax adviser and negotiate on behalf of the client? The current situation is that most auditors do act in this capacity for their clients especially in the SME (small and medium sized) sector. Indeed many small companies see the auditor primarily as a tax negotiator and as an auditor only secondly. But should an auditor act in this way?

The dispute between the Big Four accounting firms and the SEC is a bitter one. Although it only relates to listed US companies, its resolution will have repercussions around the world. Part of the problem is the concentration of auditing of listed companies with a handful of giant accounting firms. This means that these firms are also the main suppliers on non-audit professional services, and the partners and staff of these firms have restricted opportunities for investment if they cannot invest in their client companies. This topic has received additional attention recently in the USA and UK as a result of the Enron scandal and Anderson's.

9.6.4 Auditor independence and audit staff joining client companies

Clearly, independence is threatened where audit staffs join a client company. For example, the knowledge of audit approach, perhaps influence over, or close relationship with, continuing audit staff could be factors which threaten an objective approach. The level of the threat would in part be determined by the seniority of position in the client company. (For example, the former engagement partner becoming a client company director would present the greatest risk).

The firm's independence procedures should include safeguards to ensure that objectivity and independence is not compromised and would include:

- Non- involvement in client audit staff leaving
- Consideration of whether to continue the audit engagement
- Rotation of audit partner/staff on subsequent audits
- Requiring a gap period
- Judgments. Objectivity is the state of mind which has regards to all considerations relevant to the task in hand but no other. It presupposes intellectual honesty.

Advantages of an Ethical Framework approach

It is also important to realize that the ethical framework approach has advantages over rule based systems. The main advantages are considered to be as follows:

- It is virtually impossible for rule based systems to be able to deal with every situation that may arise.
- The onus is very much placed on the auditor to demonstrate that each matter is properly considered within the principles of the framework
- A framework is more appropriate to changing circumstance in a dynamics profession.

- Rule based systems can be interprets narrowly in order to circumvent the underlying 'spirit' or intention of the rule.

- A framework approach may include some specific 'prohibitions' or rules to deal with certain specific matters.

9.7 AUDIT COMMITTEES (Introduction to Audit Committees and the Reasons for their Growth)

a) The roles of an audit committee might include:

- To review the company's financial statements prior to their submission to the board;
- To review the scope and planning of the audit;
- To review the findings of the independent auditor;
- To ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and best practice;
- To keep under review the effectiveness of the company's systems of accounting and control;
- To make recommendations to the board concerning the appointment and remuneration of the independent auditors;

A particular role is to assist in the communication process between the board and the auditors throughout the medium of the non-executive directors and it provides a useful way of assisting the latter in the discharge of their duties.

b) The benefits may include

- Helping directors to meet their legal responsibilities. Very often main boards spend very little time on reviewing the financial statements. An audit committee could spend the time on completing this task in depth;
- Enabling non-executive directors to become deeply involved in the company's affairs;
- The audit committee can review the financial statements objectively. This may improve the quality of financial reporting and improve public confidence;

- The audit function may become more independent as there will be a quasi-independent body between the board and the auditors. It may paradoxically improve communications between auditor and board;

- Improvement in the quality of the accounting and auditing functions. A continuous review of the functions of financial management and internal and external audit will inevitably result in higher status to the practitioners and superior performance.

c) Some of the arguments against the formation of Audit Committees

- Audit committees would split the board;
- Audit committees would pre-empt (and hence delay the coming) of two-tier boards (which is the European practice);
- Audit committees would create conflicts within companies;
- Audit committees would encroach on management's responsibilities;
- Audit committees would be a talking shop with no real power;
- There are not enough non-executive directors;
- Audit committees would take too much time and cost too much;
- Audit committees would be least effective in companies which need them most (e.g. companies dominated by ambitious and unscrupulous entrepreneurs).
- The production of financial statements may be delayed.

d) Detailed matters to be considered by the Chairman of a new audit committee

- Ensuring the committee has the full backing of the board;
- The precise constitution and program of the committee;
- Adequate resources (secretarial, communication, time etc must be made available);
- The correct number of members. Three to five is probably optimal;
- Membership - probably but not essentially non-executive;
- His own role as chairman;
- The frequency of meetings;

- The establishment of agendas;
- The establishment of administrative arrangement - calling meetings, involving other people, auditors, managers etc. taking minutes;
- The dissemination of findings to the offers responsible for changes consequent upon the findings.
- The relationships required with the main board, external audit, internal audit, financial managers etc.
- Any publicity requirements.

9.8 DEVELOPMENT IN THE US

In the US the Sarbanes Oxley Act (2002) has been enacted. This attempts to address many aspects of auditor independence and corporate governance issues. For example it places restrictions on the nature of non- audit services that can be performed by h auditors and also require that the audit committees approve any allowed additional services.

9.9 DEVELOPMENTS IN THE UK AND OTHER COUNTRIES

New measures for the UK's accountancy profession, aimed at preventing Enron- style financial scandals, have been announced by the government. The proposals include a new, single regulator governing accounting standards, and limits on how long auditors can work on the accounts of one company.

- Senior auditors will not be allowed to spend more than five years working on a single company's books
- New voluntary rules will stop partners and senior employees of audit firms moving to jobs with the companies they have audited for two year.
- A single regulator governing accounting and auditing standards will also be created
- The code on corporate governance of listed companies would be strengthened requiring that half of board members and the chairman should be independent

9.10 THE CONSULTANCY AND AUDITING PROFESSION

Tiers in the Profession. The auditing profession is currently seen as having three layers or tiers:

- The Big Four (previously the Big Five before Enron!) international firms
- The second tier – smaller firms which have numerous branches and international connections
- The small firms

The great majority of listed company audits are conducted by the Big Four with the remainder conducted by the second tier. The concentration of the market into very large firm has come about because of the growth of globalization in world markets everywhere. As a result audit firms have to have the resources and expertise to operate in every country and have to know how to audit highly regulated modern businesses. The larger firms found that amalgamations amongst the audit firms were the way forward and as a result the world audit market is now concentrated in very few firms.

There are clearly benefits to this as these firms have expertise and global facilities and can invest in expensive systems and the necessary Information Technology to meet their international clients' needs. The disadvantages are the lack of competition and choice particularly for large companies.

Globalization of business is now established fact and local factories, shop and service organizations in many countries are likely to be foreign owned or controlled. The problem with global businesses is that they operate in widely different legal and ethical systems. Only the large audit firms can acquire the global expertise to handle such audits.

9.11 THE FUTURE OF THE PROFESSION

Current trends are still towards more mergers both of firms in the countries where the profession is more highly developed, for example USA and many European countries with firms in overseas locations.

Another trend is the debate about audit firms offering other services and the trend may be for audit firms to divest themselves of such consultancy services. A possible scenario is for firms to offer only a relatively limited range of services such as auditing, accounting and taxation. (Some firms have already sold off their consultancy services).

STUDY TEXT

9.12 PARTNERSHIP OR INCORPORATION

In the past accounting firms were always sole traders or partnerships. The main reason for this form of trading was the requirement for unlimited liability. Firms who damage their clients in any way may have damages awarded against them and all the partners in the firm are then jointly and severally liable up to the limit of their personal estates.

This liability still exists in many countries and is a substantial worry to the profession.

Possible alternative forms of trading for audit firms are as follows:

- Sole trading for the one man band
- Global partnerships
- Local partnership with a loose connection between them but sharing expertise, systems and the name
- Limited partnerships
- Incorporation as companies but with unlimited liability
- Limited liability company

Few firms have as yet opted for incorporation. In the UK the Limited Liability Partnership Act received the royal assent in 2000 and is now law. Probably many firms will register under this stature (KPMG have already done so). Registration under this statute gives firms the organizational and tax flexibility they need and also limits liability to some extent. If a member of the firm is negligent and has to pay damages then the LLP is fully liable as well as the member. Further the negligent member may be required to contribute to assets up to the limit of his estate but other members are not so liable unless they agree to be.

9.13 INFORMATION TECHNOLOGY AND THE AUDITOR

9.13.1 Audit Automation

Automation and rapid developments are affecting all aspects of life and the auditing profession is no exception. Whilst the essential process of the audit is the same the computerized techniques and software available to the auditor have developed significantly.

Useful packages include the following:

- File interrogation packages, e.g. search sales ledger
- Audit programme generators
- Checklist software
- Spreadsheets for calculations, listings etc
- Word processors to generate documents and store audit working papers and reports
- Relational databases
- Reference information over the internet – all regulations and rules governing auditing and accounting can be searched
- Systems documentation
- Risk analysis software
- Trial balance processors
- Time management software

9.13.2 File Interrogation software

File interrogation software has been around for a long time. Its principal uses include the following:

- Totaling and subtotaling files
- Stratifying and analyzing files
- Re-performing calculations
- Producing exception reports
- Detecting gaps or duplicate entries
- Selection of audit samples including monetary unit sampling
- Comparison of information on separate computer files
- Multiple file format handling, so that client files written in different formats can still be worked.

9.13.3 Automating Procedures

There are obvious benefits in automating audit procedures and these include the following:

- Files are kept in a more compact form
- Systems designed for optimal auditing are adhered to by audit staff
- Automatic generation of audit plans, programmes, schedules and procedures
- Instant availability of information on a wide range of audit related subjects
- The creation of data for audit examination or analytical review that is not readily available from clients records
- Savings due to more efficient working
- Better compliance with audit firm procedures and ISAs
- Better Public Relations as clients expect and demand that their auditors are up to date and efficient
- Freeing audit personnel to think rather than merely to go through procedures
- Creation of networks so that online supervision becomes possible
- Rapid sharing of information

As indicated above there are many benefits in automating audit procedures. However automation also brings problems. Increased automation (added to the need for firms to be competitive) may reduce the level if trained and experience staff used on the audit thereby increasing the risk of errors not being detected. Furthermore there is also a danger that automation may result in a 'standard' approach to audit work being followed rather than being tailored to the business audited.

9.14 IAPS 1013 ELECTRONIC COMMERCE – Effect on the Audit of Financial Statements

This IAPS was issued in 2002 and this new guidance responds to the increasing use of the internet for business to consumer business to business, business to government and business to employee eCommerce and how emerging new elements of risk need to be considered when planning and performing the audit of financial statements. This new IAPS helps auditors address e-commerce issues by focusing on, among other matters the level of skills and knowledge required to understand the effect of e-commerce on the audit; the business, legal, regulatory and other risk faced buy entities engaged in e-commerce activities; internal control considerations, such as an entity's security infrastructure and transaction integrity; and the effect of electronic on audit evidence.

9.15 THE FUTURE OF AUDITING

There are many factors that are continually causing changes in the auditor's approach to his work. Some of these relate to the nature of the service that the auditor provides while others reflect external demands on the role of the auditor in society. Some have already been mentioned but are included here for completeness:

a) Changes in reporting objectives and the introduction of accounting and auditing standards;

b) The increasing complexity of the business unit, e.g. conglomerates and multinational companies;

c) The widespread use of electronic data processing and, in particular, of real time, data base systems and micro-computer systems;

d) Increased government awareness of the profession exemplified by the increasing number of accountants in the Civil Service.

e) The increased responsibility that accountants bear towards third parties, as a result of such cases as Jeb Fasteners Limited v. Marks Bloom and Co.

f) The reaction of clients to alarming increases in audit fees. This has prompted many accountants to feel that it is essential that the profession develops new ways of increasing the efficiency of audit work, and may well lead to greater use of statistical and other analytical review techniques.

g) Increased public awareness and criticism of the auditing profession, resulting in the Ethical Guidelines.

h) The development of public sector auditing beyond the traditional role of reporting on financial statements in terms of truth and fairness, into the realms of measuring economy, efficiency and effectiveness of an entity - so called ‘value for money’ auditing.

ACCOUNTING AND AUDITING STANDARDS

Standard setting process

- International federation of accountants-is the global organization for the accounting profession. It was founded in 1977 and is based in Newyork. IFAC has more than 160 member bodies of accountants including the ACCArepresenting 2.5 million accountants from 120 separate countries. IFAC overall mission is to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards

- International standards on auditing (ISA)-they are set by international auditing and assurance standards board. IAASB is a subsidiary IFAC. There are more than 30 ISAs. All audits carried out under the laws of member states of the EU have had to be conducted under ISAs for all accounting periods beginning on or after 1 January 205.

The process

- IAASB identifies new projects based on a review of auditing developments and suggestions from interested parties

- IAASB then appoints a project task force to work up the details of the standard

- There maybe consultation through a round table meeting or the issue of consultation paper for comment

- A draft standard is then produced for public exposure usually for period of 120 days during which interested parties may submit their comments .Comments are a matter of public record and posted on IAASB website

- The project taskforce considers the comments and amends the draft standard as appropriate

- If there are significant changes there maybe another exposure period

- When the standard is finalised it is formally approved by a meeting of the IAASB at which there must be a quorum of 12 members.

