AUDITING AND ASSURANCE

STUDY TEXT

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ISBN NO: 9966-760-23-7

First Published 2009

Strathmore University Press

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Acknowledgment

We gratefully acknowledge permission to quote from the past examination papers of the following bodies: **Kenya Accountants and Secretaries National Examination Board (KASNEB)**.

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CHAPTER ONE

THE GENERAL AUDIT ENVIRONMENT

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▶ CHAPTER OBJECTIVES:

- By the end of this chapter, you are expected to have a general understanding of the following.
- Definition of Auditing
- Distinction between auditing and accounting
- Objects of an audit
- What is true and fair?
- Benefits of an audit to a public limited company
- Types of audits
- Users of audited reports
- Stages of an audit

▶ INTRODUCTION

At the end of every financial year, company's are expected by statute to have their financial statements reviewed by an independent professional who after going through the accounts, expresses an opinion as to whether the financial statements present a true and fair view of the financial position of the company. This procedure is normally called a year end audit and is conducted by an auditor. This chapter gives an introduction of auditing and its benefits.

By the end of this chapter, you are expected to have a general understanding of the general Audit environment by being able to distinguish between auditing and accounting, the objects of an audit, types of audits, stages of an audit and the benefits

▶ KEY TERMS

Audit This is the independent investigation into the quality of published accounting information.

▶ EXAM CONTEXT

This topic gives you an introduction into the auditing. It covers the basic aspects of auditing and will be tested in conjunction with the topics covered later on this book.

▶ INDUSTRY CONTEXT

Audits are conducted for most businesses especially where there is separation of ownership from management. At the end of an audit the auditor is expected to give a report to provide some form of assuarance to the users of financial statements. An audit therefore is necessary in the current world.

NEED FOR AN AUDIT

Industrialization has led to growth of business through pooling together savings of investors. This has lead to a company having a large number of shareholders. Limited liability companies were created with the intention of having widespread shareholding.

It is consequently impractical for the shareholder to be involved in everyday running of the company. Also the shareholders may lack skills and the time to manage their company. Thus, the shareholders delegate the task of running the company to a small number of qualified directors through agency relationship. The agents who are the directors have a total discretion over strategy, investment and financing decisions, which have enormous implication on the shareholders.

The directors can easily be tempted to satisfy their own welfare at the expense of shareholders welfare by awarding themselves excessive remuneration packages. This situation shareholders find themselves in entrusting their savings with the directors who can easily misuse the savings is called the agency problem.

The shareholders must put in place mechanisms in order to protect themselves from possible excesses of directors. This can be, through:

a. Remunerating the directors (agent) in such a way that their interests coincide with those of the shareholders (principal) e.g. profit based salaries, bonus based performance or share options that give the directors right but not obligation to buy specified number of shares at a specified price.
b. Monitoring the action of the agent and penalize for any exploitation by having major shareholders as their representatives on the board of director the Kenya Companies Act has put in place additional measures for monitoring management behavior for the benefit of all shareholders. These are:
    - Section 147 of the Companies Act requires the company to keep proper books of accounts and other statutory records. This is to ensure that actions of directors will be properly documented so that the shareholders can inspect the company records at anytime they wish.
    - Section 159 of the Companies Act requires the directors to prepare accounts of their financial stewardship and sent them to all the shareholders so that they can ascertain the operation and financial position of their company.
    - The sixth schedule of Company Act and other several sections stipulate the minimum information these accounts must state ensuring that the shareholders have the relevant information for decision making and evaluation of directors.
    - Section 159 further requires the directors to call an annual general meeting (AGM) at which the company accounts are laid before the shareholders as a group. This ensures that the shareholders can use their powers to oversee operation of their company e.g. questioning the directors on matters of managing the company.

The major problem is that these company accounts and reports the shareholders use to evaluate the financial stewardship of directors and which can be used to discipline or reward the directors are prepared by the directors themselves. Indeed, any performance based bonus is likely to be calculated from figures published in the company accounts.

This can tempt the directors to manipulate figures which are published in the accounts. Thus the company accounts prepared by the directors lack credibility and hence section 159 of the Company Act requires that every company must have an auditor regardless of the wish of the directors or shareholders.

The shareholders receive company accounts and other information from the directors therefore need assurance regarding quality of the information. Hence an individual shareholder should inspect the company accounts to establish their credibility if he so wishes but due to lack of time and skill, an audit remains the obvious solution to the agency problem facing the shareholders.

Definition of an Audit:

An audit is the independent examination of and expression of an opinion on the financial statements of an economic entity by appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation .

The objective of an audit is to enable the auditor express an opinion whether financial statements show a true and fair view of the company state of affairs in accordance with an identified financial reporting framework.

The purpose of an audit is not to provide additional information but rather it is intended to provide the users of the accounts with assurance that the information provided to then by directors is reliable. However, the users should not assume the auditor's opinion is one to efficiency with which management has conducted the affairs of the entity.

Financial statement: According to the Companies Act, the company accounts refers to the balance sheet and the profit and loss account but due to development in business practice and shareholders information needs, these are inadequate as to the information regarding financial position and performance of the company. Since most balance sheets and profit and loss accounts are summarized statements amplified by notes to the statements, the business community and the accountancy profession require that a cash flow statement as well as a statement of changes in equity be prepared. The terms company accounts and financial statements have the same meaning.

Financial Reporting framework: According to International Auditing Standards (ISA 200, the framework of international standards of auditing), financial statements are usually prepared and presented annually and are directed at common informational needs of a wide range of users. Many of the users rely on the financial statements as their major source of additional information to meet their specific information needs. Therefore financial statements need to be prepared in accordance with one or combination of:

- International Financial Reporting Standards (IFRS)or IASs
- National accounting standards
- Any other authoritative and comprehensive financial reporting framework designed for use in financial reporting and is identified in the financial statements. In Kenya the financial reporting framework adopted is as prescribed by IFRS.

Role of IFRS and IASs in preparation of financial statements

Though not specifically set out in