Other IFAC and IAASB activities

- IFAC publishes a code of ethics governing all assurance engagements carried out under
- IAASB publishes ISQC 1 setting out quality control principles for all assurance engagement including audits conducted under its standards
- IAASB sets standards for other types of assurance engagements in addition to audits

The relationship between international and national standards and regulations

National regulatory bodies enforce implementation of auditing standards and have disciplinary powers to enforce quality of audit work. They also have rights to inspect audit files to monitor audit quality. There are twp possible schemes for regulation at the national level

1) Self regulation by the audit/accountancy profession

2) Regulation by government or by some independent body set up by government for the purpose

National standard setters may set their own auditing standards and may also adopt and implement ISAs possibly after modifying them to suit national needs

Following the decision by EU to implement ISAs in all member states for all accounting periods beginning on or after 1 January 2005, countries with their own standards setting bodies such as the UK had to decide whether to modify their standards to bring them into line with ISAs or adopt ISAs and modify them to suit national requirements.

CHAPTER SUMMARY

- There are basically two broad categories of fraud

a) Fraud involving the manipulation of the records and the accounts usually by the company's senior officer with a view to benefiting in some way from the false picture which they convey.

b) Frauds usually by employees involving the theft, misappropriation or embezzlement of the company's funds usually in the form of cash or other assets.

- Before accepting an engagement to examine prospective financial information, the auditor would consider, among other things:

1) The intended use of the information.

2) Whether the information will be for general or limited distribution

3) The nature of the assumptions, that is, whether they are best –estimate or hypothetical assumptions
4) The elements to be included in the information; and

5) The period covered by the information.

- A debtor can be declared bankrupt if;

a) Has committed or suffered an act of bankruptcy within the three months immediately preceding the presentation of a petition seeking to have him made bankrupt;

b) Owes liquidated debt (or debts) of at least Shs. 1,000/= to the presenter(s) of the petition, such (debts) being due both at the relevant act of bankruptcy and at the date of the petition's presentation; and

c) Is domiciled in Kenya or, within the year prior to the petition, was resident or carried on a business (personally or through an agent) in Kenya.

- The roles of an audit committee include**:**

- To review the company's financial statements prior to their submission to the board;

- To review the scope and planning of the audit;

- To review the findings of the independent auditor;

- To ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and best practice;

- To keep under review the effectiveness of the company's systems of accounting and control;
- To make recommendations to the board concerning the appointment and remuneration of the independent auditors;

CHAPTER QUIZ

What are the two broad categories of fraud?

1. What are the circumstances when a receiver will be appointed by the court?
2. What are the advantages of an auditor taking up non audit work for a client?
3. What are the roles of an audit committee?

ANSWERS TO THE CHAPTER QUIZ

1.

a) Fraud involving the manipulation of the records and the accounts usually by the company's senior officer with a view to benefiting in some way from the false picture which they convey.

b) Frauds usually by employees involving the theft, misappropriation or embezzlement of the company's funds usually in the form of cash or other assets.

2.

a) If the principal sum becomes due

b) If default is made in the payment of principal or interest

c) If the company is being wound up, or the winding up is imminent

d) If the company is disposing of its undertaking in violation of the terms of the security

e) If there are judgements against the company

f) If the security is in jeopardy, i.e. in danger of loss or serious deterioration in value. The question whether the security is in danger is one of fact in each case.

3.

a) In economics terms, an extensive knowledge of the client will enable the auditor to offer his or her services to his or her client in context which he/she already understands.

b) The auditor will not need to obtain large amount of background knowledge before conducting the other work.

4.

a) To review the company's financial statements prior to their submission to the board;

b) To review the scope and planning of the audit;

c) To review the findings of the independent auditor;

d) To ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and best practice;

e) To keep under review the effectiveness of the company's systems of accounting and control;

f) To make recommendations to the board concerning the appointment and remuneration of the independent auditors;

PAST PAPER ANALYSIS

This is also a frequently tested area in the recent past especially the current occurrence in reference to auditing and technology. Sittings in which it has been tested include; 6/07 Question 5, 6/04 Question 5, 12/04 Question 5, 6/00 Question 4

EXAM QUESTIONS

Question one

(a) Differentiate between a business risk approach and an audit risk approach to auditing assignments. (4 marks)

(b) The auditors and professional accountants are sometimes called upon to act as receiver managers and liquidators of companies.

Required:

(i) Explain the risk faced by an auditor in his role as a receiver as opposed to the risk an auditor is exposed to when performing his role as the external auditor of a company. (4 marks)

(ii) Explain the matters that an auditor who has been appointed a receiver or liquidator should discuss with the appointing authority before accepting the appointment. (6 marks)

(iii) Identify the ethical and practical challenges faced by an auditor when performing the duties of receiver or liquidator; and in each case highlight the provisions of the professional ethics that may assist the auditor (in his capacity as receiver or liquidator) overcome such challenges. (6 marks)

(Total: 20 marks)

Question two

The firm for which you work, is the auditor of STEP Manufacturing Ltd,. and you have been asked by the senior in charge to describe how you can use computer assisted audit techniques to audit the company's computerized sales and sales ledger system. STEP Manufacturing Ltd. will allow you to use your data on test files to check the correct operation of the accounting computer programs and to use computer audit programs to interrogate the sales ledger file. You have already satisfied yourself that controls over access to the sales ledger system are effective. You have established the following details pertaining to the computerized sales system:

1. Details of goods to be dispatched a re input into the computer and after approval by the credit controller, dispatch notes are printed in the dispatch department who send the goods to the customers.

2. The computer department prepares the sales invoices using prices from the price file. It posts the invoices to the sales ledger and the sales and VAT to the nominal ledger. The invoices are then sent to the customers.

3. Cash received and discounts allowed are posted to the sales ledger by the accounts department

4. The system allows posting of credit notes, adjustments (to correct errors) and writing off bad debts

5. At monthly intervals, statements are sent to customers.

6. The computer may print out the following information ay any time:

    - Details of transactions on any account.
    - An age analysis of sales ledger accounts.
    - The total of the balances on the sales ledger.
    - Details of transactions posted during the month
    - An analysis of sales income for the month.

7. The information required when inputting dispatch note details is as follows:

    - Customer account number
    - Date of dispatch (if different from the current date)
    - Part number and quantity of each item dispatched.
    - Any special discounts allowed to a customer.

Required:

(a) Describe the test data you would enter into the computerized sales system to check the correct processing of dispatch notes and sales invoices. (8 marks)

(b) Explain how a computer audit program may assist you in

  i. Carrying out a circularization of accounts receivable including selecting the accounts to circularize. (5 marks)

ii. Verifying the year end receivables in the sales ledger. (7 marks)

Notes:

i. In part (a) you are not required to describe how you would check the correct processing of cash discounts, credit notes and adjustments to correct errors.

ii. You are not required to describe in detail how you would carry out a circularization of accounts receivable. You are only required to consider the aspects of a circularization required by part (b) of the questions.

(Total: 20 marks)

Question three

Mwebeni Manufacturing Ltd. which has several branches in Kenya is proposing to install a new computer system. The finance director has asked you to suggest the controls which should be exercised over access to the computer system from remote terminals. All accounting data will be input into the computer from terminals and data from the branches transmitted to the main computer through the national telephone system.

Required:

a) Describe the general controls which may be established to prevent unauthorized access to the computer system from the remote terminals. Your answer should consider the effectiveness and limitations of each type of control. (8 marks)

b) Describe the additional procedures which could be exercised to prevent unauthorized access to the computer system through the national telephone system. (6 marks)

c) Briefly describe the controls which should be implemented in the accounts payable and payroll systems over:

i) Retrieval of information. (2 marks)

ii) Input of transaction data. (2 marks)

iii) Updating of standing data files. (2 marks)

(Total: 20 marks)

CASE STUDY

(Courtesy of www.wikipedia.com)

The Enron scandal

Kenneth Lay, the former Chairman of the Board and Chief Executive Officer and Jeffrey Skilling, former Chief Executive Officer and Chief Operating Officer, went on trial for their part in the Enron scandal in January 2006. The 53-count, 65-page indictment covers a broad range of financial crimes, including bank fraud, making false statements to banks and auditors, securities fraud, wire fraud, money laundering, conspiracy and insider trading. U.S. District Judge Sim Lake had previously denied motions by the defendants to hold separate trials and to move the case out of Houston, where the defendants argued the negative publicity surrounding Enron's demise would make it impossible to get a fair trial.

Lay pleaded not guilty to the eleven criminal charges. Lay stated that he was misled by those around him. At the time of his death in July, 2006 the U.S. Securities and Exchange Commission (SEC) had been seeking more than Ksh90 million from Lay in addition to civil fines.

The case surrounding Mrs. Linda Lay is a difficult one. Mrs. Lay sold roughly 500,000 shares of Enron ten minutes to thirty minutes before the information that Enron was collapsing went public on November 28, 2001. This was information that Enron executives had known for over a year.

Former managing director of investor relations for Enron Paula Rieker pleaded guilty in federal court to a criminal insider trading charge. She obtained 18,380 Enron shares for Ksh15.51 a share and sold that stock for Ksh49.77 a share in July 2001, a week before the public was told what she already knew about the Ksh102 million loss. The one felony charge against Rieker carries a maximum penalty of ten years in prison and a Ksh1 million fine. Rieker agreed never again to serve as an officer or director of a public company. If a federal court approves the settlement, Rieker will pay the SEC Ksh499,333, the profit from the sale of 18,380 shares of Enron stock. Rieker has been a valuable witness for the government as she prepared earnings releases and conference calls with Enron analysts.

On December 28, 2005, former CAO Richard Causey pleaded guilty to securities fraud. He will have to serve 7 years in prison and pay Ksh1.25 million to the U.S. Government. Causey has the possibility of only serving 5 years in prison if he cooperates and testifies with Lay and Skilling.

On January 13, 2006 lobbyist William "Art" Roberts pleaded guilty to impersonating Senate staff members during the investigation. Roberts was hired by a German bank in June 2004 to get a letter from a Senate subcommittee stating the bank had done their due diligence investigating the Enron collapse, as part of the bank's defense in a suit filed against it by a London bank.

Lay and Skilling were indicted for securities and wire fraud in July 2004, leading to a highly-publicized trial in which Lay was convicted on all six counts and Skilling on 19 of 28 counts on May 25, 2006. On July 5, 2006, Lay died at age 64 while vacationing in Aspen, Colorado, after suffering a heart attack on July 4. Skilling was convicted and sentenced to 24 years, 4 months in a federal prison on October 23, 2006. As well as his sentence of 24 years, 4 months, he was ordered to restore the Enron pension fund with Ksh26 million out-of-pocket. It is expected that he will appeal.

CHAPTER TEN

STUDY TEXT

ANSWERS TO THE EXAM QUESTIONS

CHAPTER TEN

ANSWERS TO THE EXAM QUESTIONS

CHAPTER ONE

Question one

The Finance Director

Industrial and Banking Holdings Limited

P O Box 2411

00202 Nairobi

05 August 2003

Dear Sir

Legal and Accounting Standard Requirements for Subsidiaries

I refer to our discussion regarding the appropriate treatment of the banking subsidiary in the group accounts.

The regulatory framework with regard to subsidiaries consists of:

1. International Financial Reporting Standards (IFRSs)
2. The Companies Act, Cap 486 requirement, and
3. Corporate governance and securities exchange guidelines

Under the applicable financial reporting framework in Kenya, the relevant IFRSs are:-

i) IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors. This IAS governs the selection and application of accounting policies consistency in the application of accounting policies, changes in accounting policies.

ii) IAS 27 – Consolidated and Separate Financial Statement governs the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.

The methods of accounting for business combinations and their effects on consolidation, including goodwill arising on a business combination are covered under IFRS 3-Business combinations.

IAS 27 defines a subsidiary as an entity including an unincorporated entity such as a partnership that is controlled by another entity known as the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The ISA requires a parent to present consolidated financial statements in which it shall consolidate its investments in subsidiaries.

However, the parent is not required to present consolidated financial statements if and only if;

(a) The parent is itself a wholly owned subsidiary or is a partially owned subsidiary of another entity and its other owners including those not otherwise entitled to vote, have been informed about, and do not object, the parent not presenting consolidated financial statements.

(b) The parent's debt or equity instruments are not traded in a public market (a domestic or foreign exchange or an over-the-counter market, including local and regional markets)

(c) The parent did not file, not is it in the process of filing, its financial statements with a security commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and

(d) The ultimate or nay intermediate parent of parent produces consolidated financial statements available for public use that comply with IFRSs.

Since your company is a listed entity, you are required to consolidate the subsidiary under the IFRSs framework.

In case the above exceptions were available, then you would have been required to prepare separate financial statements in which investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5, are accounted for either at cost or in accordance with IAS 39. This same accounting treatment is applied for each category of investments.

A subsidiary cannot be excluded from consolidation simply because the investor is a venture capital organisation, mutual fund, unit trust or a similar entity.

A subsidiary is also not excluded from consolidation because its business activities are dissimilar from those of other entities within the group. Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the differences in the activities of subsidiaries. For example, the disclosures required by IAS 14 – Segment Reporting, help to explain the significance of different business activities within the group.

IAS 27 goes further to require the following disclosures to be made in the consolidated financial statements;

i) The nature of the relationship between the parent and the subsidiary when the parent does not own, directly or indirectly through subsidiaries more than half of the voting power.

ii) The reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting power or potential voting power of an investee does not constitute control

iii) The reporting date of the financial statements of a subsidiary when such financial statements are used to prepared consolidated financial statements and are as of a reporting date or for a period that is different from that of the parent and the reason for using a different reporting date or period.

iv) The nature and extent of any significant restrictions (e.g resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances.

In the case of the banking subsidiary, has the same reporting date as the parent and control is direct, only the disclosure in (iv) above may apply.

With respect to the Companies Act, cap 486, Laws of Kenya, Group Accounts are required under section 150 which states that where at the end of its financial year, a company has subsidiaries, accounts statements dealing with the state of affairs and profit and loss of the company and the subsidiaries shall, subject to subsection (2) be laid before the company in general meeting when the companies own balance sheet and profit and loss account are so laid.

The Companies Act allows exclusion from consolidation on the following bases;

1) Group accounts shall not be required where the company is at the end of its financial year the wholly owned subsidiary of another body incorporated in Kenya and;

2) Group accounts need not deal with a subsidiary of the company if the company's directors are of the opinion that:-

   i) It is impracticable, or would be of no real value to the members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to the members of the company or:-

   ii) The result would be misleading or harmful to the business of the company or any of its subsidiaries or;

   iii) The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking and if the directors are of such an opinion about each of the subsidiaries, group accounts shall not be required;

The requirements of IAS 27 are more stringent than legislation. However, the IFRSs requirements present a more true and fair view and therefore should be followed to avoid qualification of the auditors reports on account of non compliance with IFRSs.

Therefore, in conclusion, the subsidiary should be consolidated and appropriate disclosures made in the financial statements.

Yours faithfully

Maungu & Co

Certified Public Accountants

Question two

Audit software may be used during many compliance and substantive procedures. Its use is particularly appropriate during substantive testing of transactions and balances, as it may scrutinize large volumes of data and extract information leaving skilled manual resources to concentrate upon the investigation of the results.

The following are the objectives:

i) To establish whether input data is validated and edited as close to the point of origination as possible.

ii) To ensure that the escalation date and percentages are reasonable

iii) To identify any duplications or unreasonable items that may have occurred during processing

iv) To ensure that the calculated amounts as reflected in the system are reasonable

v) To ensure that all documents produced by the system are accounted for, to the invoices on the rent due for collection.

(b) The audit retrieval software package could be used as follows:

i. Calculation checks: the audit program adds the value of open items on a file to ensure that they agree with control records which are maintained by City Premises Kenya Ltd. This will ensure that the monthly rental charged for the tenants are as per the agreed rental amounts in the lease agreements.

ii. Detecting violations of system rules: the audit program checks all accounts on the sales (rent receivable) ledger to ensure that no tenant or landlord has a balance above a specified credit limit.

iii. Detecting unreasonable items: The program will check that the escalation dates, escalation percentages and commission percentages are within the set ranges in the system i.e. they do not exceed the range or where the rent or amount outstanding is more than what was billed to the client.

iv. Conducting frequency of analysis: Where a statistical analysis of those that are regular in payment of the rent or commission due and their default rate.

v. Selection of items for audit testing: This is done by obtaining a stratified sample of sales ledger to be used as a basis for confirming the balances outstanding for a debtor's analyzation.

vi. Completeness Checks: Where the program will check for continuity of rental and commission invoices to ensure that they are all accredited for.

vii. Recalculation checks: Through the mathematical option the audit program will recalculate the monthly rental including these escalation percentages in addition to consideration of the escalation date.

viii. Existence checks: Through the comparison with a norm feature, the data entered agree with predetermined criteria.

ix. Duplicate check: Where the new transactions are matched to those previously input to ensure that they have not already been entered. This is to ensure that the clients are not billed twice.

x. Exception reports: Through the reporting module an exception report is generated by a program that identifies transactions or data that appear to be incorrect. These items may be outside a pre determined range or may not conform to specified criteria

Question three

For many businesses, sales are made on credit and thus the sales cycle includes control objectives for receivables. These controls objectives include:

(a) Customers' orders should be authorized, controlled and recorded in order to execute them promptly and determine any allowance required for losses arising from unfulfilled commitments.

(b) Goods shipped and work completed should be controlled to ensure that invoices are issued and revenue recorded for all sales.

(c) Goods returned and claims by customers should be controlled in order to determine the liability for goods returned and claims received but not entered in the accounting records.

(d) Invoices and credits should be appropriately checked as being accurate and authorized before being entered in the accounting records.

(e) Validated receivables transactions, and only those transactions, hold be accurately entered in the accounting records.

(f) There should be procedures to ensure that sales invoices are subsequently paid and that doubtful amounts are identified in order to determine any allowance required.

In order to achieve these objectives there should be good segregation of duties. There are three distinct processes in the sales system which should be segregated and performed by different staff in order to establish effective internal controls. They are:

(a) *Accepting customers' orders*: Sequence controlled documents should be used to acknowledge all order received. Any uncompleted orders should be regularly reviewed.

Credit limits should be checked by the credit control department. Selling prices, special discounts and delivery dates should be fixed by senior members of the salesdepartment – never by the account staff.

(b) *Dispatch department*: Sequence controlled documents should be used (goods outwards or dispatch notes) for all goods leaving he premises. These should be completed by the gatekeeper or the dispatch department – never by the account staff.

(c) *Invoicing the goods*: Sequence-controlled invoices should be raised by the sales department and then passes to the accounts department for recording. Independent checks should be made to ensure that invoices have been raised for all goods outwards notes.

In addition strict control of credit notes is essential to ensure that they are raised by proper authority in the sales department against goods received notes. It is not uncommon for credit notes to be raised to 'hide' what are in fact bad debts or to conceal theft of cash receipts. Credit notes can also be used to cancel out fictitious sales invoices which have been raised in order to boost sales figures artificially.

There are a large number of controls that may be required in the sales cycle due to the importance of this area in any business and the possible opportunities that exist for diverting sales away from the business and other persons benefiting.

(a) Orders

(i) The orders should be checked against the customer's account; this should be evidenced y initialing. Any new customers should be referred to the credit control department before the order is accepted.

(ii) Existing customers should be allocated a credit limit and it should be ascertained whether this limit is to be exceeded if the new order is accepted. If so the matter should be referred to credit control.

(iii) All orders received should be recorded on pre-numbered sales order documents.

(iv) All orders should be authorized before any goods are dispatched.

(v) The sales order should be used to produce a dispatch note for the goods outward department. No goods may be dispatched without a dispatch note.

(b) Dispatch

(i) Dispatch notes should be pre-numbered and a register kept of them to relate to sales invoices and orders.

(ii) Goods dispatch notes should be authorized as goods leave and checked periodically to ensure they are complete and that all have been invoiced.

(c) Invoicing and credit notes

(i) Sales invoices should be authorized by a responsible official and referenced to the original authorized order and dispatch note.

(ii) All invoices and credit notes should be entered in sales day book records, the accounts receivables ledger, and accounts receivable ledger control account. Batch totals should be maintained for this purpose.

(iii) Sales invoices and credit notes should be checked for prices, casts and calculations by a person other than the one preparing the invoice.

(iv) All invoices and credit notes should be serially pre-numbered and regular sequence checks should be carried out.

(v) Credit notes should be authorized by someone unconnected with dispatch or accounts receivable ledger functions.

(vi) Copies of cancelled invoices should be retained.

(vii) Any invoice cancellations should lead to a cancellation of the appropriate dispatch note.

(viii) Cancelled and free of charge invoices should be signed by a responsible official.

(ix) Each invoice should distinguish between different types of sales and any sales taxes. Any coding of invoices should be periodically checked independently.

(d) Returns

(i) Any goods retuned by the customers should be checked for obvious damage and, when accepted, a document should be raised.

(ii) All goods returned should be used to prepare appropriate credit notes.

(e) Receivables

(i) A receivables ledger control account should be prepared regularly and checked to individual sales ledger balances by an independent official.

(ii) Receivables ledger personnel should be independent of dispatch and cash receipt functions.

(iii) Statements should be sent regularly to customers.

(iv) Formal procedures should exist for following up overdue debts which should be highlighted either by the preparation of an aged list of balances or in the preparation of statements to a customers.

(v) Letters should be sent to customers for collection of overdue debts.

(f) Bad debts

(i) The authority to write off a bad debt should be given in writing and adjustments made to the account receivable ledger.

(ii) The use of court action or the writing-off of a bad debt should be authorized by an official independent of the cash receipt function.

Tests of Control

Tests of control should be designed to check that the control procedures are being applied and that objectives are being achieved. Tests may be appropriate under the following broad headings:

(a) Carry out *sequence test checks* on invoices, credit notes, dispatch notes and orders. Ensure that all items are included and that there are no omissions or duplication.

(b) Check the *authorization* for the

- Acceptance of the order (the credit worthiness check)

- Dispatch of goods

- Raising of the invoice or credit note

    - Pricing and discounts

    - Write-off debts

Check both that the relevant signature exists and that the control has been applied, e.g. check pricing for accuracy and credit limits to ensure that they have not been exceeded. This last test will also serve as a substantive procedure.

(c) Seek evidence *of checking of the arithmetic accuracy* of

- Invoices
- Credit notes
- Sales tax

This is often done by means of a 'grid stamp' requiring several signatures on the face of the invoice. Ensure that the control has in fact been applied by checking the accuracy of such invoices and credit notes. This last test will also serve as a substantive procedure.

(d) Check *dispatch notes* and gods returned notes to ensure that they are referenced to invoices and credit notes and vice versa.

(e) Check that *control account reconciliation* have been performed and reviewed. Reper form the control by checking the reconciliation to source documentation.

(f) Ensure that *batch total controls have been applied* by seeking signature and tracing batches from input to output.

In all cases, test should be performed on a sample basis. The auditor should investigate errors and consider the need for further testing to obtain comfort on the proper application of the control procedures.

CHAPTER TWO

Question one

(a) Respective responsibilities of directors and management of a company and its external auditors with respect to financial statements.

ISA 200, explains the respective responsibilities.

The responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity with oversight from those charged with governance.

The auditor is responsible for forming and expressing an opinion on the financial statements.

The audit of financial statements does not relieve management or those charged with governance their responsibility.

(b) The inherent limitations facing auditors in undertaking their work;

The inherent limitations in an audit of financial statements that affect the auditor ability to detect material misstatements include:-

i) The use of testing

ii) The inherent limitations of internal control (for example, the possibility of management override or collusion)

iii) The fact that most audit evidence is persuasive rather than conclusive

iv) The work is also permeated by judgment

v) Assessing the reliability of estimates made by management

(c) Significant types of judgments made by auditors in:

iii) Gathering audit evidence

The work undertaken by the auditor to form an audit opinion is permeated by judgment in particular regarding the gathering of audit evidence, for example in deciding the nature, extent and timing of audit procedures. Also the drawing of conclusions based on the audit evidence gathered for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

iv) Arriving at an opinion in the financial statements

In expressing an audit opinion, the auditor provides uses of financial statements with reasonable assurance that the financial statements are free from material misstatements. In other words, the engagement risk has been minimized to acceptable level. It implies that sufficient appropriate audit evidence has been obtained.

The auditor makes judgments regarding matters affecting or not affecting his audit opinion and also decides on the appropriate forms of the report.

He also considers compliance with laws to satisfy regulatory requirements in a given jurisdiction.

Question two

THE STOCK SYSTEM

The stock system can very important in an audit because of the high value of stock or the complexity of its audit. It is closely connected with the sales and purchases system.

Control considerations

2.2 Stocks may be as susceptible to irregularities as cash and, indeed, in some circumstances the risks of loss may be materially higher. Arrangements for the control of stocks should be framed with this in mind.

2.3 The stock control procedures should ensure that stocks held are adequately protected against loss or misuse, and are properly applied in the operations of the business.

2.4 Stock should be duly accounted for by appropriate recording and authorization of all movements.

2.5 It is also important that the business has proper control over stock levels to prevent on the one hand the possibility of running out of stock and on the other of holding too much stock, and hence incurring increased holding costs and the risk of stock obsolescence.

A further aim should be to ensure stock is appropriately valued, and that write-downs of stock are kept to a minimum.

According to the nature of the business separate arrangements may be necessary for different categories of stocks, such as raw materials, components, work in progress, finished goods and consumable stores.

Other controls:

1. Segregation of duties;
2. Custody and recording of stocks received
3. Checking and recording of goods inwards
4. Precautions against theft
5. Misuse and deterioration
6. Restriction of access to stores
7. Controls on stores environment (temperature, precautions against damp)
8. Control of stock levels
9. Maximum stock limits
10. Minimum stock limits
11. Maintenance of stock records
12. Stock ledgers
13. Bin cards
14. Transfer records
15. Arrangements for dealing with returnable containers
16. Security over stock held by third parties, and third party stock held by entity.
17. Stocktaking
18. Regular stocktaking
19. Fair coverage
20. Counts by independent persons
21. Recording
22. Cut-off for goods in transit and time differences
23. Reconciliation of stock counts to book records and control accounts
24. Computation of stock valuation

Accord with IAS 2

Checking of calculations

25. Review of condition of stock

    Treatment of slow-moving, damaged and obsolete stock

    Authorization of write-offs
26. Accounting for scrap and waste
27. Control considerations: cash at bank and in hand-receipt
28. Segregation of duties between the various functions listed below is particularly important.

(b) Receipts by post

1. Safeguard to prevent interception of mail between receipt and opening
2. Appointment of responsible person to supervise mail
3. Protection of cash and cheques (restrictive crossing)
4. Amounts received listed when post opened
5. Post stamped with date of receipt

Control over sales of and collections

1. Restrictions on receipt of cash (by cashiers only, or by salesmen etc)
2. Evidencing of receipt of cash
    - Serially numbered receipt forms
    - Cash registers incorporating sealed till rolls
3. Clearance of cash offices and registers
4. Agreement of cash collections with till rolls
5. Agreement of cash collections with banking and cash and sales records
6. Investigation of cash shortage and surpluses

Recording

1. Maintenance of records
2. Limitation of duties or receiving cashiers
3. Holiday arrangements

4. Giving and recording of receipts

- Retained copies
- Serially numbered receipt books
- Custody of receipt books
- Comparisons with cash records and bank paying in slips

Paying into bank

1. Daily banking
2. Make-up and comparison of paying-in-slips against initial receipt records and cashbook
3. Banking of receipts intact/control of disbursements

Cash and bank balances

1. Restrictions on opening new bank accounts
2. Limitations on cash floats held
3. Restrictions on payments out of cash received
4. Restrictions on access to cash registers and offices'
5. Independent checks on cash floats
6. Surprise cash counts
7. Custody of cash outside office hours
8. Safeguarding of IOUs, cash in transit
9. Insurance arrangements
10. Control of funds held in trust for employees
11. Bank reconciliation's.

- Issue of bank reconciliation's
- Frequency of reconciliation's by independent person
- Reconciliation procedures
- Treatment of longstanding unpresented cheques
- Stop payment notice
- Sequence of cheque numbers
- Comparison with cashbooks.

Question three

Managing Director,

Tropical Garments Ltd.,

P.O. Box 2411 K.N.H., 00202

Nairobi.

Dear Sir,

Re: <u>RECOMMENDATIONS FOR A SUITABLE SYSTEM OVER THE PAYMENT OF WEEKLY WAGES</u>

Following your request for a new payroll system internal control, we have the pleasure of submitting our recommendations:

We have taken into consideration the control already set and the financial position of the company to ensure that our recommendations are simple, efficient and effective in their implementation.

The recommendations cover the following areas:

(i) The hire and dismissal of employees

(ii) The recording of attendance and job time by use of the clock card and time sheets

(iii) The reparation of the payroll including checking the hours worked, calculation of gross pay and net pay.

(iv) Authorization and approval of the payroll

(v) Signing of the pay check

(vi) Distribution of the money during the payout parade

(vii) Dealing with unclaimed wages

(viii) Dealing with dummy employees

The above components of the internal control system will ensure that the payments of weekly wages objectives are achieved.

Specific Control Procedures include:

- There should be written authorization to employ or dismiss any employee, in accordance with company procedures and legal requirements.
- Changes in rates of pay or salary should be authorized in writing by an official outside the wages department. This may be through a standard form for authorization of changes to payroll details.
- Overtime worked should be authorized by the works manager or employee's manager or someone outside of payroll and be in accordance with company procedures. Some staff may not be entitled to overtime because of their level or type of employment and therefore appropriate mechanisms for ensuring only authorized staff receive overtime.
- An independent official should check the payroll and sign it.
- The wages cheque should be signed by two signatories evidenced against the signed payroll. Cheques should have two signatories and should be checked against an approved payroll entry.
- Where pay relates to hours at work, some form of time recording should be used for example; time keys, automatic entry swipe card systems or other clock cards should be used. There should be supervision of the time recording systems or cards and the timing devices, particularly when employees are clocking on or off. There is a clear risk that staff can manipulate systems to obtain additional hours and therefore additional payments. This could include getting other staff to clock in or out for them. The manager or supervisor should know the hours worked by staff and check outputs to ensure that expected and actual hours tally.
- When employees have been absent for a significant period their entitlement to salary should be checked against personnel details.
- Personnel records should be kept for each employee giving details of engagement, retirement, dismissal or resignation, rates of pay, holidays etc., with a specimen signature of the employee.
- A wages supervisor should be appointed who could perform some of the authorization duties listed above.

Prompt recording and arithmetical accuracy

- Payroll should be prepared from clock cards, job cards etc., and a sample checked for accuracy against current rates of pay.
- Payroll details should provide for the accurate calculation of deductions such as tax, social insurance, pensions and other approved deductions, which should be checked periodically.

Access to assets and records

- Employees should sign for their wages
- No employees should be allowed to take the wages of another employee
- When wages are claimed late, the employee should sign for the wage packet and the release of the packet should be authorized.
- The system should preferably allow the wages to be checked by the employee before the packet is opened, by using specially designed wages packets.
- The duties of the wages staff should preferably be rotated during the year, and ensure that no employee is responsible for all the functions in respect of any particular department.
- The employee making up the pay packets should not be the employee who prepares the payroll.
- A surprise attendance at the pay-out should be made periodically by an independent official.
- Unclaimed wages should be recorded in a register and held by someone outside the wages department until claimed or until a predefined period after which he money should be re-banked. An official should investigate the reason or unclaimed wages as soon as possible.

Control accounts

- Control accounts should be maintained in respect of each of the deductions showing amounts paid periodically to the tax authorities etc.

- Overall checks should be carried out to highlight major discrepancies e.g. check against budgets, changes in amounts paid over a period of time, check against personnel records.

- Management should exercise overall control.

- The above categorization is based on the list of types of controls included in ISA 400 Risk Assessment and Internal Control. The following parts of this section illustrate controls expected in other major areas. These are not classified by type.

Tutorial Note:

Try generating a couple of these areas yourself then review the controls suggested. There is no necessity to learn these lists but you should practice the technique to generate them, and use the rest of the section for reference.

Control procedures – Salaries

- Personnel records should be kept similar to those for hourly paid employees.
- Written authority should be required to employ or dismiss an employee or change salary rate.
- Overtime should be authorized by someone outside the payroll department.
- The usual checks on deductions are required.
- When employees have been absent for a significant period their entitlement to salary should be checked against personnel details.
- Cheques should have two signatories and should be checked against an approved payroll entry.

We look forward to discussing the above controls to evaluate the feasibility of the above recommended controls. Thank you.

Kamau and Company

Certified Public Accountants

CHAPTER THREE

Question one

a) Changes to be made at the interim audit:

(i) The timetable for the audit will be considered for it applicability in view of the fact that more substantive procedures will be undertaken. Significant dates in the timetable include, the date of the AGM, the date when the directors sign the financial statements, the period of the final audit, stock take dates

(ii) A visit will be made to the company prior to any detailed work to meet the directors to make them aware of the fact that the controls are not operating effectively. I will show them the revised timetable to ensure that they understand the need for the changes and schedule the role of the clients staff in areas such as bank reconciliations, suppliers statements, doubtful debt schedules and fixed asset movements.

(iii) Ascertain early in the process key changes in accounting personnel

(iv) Resolve previous years problems

(v) The introduction of any new standards will be considered.

(vi) I will assess the level of experience required in this audit which can be described as being risky.

(vii) Specify the materiality levels at slightly lower levels compared with the preliminary materiality levels in view of the ineffective controls.

(viii) Prepare a detailed audit planning memorandum including moist of the issues mentioned above.

(ix) Discuss the above issues with the partner responsible for the audit.

b) Changes to the audit plan at the final audit

a. During the final audit the impact of the ineffective controls will be mainly to emphasize on substantive procedures, increase samples and lower materiality levels.

b. I will attend the stock take since this is likely to a material figure in the accounts and is likely to be affected by the weak controls. Issues to be taken care of include existence, ownership and valuation.

c. The audit procedures and the results will be recorded in sufficient details to ensure that all work done, matters considered, and the conclusions reached have been recorded.

d. Similarly to what happens during the interim audit level of quality control will, be very strict.

e. Work will be allocated to staff according to their abilities and all work will be reviewed by senior staff.

f. For the partners review, I will prepare a detailed memorandum which will include:

g. A summary of the financial statements and rations

h. Summary of work done including material items in the financial statements and in areas of high audit risk.

i. A list of all significance errors and suspected fraud

List of matters to be discussed with company directors and suggested adjustments

Question two

There has been much debate recently about the issue of auditor independence. Independence is something that is both a matter of fact and appearance. It is important to be independent and it is also important to appear to the independent. In recent years auditing firms have seen auditing at most as a loss leader, giving access to a client so that the client can be sold all manner of additional services, all of which are the really lucrative ones for the audit firm as a whole. Financial disasters of Enron and world com have concentrated the collective professional minds on how to deal with the issues which have been highlighted by these cases.

Our principles of independence include;

- An auditor may not have a mutual or conflicting interest with the client.
- An auditor may not audit his own firm's work
- An auditor may not function as management or as an employee of the audit client.
- An auditor may not act as an advocate for the audit client.
- To ensure both independence and the appearance of independence, rules have been set out in the professional bodies, ethical codes (ICPAK).

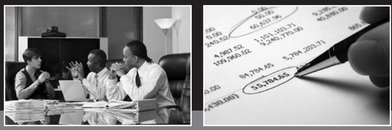
The following are the major threats to the audits firms' independence;

The imitation for the audit firm to tender for the provision of internal audit function. This impairs the ability of the audit firm to comprehensively assess has the tendering process was carried out, since is an interested party.

By undertaking to provide the internal audit, it will almost be akin to the auditor performing management functions and this will limit the ability of the firm to objectively carry out the external audit.

The audit firm, since it is also provides other consultancy work to D Ltd, the income derived from the firm could exceed the ceiling recommended by the accounting professional body and thus impair the independence of the audit firm.

Insider dealing which is illegal is likely to be practiced by the audit firm. D ltd is a company that is quoted in the stock exchange. The auditors in the course of their work come across unpublished price sensitive information are prohibited from dealing in the shares to which that information relates. Unpublished price sensitive information covers specific matters not generally known to hose who normally deal on the stock exchange but which if it were known to them would alter the price of those securities to which the information relates. The auditors of the company are often in possession of insider information. For example they know that the profit is Ksh. 2 billion when the market is expecting only Sh 900 million. They could take advantage of this information by buying the shares in the company on the expectation of a rise in the price when the accounts are published.



These threats can be resolved as follows;

- The audit firm should ensure that the amount of fees received from client does not exceed the limit imposed, so then it may consider not withstanding some of the non-audit services.
- The provision of internal audit services should not be undertaken by the audit firm, rather could recommend for a different firm to provide such services.
- Insider dealing can be dealt with by simply prohibiting staff of the audit firm from holding shares in the client company, and compliance to this should be enforced the audit firm.

Question three

(a) BCD Stores Ltd is a high risk audit client in view of the problems associated with

i) Inventory misappropriation by employees and customers

ii) Slow moving and damaged goods, work less than cost.

iii) Incomplete recording of sales when customers pay by cash

The above are areas of high audit risk and as the manager responsible for the audit, I would consider the following matters and carry out the necessary audit work before the commencement of detailed audit work;

Matters to be considered;

i) The significance and materiality of the audit risk areas

ii) The relevance of the knowledge gained in previous audits and whether any changes have occurred that may affect the relevance of the information to the current audit

iii) Since BCD has high audit risk areas, I will consider the following logistical issues

- Staffing of the audit – level of qualification, relationship with audit staff, availability, special correct level of experience
- Client management
- Locations of the client considering distance to be travelled by audit staff, mobility, determine which location to visit, staff allocations.
- Deadlines, considering the key dates which the audit team will need to know such as date of inventory count, main audit visit, reviews by managers, draft accounts, date when audit report is signed and date of AGM.

iv) Consider the use of information technology

v) Consider time budgets

vi) Consider other objectives of the audit in addition to the expression of an opinion.

The audit work to be carried out includes;

i) Review client acceptance and continuance relationships and for this specific audit engagements and ethical clearance.

ii) Determine adequate staffing of this audit assignment

iii) Hold meetings to discuss the risk of material misstatement in the areas of risk and its implications for the financial statements.

iv) Determine an appropriate audit strategy. In this audit, a combination of tests of control and extensive substantive testing will be required

v) Review stock taking instructions by the client for adequacy, staffing of the stock take and recommend changes as appropriate.

vi) Review stock taking procedures for identifying obsolete and damaged stock

vii) Discuss with the client and the audit staff to agree on timings for interim vist, final visit and stock take data.

viii) Allocate adequate resources for this audit

ix) Prepare the overall audit strategy and audit plan, document it and communicate with the relevant audit staff

x) Review the internal audit, and decide whether to rely on its work.

Procedures to be carried out to control the audit

ii) Communication to the audit staff of the engagement details and ensuring that all logistical arrangements are complete

iii) Ensure that staff follows the detailed audit plans especially in the high audit risk areas.

iv) Review the audit plans and the ICE and ICQs for completion

v) Consult as necessary with the engagement partner and the clients' management in case of any difficulties.

vi) Ensure that stock taking instructions are followed, be present at some locations during the stock take and ensure that I test the stock sheets for accuracy.

vii) Review the work done by the internal audit department if we decided to rely on it.

viii) Ensure that deadlines are being met and if not, consult with the client and engagement partner.

CHAPTER FOUR

Question one

The Directors

Kenya Computer Sales Ltd.

P.O. Box 12345 004000

Nairobi

Dear Sirs

Re: INTERIM MANAGEMENT LETTER

1.0 **INTRODUCTION**

In accordance with our normal practice we wish to bring to your attention certain matters that have come to our attention during our interim audit visit. These do not represent an exhaustive list of all weaknesses that may exist in the systems of accounting and internal controls.

Our report is a draft report and we hope that you will review it and append your management comments to enable us to finalise our report.

2.0 The issue we came across, implications and our recommendations for improvement

2.1 **Credit limits**

We noted that the credit limits for four customers have been substantially exceeded and that new customers in the last twelve months had not been allocated credit limits.

Enforcing credit limits reduces the incidence of bad debts. Conversely when credit limits are exceeded or not established the company's liquidity position is adversely affected.

We recommend that credit limits be carefully established and then once established they should be enforced. When necessary that the limits be revised then proper formalities should be followed and the extension be approved by senior management.

Management comment:

2.2 **Purchases invoices**

We came across a situation where an invoice from a supplier had been posted twice to the suppliers ledger card.

We also were unable trace two other purchase invoices that had been credited to suppliers accounts.

These discoveries raise the possibility that there a fictitious charges and invoices being introduced into the system. The company runs the risk of paying for services or goods not received not ordered for

We recommend that for the acquisition of goods there must e raised a purchase order, when the invoice is received it must be checked against the purchase order and the goods received note before it is entered into the records. All invoices should be validated before payment and the cheque should be supported by invoices. All claims that cannot be supported by invoices should be rejected for payment.

Management comment:

2.3 **Missing stock items**

We attended the half year stock take and the following discrepancies came to our attention

(a) Some microcomputers that were supposed to be in stock were missing and

(b) Some microcomputers returned by customers and in stock had not been recorded as retuned

(c) Some of the missing computers had been borrowed by the directors and some other staff for personal use at home.

The clear risks that arise include the overstatement of sales if the computers were returned and the related invoices had not been reversed. Also the stocks would be materially misstated because items that should be in stock are actually being used by staff. Furthermore the stocks or which no record exists could then be misappropriated and sold, thereby the company suffering more loss.

We recommend that the company puts in place proper measures to protect the stocks from misuse and other deterioration. The company should maintain full stock records so that the movements of all stock items are closely monitored to guarantee proper use of the company's resources.

Management comment

2.4 **Leasing agreements**

The Kenya Revenue Authority have queried the terms of the lease agreements. In their view these are hire purchase agreements since the customers have the right to purchase the equipment at a future date. We have vetted these agreements in the past and agreed with your treatment. Our position has not changed and we shall take it up with the Kenya Revenue Authority.

The risk is that additional assessments may be raised by the Kenya Revenue Authority.

We recommend that the chief accountant immediately commence an analysis exercise of the position depending on the two different scenarios. In this way we will be able to assess the exposure.

Management Comment

3.0 **Conclusion**

These are the weaknesses that came to our attention. There may be other weaknesses that we did not detect. We request that you critically consider these points and append your comment where indicated on the draft.

Having incorporated your comments we will then release the letter formally.

Should you require any clarification please do not hesitate to contact us.

Yours truly

Turn & Feya

Certified Public Accountants (Kenya)

(b) The possible impact these matters may have on the year end work

(i) The concern over credit limits being exceeded or not fully enforced means that audit effort must focus on the adequacy of the provision for bad and doubtful debt at the year end audit visit as well considering the company's overall financial position, particularly insolvency.

(ii) Creditors could be materially overstated having non-genuine liabilities recognized. The existence of creditors will be an area of audit focus at the year end visit

(iii) The valuation and existence of stocks at the year end will be key areas of audit.

(iv) The potential exposure to additional assessments will be of concern to the auditors. If possible all efforts should be made to resolve the matter before the year end so that any outstanding matters can be considered.

Question two

(a) Respective responsibilities of directors and management of a company and its external auditors with respect to financial statements.

ISA 200, explains the respective responsibilities.

The responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity with oversight from those charged with governance.

The auditor is responsible for forming and expressing an opinion on the financial statements.

The audit of financial statements does not relieve management or those charged with governance their responsibility.

(b) The inherent limitations facing auditors in undertaking their work;

The inherent limitations in an audit of financial statements that affect the auditor ability to detect material misstatements include:-

vi) The use of testing

vii) The inherent limitations of internal control (for example, the possibility of management override or collusion)

viii) The fact that most audit evidence is persuasive rather than conclusive

ix) The work is also permeated by judgment

x) Assessing the reliability of estimates made by management

(a) Significant types of judgments made by auditors in:

v) Gathering audit evidence

The work undertaken by the auditor to form an audit opinion is permeated by judgment in particular regarding the gathering of audit evidence, for example in deciding the nature, extent and timing of audit procedures. Also the drawing of conclusions based on the audit evidence gathered for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

vi) Arriving at an opinion in the financial statements

In expressing an audit opinion, the auditor provides uses of financial statements with reasonable assurance that the financial statements are free from material misstatements. In other words, the engagement risk has been minimized to acceptable level. It implies that sufficient appropriate audit evidence has been obtained.

The auditor makes judgments regarding matters affecting or not affecting his audit opinion and also decides on the appropriate forms of the report.

He also considers compliance with laws to satisfy regulatory requirements in a given jurisdiction.

Question three

Preliminary Considerations

Acceptance of Engagement

The International Standard on Assurance Engagements no. 3400 states that before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- The intended use of the information;
- Whether the information will be for general or limited distribution;
- The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions;
- The elements to be included in the information; and
- The period covered by the information.

ISA 3400 adds that the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

(b) The main points to be considered in conducting the review

(i) **Nature and background of the company's business**
Establish its activities, products, customers, markets, labour force, prospects, and the trends of its financial results.

(ii) **Accounting polices**
Establish the accounting policies adopted for interim and final accounts and forecasts. Ensure that they are reasonable and are consistently followed especially in the forecasts. Special areas to be watched include stock and work in progress valuations, depreciation, the method of taking profit on long term contracts, exceptional and extraordinary items and deferred tax.

(iii) **The assumptions**
- These should be stated
- The forecast should be consistent with the assumptions which may be economic (e.g. growth in G.N.P.), financial (e.g. interest rate movement), marketing (e.g. market share), industrial (e.g. output potential), labour relations (e.g. strike free periods) etc.

The accountant is not concerned with the correctness of these assumptions although he should be sure the directors are responsible for them and that they are reported on by the advisers.

(iv) The procedures adopted by the company to prepare the forecasts

The accountant should investigate:

- Whether forecasts are regularly prepared for management or prepared only for this occasion
- Whither the recasts are best estimates, honestly believed to be achievable, or simply targets
- The extent to which forecasts for wholly or partly expired periods are covered by reliable interim accounts.
- The extent to which the forecasts are built up form detailed divisional or activity based sectional accounts, distinguishing those woith steady performance foam those with more volatile results
- The treatment of material, extraordinary, and exceptional items
- The adequacy of provisions for future losses and contingencies

- The adequacy of working capital. If finance will be required to fulfill the forecast, this should have been arranged and confirmed.

The report

This will be addressed to the directors and will contain:

(i) A statement that the reporting accountants have carried out a review of the accounting bases and calculations on which the profit forecasts have been based.

(ii) Specific identification of the forecasts and documents to which the report refers.

(iii) If, as likely, the accountant have not carried out an audit of the results of expired periods, a statement to that effect.

(iv) Whether in the opinion of the reporting accountants the forecasts have been properly compiled on the basis of the assumptions made by the Board of Directors, as set out in the prospectus or circular, and are presented on a basis consistent with the accounting practices normally adopted by the company.

(v) If the accountant has material reservations about any part of the forecast they should qualify their report.

c. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information, or withdraw from the engagement.

CHAPTER FIVE

Question one

Tutorial Note: This question deals with the audit of stocks

(i) Audit procedures to verify the accuracy of the inventory count.

(ii) Before the inventory count.

(iii) On the day of the inventory count.

(b)

(i) Request for the schedule and check its arithmetical accuracy

(ii) Take a sample of the stock sheets and evaluate the accuracy

(iii) Select a random sample of the goods received on the same day

(iv) Evaluate the reasonable of the overhead allocation and the basis

(v) Request a schedule for production labour and their work areas to ensure that non production labour is not include

(vi) Request a letter of representation

(c) **Purchases cut off procedures**

The procedures applied by the auditor will be designated to ascertain whether:

(i) Goods received for which no invoice has been received or accrued;

(ii) Goods received which have been invoiced but not yet posted are accrued; and

(iii) Goods returned to suppliers prior to the year end are excluded from stock and trade creditors.

At the year end stock take the auditor will have made a note of the last serial numbers of goods received notes. Suggested substantive procedures are as follows:

(a) Check from goods received notes with serial numbers before the year end to ensure that invoices are either

(i) Posted to purchase ledger prior to the year end; or

(ii) Included on the schedule of accruals

(b) Review the schedule of accruals to ensure that goods received after the year end are not accrued

(c) Check from goods returned notes prior to year end to ensure that credit notes have been posted to the purchase ledger prior to the year end or accrued

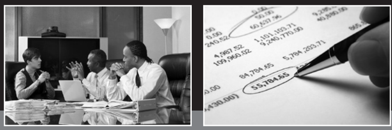
(d) Review large invoices and credit notes included after the yearend to ensure that they refer to the following year

(e) Reconcile daily batch invoice totals, around year end to purchase ledger control ensuring batches are posted in the correct year.

(f) Review the control account around the year end for any unusual items.

Evidence of completeness, existence and ownership – credit circularization

We have established that the verification of trade debtors by direct communication is virtually a standard procedure. Is it therefore also standard procedure to carry out a creditor circularization? The answer is qualified 'No'. The principal reason for this lies in the nature of the purchase cycle



– third party evidence in the form of suppliers' invoices and even more significantly suppliers' statements are part of the standard documentation of the cycle. He auditor will hence concentrate on these documents when designing and conducting his test to gain assurance in respect of objective – Do trade creditors represent bonafide amounts due to the company.

In the following circumstances the auditor may, however, determine that a circularization is necessary

(i) Where suppliers statements are, for whatever reason, unavailable or incomplete.

(ii) Where weaknesses in internal control or the nature of the client's business make possible a material misstatement of liabilities that would not otherwise be picked up

(iii) Where it is thought that the client is deliberately trying to understate creditors

(iv) Where the accountants appear to be irregular or if the nature or size of balance transactions is abnormal.

In these cases confirmation requests should be sent out and processed in a similar way to the debtors' confirmation requests described above. 'Positive' requests will be the order of the day in these circumstances.

In normal circumstances the following substantive procedures based on accounting records and documentation maintained and retained by the company will be performed:

(i) Select from the trade creditors listing and check to supporting documentation (invoices, goods received notes, purchase orders, etc.)that the purchase was for the purpose of the business.

(ii) Reconcile a sample of purchase ledger balances with suppliers' statements

(iii) Review balances for unusually low balances with major suppliers

(iv) Compare ratio of trade creditors to purchases with previous year's figures.

(v) Compare ratio of trade creditors to stock with previous year's figures.

(vi) Verify reasonableness of deductions from liability figures (e.g. discounts) by reference to subsequent events.

(vii) Ascertain reasons for significant debit balances.

Question two

Principal business risks

(i) Communication industry – Rapid and new technological developments in the industry, providing faster rate transmission and increasingly interactive capacities, will render certain existing products and services obsolete.

(ii) KMC cannot predict how emerging and future technologies (e.g. cordless technologies such as “blue tooth” will affect demand for its services.

(iii) Competition – Although KMC may have reduced competition in the short-term by having acquired a competitor, he communications market is still expanding. Increasing competition from other existing and new competitors offering new technologies could:

- Affect KMC’s ability to attract and retain customers.
- Reduce KMC’S share of new customers.
- Force KMC to reduce prices

The cost (and revenue-generating capabilities) of new technologies tends to full significantly and relatively quickly (e.g. mobile phone technology is now available in disposable form.

Integration

Combining two groups which have previously operated independently (and competitively against each other) is likely to result in disruption. Potential difficulties may be encountered in seeking to retain customers and key personnel.

The anticipated significant synergies (in revenue, cost and capital expenditure) may have been optimistic. If they do not materialize to the extent predicted. KMC’s operational activities, financial condition and future prospects are likely to be adversely affected.

Sustaining growth

Growth may not be sustainable as further expansion will incur significant costs and investment which must be financed. The significant costs expected to be incurred in upgrading networks may not be recouped if additional revenues are insufficient. Failure to maintain existing networks is likely to result in a loss of customers and market share.

If KMC’s financial resources are insufficient to meet the operating losses it may need to issue equity and/or increase its debt.

Possible adverse consequences of increasing indebtness include:-

High debt – service costs

- Operating and financial restrictions being imposed by lenders.
- Difficulty in obtaining further finance in the future.
- Being unable to take advantage of business opportunities.
- Reduction in ratings

Countries of operation

Operations have been expanded from Kenya to Uganda. KMC’s inexperience of economic and legal developments in Uganda may impair the investment in Uganda communications.

Foreign exchange rates

KMC transacts business in two countries and foreign exchange rate fluctuations could have a material adverse effect on operation results.

Highly regulated market

Network operations could be adversely affected by changes in the laws, regulations or government policies which regulate the industry, in this case the communications commission of Kenya (CCK).

Difficulties in obtaining approvals for the erection and operation of transmitters could have an adverse effect on the extent, quality and capacity of KMC's network coverage.

Impact of acquisition on planning

Group structure

The new group structure must be ascertained to identify the entities which will be consolidated in the group-financial statements of KMC or he year ending 31st October 2007.

Materiality assessment

Preliminary materiality will be much higher in monetary terms, than in t6he prior year. For example, if a % of turnover is a determinant of preliminary materiality, it will increase by 53% based on estimate.

"Profit" is not a suitable option as group is loss-making the materiality of each subsidiary should be assessed, in terms of the enlarged group as at the planning stage. For example, any subsidiary contributing more that 10% of the group's assets and turnover (but no result) is material and less that 5% (say) is not. This will identify, for example those entities which will require an audit visit and those for which analytical procedures may suffice.

If FC and VC are particularly material to the group, Mwihaki Kang'ethe and Associates may plan (provisionally) to visit FC's and UC's auditors to discuss any problems shown to arise in their audit work.

Goodwill arising

The audit plan should draw attention to the need to audit the amount of goodwill arising on the acquisitions and the period over which is to be amortized.

The assets and liabilities of FC and UC, at fair value to the group, will be combined on one line-by-line basis and any goodwill arising recognized. The calculation of the amount attributed to goodwill must be agreed o the excess of the cost of the acquisition over the fair value of the identifiable assets and liabilities existing at the date of acquisition (FC – May 2007, UC – October 2007).

Significant fixed assets such as properties are likely to have been independently valued prior to the acquisition. It may be appropriate to place reliance on the work of expert valuers.

Group (related party) transactions and balances

List of all the companies in the group (including any associates) could be included in group audit instructions to ensure that inter-group transactions and balances (and any unrealized profits and asses on transactions with associates) are identified for elimination on consolidation.

It should be confirmed at the planning stage that inter company transactions are identified as such in the accounting systems of all KMC companies and that inter company balances are regularly reconciled. (Problems are likely to arise if new inter company balances are not identified/reconciled. In particular, exchange differences are to be expected).

On analytical procedures

Saving brought in the operations of a group of companies with similar activities may extend the scope of analytical procedures available. It could have the effect of increasing audit efficiency

UC on income statement

The effective date of the acquisition of UC may be too late in the financial years (only 4 weeks, before the year end) that it is possible that its post-acquisition results are not material to the consolidated income statement.

Other auditors

Other auditors will include:-

Any affiliates of Mwihaki Kang'ethe and Associates in any of the countries in which KMC (as combined with FC) operates, and the unrelated auditors (of UC)

Mwihaki Kang'ethe Associated will plan to use the work of UC's auditors. Their competence and independence should be assessed (e.g. through information obtained from a questionnaire and evidence of their work)

Letter introduction should be sent to the unrelated auditors, with KMC's permission, as soon as possible (if not already done) e.g. testing their co-operation in providing specified information within a given timescale.

Accounting policies (FC and UC)

Whilst it is likely hat FC has the same accounting policies as KMC (because, as a competitor, it operates in eh same jurisdictions). UC may have material accounting policies which do not comply with the rest of the group. Mwihaki Kang'ethe may request that UC's auditors calculate the effect of any non-compliance with a group accounting policy for adjustment on consolidation.

Use of analytical procedures

At the planning stage

Analytical procedures must be used at this stage (sometimes called preliminary analytical review).

Mwihaki Kang'ethe's knowledge and understanding of KMC's business will be assisted by the accumulation of information. For example the 49% increase in revenue should be commensurate with the purchase of the FC group.

Analytical procedures can also be used to identify areas of potential business ands audit risk for example;

Although the 56% increase in cost of sales is in line turnover, distribution and administrative costs have increased by nearly 22% and 32% respectively. If KMC is not realizing the cost benefits, this is a business risk. Mwihaki can use analytical procedures to assist in determining the nature, timing and extent of other audit procedures (i.e. audit strategy are example; Mwihaki might expect a high degree of disaggregatation is available information (e.g. between the KMC and FC companies). A retailed review of gross profit margins by Uganda may highlight those which require detailed substantive procedures (tests of details).

As substantive procedures

Analytical procedures at this stage are optional. They are based on the expectation that relationships which are known to exist may be expected to continue in the absence of clear evidence to the contrary. For example, the relationship between gross profit and sales avenue may be expected to remain constant unless there are changes in sales prices, sales mix and/or cost structure.

Analytical procedure can themselves provide sufficient audit evidence where an item. For example Mwihaki may be able to substantiate the finance cost using a (brief in total) or (reasonable test). The mechanics of this are that the expected value of the population is:-

Calculated using base data (e.g. outstanding debt and % costs of debt), which has been confirmed to be materially correct; and compared with recorded value.

Any difference is not expected to be material Mwihaki may find even such simple models to be very effective.

Trend analysis (i.e. the comparison of current data prior periods may be particularly useful for analyzing income (e.g. monthly revenue by customer type and market). Mwihaki might expect that trends in the combined KMC and FC are similar whilst those in UC might be very different (e.g. because market penetration and growth may be less rapid).

At the review stage

Analytical review at this stage is required in forming an overall inclusion as to whether the financial statements as a whole are consistent with Mwihaki knowledge of the substitutive procedures. Ratio analysis is particularly useful in testing the consistency of the inter-relationship of amounts disclosed in the financial statements is usual to compare ratios calculated at this stage with those of the preliminary analytical review.

CHAPTER SIX

Question one

a) International Accounting Standard (IAS) 1, "Presentation of Financial Statements" paragraphs 23 and 24 state: "When preparing financial statements, management should make an assessment of an enterprise's ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reasons why the enterprise is not considered to be a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate can be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the enterprise's ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the ISA's, the phrase "significant uncertainties" is used in similar circumstances.

The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may be set out in accounting standards, legislation or regulation.

b) In planning the audit, the auditor should consider whether there are events or conditions which may cast significant doubt on the entity's ability to continue as a going concern. The auditor should remain alert for evidence of events or conditions which may cast significant doubt on the entity's ability to continue as a going concern throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures in paragraph 26, consider whether they affect the auditor's assessments of the components of audit risk.

The auditor should evaluate management's assessment of the entity's ability to continue as a going concern.

The auditor should consider the same period as that used by management in making its assessment under the financial reporting framework. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.

The auditor should inquire of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern.

When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:

(a) Review management's plans for future actions based on its going concern assessment;

(b) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and

(c) Seek written representations from management regarding its plans for future action.

Procedures that are relevant in this regard may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.

- Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.

- Considering the entity's plans to deal with unfilled customer orders.

- Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

When analysis of cash flow is a significant factor in considering the future outcome of events or conditions the auditor considers:

(a) The reliability of the entity's system for generating such information; and

(b) Whether there is adequate support for the assumptions underlying the forecast.

In addition the auditor compares:

(a) The prospective financial information for recent prior periods with historical results; and

(b) The prospective financial information for the current period with results achieved to date.

c) Examples of events or conditions, which individually or collectively, may cast significant doubt about the going concern assumption, are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty3 exists.

Financial

- Net liability or net current liability position. DITING
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.

- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labor difficulties or shortages of important supplies.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

d) The current requirements are mainly passive and the interests of all stakeholders would be better served by making the auditor proactive in dealing with going concern issues. The auditor should be required to participate actively.
The procedures should be dictated by statute so that the auditor will have no alternative but to deal with the issue.

Question two

a) Changes to be made at the interim audit:

(i) The timetable for the audit will be considered for it applicability in view of the fact that more substantive procedures will be undertaken. Significant dates in the timetable include, the date of the AGM, the date when the directors sign the financial statements, the period of the final audit, stock take dates

(ii) A visit will be made to the company prior to any detailed work to meet the directors to make them aware of the fact that the controls are not operating effectively. I will show them the revised timetable to ensure that they understand the need for the changes and schedule the role of the clients staff in areas such as bank reconciliations, suppliers statements, doubtful debt schedules and fixed asset movements.

(iii) Ascertain early in the process key changes in accounting personnel

(iv) Resolve previous years problems
(v) The introduction of any new standards will be considered.
(vi) I will assess the level of experience required in this audit which can be described as being risky.
(vii) Specify the materiality levels at slightly lower levels compared with the preliminary materiality levels in view of the ineffective controls.
(viii) Prepare a detailed audit planning memorandum including moist of the issues mentioned above.
(ix) Discuss the above issues with the partner responsible for the audit.

b) Changes to the audit plan at the final audit

(i) During the final audit the impact of the ineffective controls will be mainly to emphasize on substantive procedures, increase samples and lower materiality levels.

(ii) I will attend the stock take since this is likely to a material figure in the accounts and is likely to be affected by the weak controls. Issues to be taken care of include existence, ownership and valuation.

(iii) The audit procedures and the results will be recorded in sufficient details to ensure that all work done, matters considered, and the conclusions reached have been recorded.

(iv) Similarly to what happens during the interim audit level of quality control will, be very strict.

(v) Work will be allocated to staff according to their abilities and all work will be reviewed by senior staff.

(vi) For the partners review, I will prepare a detailed memorandum which will include:

(vii) A summary of the financial statements and rations

(viii) Summary of work done including material items in the financial statements and in areas of high audit risk.

(ix) A list of all significance errors and suspected fraud.

CHAPTER SEVEN

Question one

INSURANCE CLAIMS

Tutorial Note: this is a question on review engagement which auditors are frequently called upon to undertake as an assurance service. In answering you need to display knowledge of required *steps in undertaking this type of assignments as well as the ability to relate to the scenario given.)*

As a background, I have given detailed notes on how insurance claims are computed and the type of evidence the auditor would require. This answer for part a is too detailed even for the best prepared student. A tabular approach would be ideal.

An insurance contract may be defined as a contract whereby, a person or a company (the insurer) agrees, in return for a premium, to pay a sum of money to a person or company (the insured) on the happening of a certain event or to indemnify the insured party against loss caused by risk insured against.

Claims for loss of stock

When a fire breaks out, it destroys a number of assets such as buildings, machinery, furniture, stocks etc. These may e insured to reduce financial difficulties of the organization suffering from the loss.

The books of account maintain accounts of all assets except usually the stock-in-trade. This therefore required estimation as to the amount at hand. This therefore requires estimation as to the amount at hand at the date of fire; and thus us accomplished using:

1. Gross profit margin/mark up for previous years adjusted for known changes
2. Records of sales (or transactions with debtors) up to date of fire
3. Records of purchases (or transactions with creditors) up to date of fire.

A memorandum of trading account is drawn in which the period covered is from the first day of the financial year to the last day i.e. the date of fire. The closing stock will therefore be the stock existing at the date of fire, if all other information apart from closing stock (e.g. sales, purchases, etc) is available for the financial period ending on the date of fire, then the closing stock may be worked out as the missing entry using appropriate margins.

Consequential loss (or loss of profits)

When a fire occurs, it destroys or seriously affects the capacity of the firm to do business until its properties are restores. In ability to produce and sell thus results in:

(i) Loss of profit that could have been earned

(ii) Constant (standing) charges non-recovery

(iii) Increased cost of working such as renting other premises temporarily

These losses are called consequential loss. It is possible to take out an insurance policy to cover against consequential losses.

This requires that should a loss occur, a claim may be made, and such a claim will require computation, leading to an estimation of profit lost.

Profit normally depends on sales, and usually loss on profit is computed by ascertaining how much sales have suffered because of the fire. The following definitions are necessary:

1. Gross profit = Net Profit + Insured Standing Charges OR Sales

   If loss, Gross profit = Insured Standing Charges – Insured Standing Charge

   X Net Loss

   All Standing Charges

2. Net profit: This is the net trading profit (exclusive of all capital receipts and outlay properly chargeable to capital) resulting from the business of the insured at the premises after due provisions has been made for all standing and other charges including depreciation.

3. Insured Standing Charges: Charges that may be insured interest on debentures, loans mortgages and bank overdrafts and rent, rates and taxes, salaries to permanent staff, wages to skilled employees, director's fees, auditor's fees, traveling, license, insurance premiums, advertising and sundry unspecified standing charges (cannot exceed 5% of specified standing charges)

4. Indemnity period: The lower of

   (i) The period for which sales is below normal; and

   (ii) The period specified in the policy

   Indemnity period cannot surpass 12 months from date of fire.

5. Rate of gross profit: The rate of gross profit earned on the turnover during the financial year before the financial year in which the fire took place

6. Annual Turnover: The turnover during the 12 months immediately preceding the fire date.

7. Standard Turnover: The turnover in the period corresponding to indemnity period in the immediately preceding financial year.

Adjustment shall be made necessary to provide for the trend of the business and variations in or special circumstances affecting the business either before or after the damage, so that the adjusted figures shall represent, the results which, but for the fire, would have been obtained during the relative period after damage.

Turnover attained in 12 months just before the fire is called annual turnover.

Procedure for computation of claim:

1. Calculate the short sales by comparing sales made during abnormal period in the year of fire with the sales of the same period in the financial year immediately preceding the fire. It should be noted that:

   (a) Calculation of short sales is to be made for the period of dislocation due to fire or period of indemnity according to policy, whichever is less;

   (b) The sales last year may be adjusted up/down to consider trends, in business growth in arriving at short sales.

2. Calculate the rate of gross profit in the last financial (accounting) year preceding that of the fire. Calculations of gross profits margin for loss-of-profit policy is different from the normal rate of gross profit (Margin). For loss of profits it is computed as follows:

   = Net profit + Insured standing charges or Sales x 100

   * The net profit excludes income from investments etc.

3. Calculate the loss of profit on short sales by applying rate of profit (as computed in step 2) to the sales lost (as computed in step 1). This is the first amount that may be claimed from the insurance company.

4. Add to the lost profit (as per step 3) the increased cost of working:

   This is restricted to the lowest of:

   (i) The actual increased cost of working

   (ii) Gross profit on annual adjusted turnover x cost of working

   Gross profit as above + standing charges not insured

   (iii) Gross profit achieved due to increased cost of working

This is simply an application of the average clause to ensure all standing charges are insured. The following alternative formulas may be used:

5. Deduct the amount of expenses due to their being not incurred as a result of non-productive activity.

STUDY TEXT

1. The gross claim can now be subject to the average clause as follows

Gross claim x amount of policy
Gross profit on annual adjusted
turnover of 12 months
Immediately preceding fire.

Notes to the steps in computation

(a) Annual adjustment turnover means the sales for the 12 months ending on the date of the fire adjusted for known charges. If before the date if the fire,

(i) Sales are 10% higher than in the previous year

(ii) Sales for the year ending on the date of the fire is Sh.500,000

Then, the annual turnover (adjusted) = 500,000 + (10/100 x 500,000)
= 550,000

(b) Gross profit here means the gross profit that would have been earned on the 12 months ending on the date of the fire.

(c) Any change in the basic working conditions giving rise to a change in the gross profit ratio should be taken into consideration. Suppose last year, the ratio was 25% but due to an increase in the wage rates it is expected to decline by 3%. The ratio should be taken to be 22%.

Therefore having obtained the claim for stock I would

(i) Compute the margins for the last five years, based on the audited accounts to 31 December 1999.

(ii) Determine that all other components except closing stock and gross profit for the trading period to 13 June 2000 are pout into the trading account.

(iii) Using an average margin if appropriate check the calculation of the gross profit

(iv) Check that the computerized balancing figure, which is the stock figure, is reasonable.

(b) ACCOUNTANTS CERTIFICATE

OMEGA FURNITURE LIMITED
CLAIM FOR LOSS OF PROFITS AND STOCKS

We have reviewed the enclosed claim for loss of profits and stocks resulting from the fire omega Furniture Ltd. suffered on 13 June 2002, which led to the closure of the company's business till November 2002 when it re-opened after rebuilding of the factory.

This claim is the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400 (or refer to relevant national standards or practices applicable to review engagements). This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and an analytical procedure applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying claim does not give a true and fair view in accordance with International Financial Reporting Accounting Standards.

Maungu & Co

Certified Public Accountants.

Nairobi

Kenya

Brief Reason for the wording of the report.

The choice of words mainly aims at informing the user of the review report that this is a moderate assurance engagement and therefore does offer the same level of assurance as an audit.

CHAPTER EIGHT

Question one

The reasons for completing disclosure checklist include

(a) Among the following

To ensure that all matters, significant that have not been included in the financial statement have been disclosed that the directors are aware of the inclusion of the disclosure which has been put and the resulting implications. It ensures that all assumptions are adequately disclosed.

The benefits that will result include;

The auditor will be assured that all matters material to the presentation of the financial statements are disclosed.

To resolve any dispute that may arise in the matter not presented in the financial statements but have been put a disclosures.

Analytical review consists of the analysis significant ratios and tends including the resulting investigation of functions and relationships that are inconsistent with other relevant information or which deviate from predictable amounts.

Analytical review are the analysis of relationships between items of financial and non financial data, deriving from he some period, or between comparable financial information patterns or significant fluctuations and unexpected relationships, and the results of investigations thereof the purpose of analytical review at the planning stage is:-

(a) To improve the auditor's understanding of the enterprise, and

(b) To identify areas where the recorded value varies from the auditor's expectations enabling him to direct resources accordingly.

(b) Matters that would be considered as part of a going review include:

A Ltd's turnover for the year ended 30 June 2007 is quite substantial at Sh. 20 billion

- There was a net profit of Sh 1.7 billion which that A Ltd is profitable and can still continue operating.
- The maximum figure as indicated by the tax specialist as liability that could be payable represents 10% of the turnover, in case of any eventuality this can be paid for.
- The directors willingness to make further disclosures on the tax inquiry indicates that they are ready to face any eventuality that may arise out o the inquiry.

In respect to A Ltd an unqualified audit opinion will be given, but with an explanatory paragraph in the audit report all be given. This is so because it is not possible to reach an objective conclusion as to the outcome of a situation due to the circumstances themselves.

In respect to B Ltd, a qualified opinion with an "except for" non-pervasive material disagreement opinion. The circumstances giving rise to the disagreement being:

Disagreement as to the manner or extent of disclosure of facts or amounts and departure from acceptable accounting practices.

In respect tp C Ltd, a qualified opinion due to a limitation on the auditor to be able to attend this stock take exercise. This is a limitation of scope which is outside the control of the auditors or the directors because of the travel restrictions if it is not possible for the auditors to attend the overseas distribution centre stock take.

In respect of A Ltd the auditor will give an unqualified opinion if the disclosure of the tax liability is adequately disclosed by the directors.

In respect to B Ltd, the qualification of the audit report will depend on whether the trustees of the charity will agree with he audit changes recommended to ensure that the income statement presents the true state of affairs, i.e. reduction of the expenses by the amount included for purchase of freehold property.

In respect to C Ltd if as a result of his investigations, the auditor is unable to substantiate the stock holding at the country how will have to consider qualifying his report on the grounds of uncertainty as he has not obtained all the information and explanations as he considers necessary (i.e. a limitation in the scope of his audit)

Question two

Discussion on the responsibility of an auditor with regard to related parties.

ISA 550 (Related parties) defines related party as follows;

Parties are related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions. Related party transactions are a transfer of resources between related parties regardless of whether a price is charged.

ISA 550 requires the auditor to perform audit procedures designed to obtain sufficient, appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related transactions that are material to the financial statements. The auditors knowledge of the client must be sufficient to identify related parties for the following reasons;

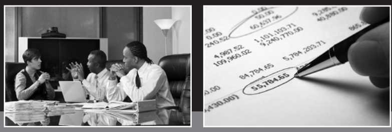
- The financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as required IAS 24.
- The existence of related parties or related party transactions may affect the financial statements i.e. tax liability
- The source of the audit evidence affects the auditors assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties.
- A related party transaction may be motivated by considerations other than ordering business considerations. (8 marks)

(a) (i) Factors to consider in deciding on the extent t which you could rely on the work of the auditor of a subsidiary.

- The materiality of the portion of the financial statements which the principal auditor audits
- The principals auditor degree of knowledge regarding the business of the components
- The risk of material misstatement in the financial statements of the components audited by the other auditor
- The performance of additional procedures resulting in the principal auditor having significant participation.
- The principal auditor should consider the competence of the other auditor in the context of the assignment
- Obtain sufficient appropriate evidence that the work of the other auditor is adequate for the principal auditor purpose

ii) When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform, sufficient audit procedures, regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.

If the other auditor issues or intend to issue, a modified auditors report, the principal auditor would consider whether the subject of modification is of such a nature and significance in relation to the financial statements of the entity on which the principal auditor is reporting, that a modification of the principal auditors report is required.



CHAPTER NINE

Question one

a)

The business risk approach in auditing requires the auditor to determine what are the very important business risks which the client faces. The line of approach both helps the client and also enables the auditor to appreciate all aspects of the business activities. It is then for the auditor to determine where the risks are likely or unlikely, and whether the risks are likely or not to produce serious consequences. This enables the audit to be focused on those matters where there is a serious possibility of misstatement.

The audit risk approach involves analyzing overall audit risk between inherent, control and detection risk.

Inherent risk is the possibility of material error arising regardless of internal controls. For example significant amounts of sales may not have been invoiced and hence sales and debtors should be understated; or material amounts of capital expenditure may be included in repairs. In many cases, the risk of such occurrences are reduced but never quite eliminated by internal controls. There is therefore a risk that once a misstatement has occurred, internal controls will not find and correct if-this is control risk. Similarly when carrying out substantive or analytical procedures, the auditor faces the risk that he will not find this misstatement i.e. detection risk.

b) (i) Risk faced by and auditor in his role as a receiver.

As a receiver manager or liquidator the auditor takes control of the assets of the company. He also takes over the powers of the directors since when a winding up order is given the powers of the directors cease. The following risks arise.

1. The auditor has to carry out management roles of managing the business, if the auditor is negligent in his role as manager he can be sued by the shareholders.
2. As receiver manager, the auditor has to give more than reasonable assurance as opposed to carrying out a statutory audit where the audit gives reasonable assurance.
3. Where an auditor acts as a receiver manager, he is personally liable on contracts made by him on behalf of the company, but as auditor his liability is limited to the scope of his work and not on contracts of the company since he undertakes none.

(ii)

Matters that an auditor who has been appointed a receiver or liquidator should discuss with the appointing authority before accepting the appointment.

It is important for the auditor when entering into a contact to act as a liquidator or receiver manager to ensure that both parties fully understand the contract. Misunderstanding could lead to a break down in the relationship and eventually resulting in legal action being undertaken.

Therefore the following should be discussed.

1. The responsibility of the auditor on a receiver manager. This will include the duties of the receiver manager and his role as receiver manager should be discussed in details.

2. The scope of the duties or receiver manager, including reference to applicable legislation, regulations or pronouncements of professional bodies to which the auditor adheres to and which might still be binding even when he acts as receiver manager.

3. The form of any reports or communication from the activities of the company under receivership. This might include the status of the assets. (Especially those sold in case, of liquidation and proceeds obtained.) And the performance of the company incase of receivership.

4. Basis of fees. This will include the level of fees, how fees will be billed and how increases in receivership fee will be discussed. This discussion will also include how disbursements will be paid.

5. Timing of the appointment.

   The commencement of the assignment will be discussed and the length of time it is expected to take.

6. Involvement of others

   Arrangement concerning the involvement of other professionals in the receivership will be discussed and how the various persons dealing with the receivership will work together and ensure that each person's responsibility is understood as well as lines of authority.

7. Dissolution of the receivership contract

   It should be well understood how either party can terminate the contract and what conditions should exist for termination.

STUDY TEXT

(iii) Ethical challenges face by auditor when acting as receiver.

1. Self interest

   Would occur if the liquidator as a receiver has some financial or other interest in assurance client. For example, the auditor could be owning some shares in the company under receivership.

   Safeguard

   Before accepting the assignment the auditor should ensure that he is independent in all respects. All financial interests should be disclosed and if necessary disposed off.

2. Self review threat

   Could occur when a previous judgment needs to be re-evaluated by members responsible for that judgment. For example, the auditor as receiver manager could also be offering other services such as consultancy and audit to the company under receivership.

   Safeguard

   Before acceptance as receiver the auditor should ensure that his firm is not offering other services that could attest his judgment on receiver manager.

3. Familiarity threat

   Could occur when, because of close relationship the auditor becomes too sympathetic to the interests of others, e.g. Creditors and employees.

   Safeguard

   The auditor should be of integrity and should not be biased in his work and should not also allow himself to be influenced by others. Any members in the receivership who have family relation in the company under receivership should be discloses so that corrective actions can be taken.

4. Intimidation threat

   Could occur when the auditor is deterred from acting objectively by threats, actual or perceived. These threats could be coming from disgruntled directors, employees of company under receivership or from the creditors.

   Safeguard

   The auditor should discuss any threats with the appointing body. If the threats are major then the auditor should consider resigning from the assignment.

5. Over due fees

Could occur where the auditor's fees is delayed.

Safeguard

Discuss the issue with appointing body in the delay of the fees. If a substantial amount of fees is delayed the auditor should withdraw from assignment.

Question two

(a) Respective responsibilities of directors and management of a company and its external auditors with respect to financial statements.

ISA 200, explains the respective responsibilities.

The responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity with oversight from those charged with governance.

The auditor is responsible for forming and expressing an opinion on the financial statements.

The audit of financial statements does not relieve management or those charged with governance their responsibility.

(b) The inherent limitations facing auditors in undertaking their work;

The inherent limitations in an audit of financial statements that affect the auditor ability to detect material misstatements include:-

(i) The use of testing

(ii) The inherent limitations of internal control (for example, the possibility of management override or collusion)

(iii) The fact that most audit evidence is persuasive rather than conclusive

(iv) The work is also permeated by judgment

(v) Assessing the reliability of estimates made by management

(c) Significant types of judgments made by auditors in:

(i) Gathering audit evidence
The work undertaken by the auditor to form an audit opinion is permeated by judgment in particular regarding the gathering of audit evidence, for example

in deciding the nature, extent and timing of audit procedures. Also the drawing of conclusions based on the audit evidence gathered for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

(ii) Arriving at an opinion in the financial statements

In expressing an audit opinion, the auditor provides uses of financial statements with reasonable assurance that the financial statements are free from material misstatements. In other words, the engagement risk has been minimized to acceptable level. It implies that sufficient appropriate audit evidence has been obtained.

The auditor makes judgments regarding matters affecting or not affecting his audit opinion and also decides on the appropriate forms of the report.

He also considers compliance with laws to satisfy regulatory requirements in a given jurisdiction.

Question three

(a) The general access controls will include both physical controls and programmed access controls.

- The computers should be kept in rooms with restricted access. Only authorized personnel should have access.
- When the computers are unattended relevant programs should not be left running.
- That the terminals will be linked to the mainframe computer through a dial up link means that the machines communicate through a telephone line. This means that there is a danger that communication between the computers could be interpreted and transmission intercepted without proper authority. Therefore I would expect that built into the system would be the provision of a dedicated line at Mwebeni Ltd. such that when the mainframe computer receives a signal from a terminal it will not accept instructions directly rather it would call back at the dedicated number at. to facilitate the dial up link.
- All authorized users should have been issued with passwords or some other form as identification such that once the dial up link has been facilitated the system should demand for a password which must be keyed in. In this way different levels of access can be given to the staff e.g. the purchases ledger clerk can access the system for reading purposes only without the authority to effect any transfers.
- The password has to be keyed in for the computer to determine the degree of access the password holder is permitted.

- The system should have been programmed that transfers can only be effected at certain times like between 11 a.m. and 3 p.m. on a working day. When any attempt is made to effect transfer the system checks against its in built clock and confirm that time access is being attempted is reasonable.

- A comprehensive creditors master file should have been built up with all details of the creditors bank and the account number at that bank. These details would have to be keyed in when a transfer is to be made. The creditor's master file must be on line when transfers are being effected so that the system automatically performs a master file check to ensure that the company does have such a supplier. At the same time the programme would also perform a reasonableness check that the proposed amounts to be transferred do not exceed the amount due to that supplier.

- Both ends of the system should have been programmed to automatically prepare a record of the transfers that have been effected.

- A limit should have been built into the system such that only transfers below this amount should be effected by line system, any amounts in excess should be rejected requiring a cheque signed by the authorized signatories.

- A requirement should have been in place that passwords should be changed regularly. There should have been built into the system to deny access or refuse to act on the instructions of password users who has not changed their password within the stipulated time.

- Should have built into the system a, mechanism for the system to close down automatically if a wrong password is entered more than 3 times.

- Similarly it should close down it require the password to be keyed in again if no activity takes place when the 2 machines are linked for a period of time, say 5 minutes.

- Should have built into the system a mechanism that informs the mainframe computer the number of transfers to be effected so that once many transfers have been effected the dial up link is immediately disconnected.

(b) The additional measures that Mwebeni. should take in order to prevent unauthorized transfers:

(1) Ideally the terminals should be located in a secure office to which access is restricted to only authorized personnel at approved times. This is the normal lock and key.

(2) The microcomputer that facilitates the dial up link could be required for other work therefore it may not be practicable to only use it to effect transfers.

(3) There should be restrictions on opening new accounts for suppliers or removing names

of suppliers from the creditors master files or even changing the supplier details. There should be pre printed, pre-numbered change forms when a new suppliers has been approved by the purchasing committee and their details entered in these forms would be approved by both the chief accountant and purchase committee.

(4) There should be arrangements for the creditors master file to be regularly dumbed and normally checked.

(5) Before any transfers are affected the invoices to be paid should be subjected to a payment selection criterion. They should have been supporting documents attached to them. A list should be prepared and it should have the written authority for the transfers to be effected in the form of a signature by the cheque signatories and this list should be retained.

(6) Once the transfers have been effected the supporting documents should be stapled and cross referenced to the transfer number.

(7) At almost all the times of the month only the minimum balance should be retained on this bank account. When the list if transfers to be effected has been approved the money can then be transferred from the main account to this account for the transfers to be made.

(8) Regular bank reconciliations should be prepared, reviewed by responsible officials and approved. Any long outstanding items should be investigated.

(9) Reconciliations of creditors statements should be regularly prepared, the long outstanding reconciling items being investigated.

c) Controls to be implemented at eh accounts payable and payroll systems over:

i) Retrieval of information:

- Access controls should be implemented by use of pass passwords
- The relevant software should not be installed in all terminal to ensure that there is no possibility of unauthorized access
- A list of all retrievals and by who should be maintained.

ii) Input of transaction data.

These controls aim at ensuring the completeness of input and it validity. Most errors in computerized accounting systems can be traced to faulty input. Controls over the completeness and validity of all input are therefore essential. The controls over input will include:

- Data conversion
- Controls over rejections which should be investigated
- Correction and processing of rejections
- Batch controls and computer edit controls.

The most common input controls include:

- Missing field checks
- Validity character check
- Reasonableness checks
- Missing file checks
- Check digits
- Document counts

REFERENCES

STUDY TEXT

REFERENCES

Distance Learning Center Study Packs

GLOSSARY

STUDY TEXT

GLOSSARY

A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

A forecast a prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best –estimate assumptions).

A qualified opinion expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not as material and pervasive as to require an adverse opinion or a disclaimer of opinion.

A true and fair view implies that all statutory and other information is not only available but is presented in a form in which it can be properly and readily appreciated. (Sir Russell Kettle).

Adjusting events are those that provide evidence of conditions that existed at the balance sheet date

An associate this is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in financial and operating policy decisions of the investee but is not control or joint control over those policies

An engagement letter defines clearly the extent of the auditor's responsibilities and so minimise the possibility of any misunderstanding between the client and the auditor

An expert or a specialist a person or a firm possessing special skills, knowledge and experience in a particular field other than accounting and auditing

An opinion opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Audit evidence This is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information.

Audit plan describes the expected scope and conduct of the audit.

Audit program sets out the nature, timing and extent of planned audit procedures required to implement the overall audit plan.

Audit sampling this is the application of a compliance or substantive procedure to less than 100% of the items within an account balance or class of transactions such that all sampling units have a chance of selection. To enable the auditor to obtain and evaluate evidence of some characteristics of the balance or class and to form or assist in forming a conclusion concerning the population from which the sample is drawn..

Auditing the independent examination of and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation:

Back duty investigation Occurs where the income tax authorities have reason to suspect that a resident individual subject to taxation has not made complete and accurate return of income for taxation purposes, they may require an investigation to determine the correct position.

Bankruptcy a legal status which a person (not a company) acquires when the court makes an adjudication order against him. The order effectively deprives him of the ownership of all his property (with certain exceptions) and subjects him to certain disabilities.

Compliance tests these are those tests which seek to provide audit evidence that internal control procedures are being applied as prescribed

Control environment the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity

Control procedures this means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives

Current assets are those assets which are expected to be sold or consumed in the course of the operating cycle or assets which are held primarily for short term trading purposes and are expected to be realised with in 12 months of the reporting date or cash and cash equivalents.

Development the application of research findings or other knowledge o a plan or design for the production of new or substantially improved materials, products devices etc. prior to the commencement of commercial production or use.

Events after the balance sheet date are those events that occur between the balance sheet date and the date when the financial statements are authorized for issue.

Fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fundamentality. When a matter is fundamental then it is considered so crucial to the view given by the accounts that it can render them totally misleading or meaningless.

Going concern can be said to be that the financial statements assume that the enterprise will continue in operational existence for the foreseeable future, or put another way the financial statements assume no intention or necessity to liquidate or curtail significantly the scale of operation or put more simply that the enterprise can meet its financial obligations as they fall due

Goodwill this is the excess of the cost over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities and is recognized as an asset.

Insolvency refers to the inability of a person (including a company) to pay debts as and when they fall due. However, although a debtor may be insolvent, he is not a bankrupt until and unless the court adjudges him to be so.

Internal control system this are all the policies and procedures (internal controls) 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, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information

Management Representations provides standards and guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

Materiality. A matter generally is held to be material if its disclosure or non-disclosure would affect the view given by the accounts. Materiality may be considered in the context of the financial statement as a whole, the balance sheet, the profit and loss account, or individual items within the financial statement

Non-adjusting events are those that are indicative of conditions that arose after the balance sheet date

Planning means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audit in an efficient and timely manner.

Prospective financial information (PFI) means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment and can be in the form of forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection.

Research original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Risk Assessment and Internal Control this is the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.

Substance over Form Transaction should show the commercial reality rather than the legal form

Substantive procedures This involves creating and using audit programs for material account balances and transactions.

Substantive test. These are those tests of transactions and balances and other procedures such as an analytical review which to seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or in the financial statements.

Verification this is proving the authenticity of the recorded amounts of assets and liabilities. Verification is achieved by confirming certain factors about an asset or a liability balance.

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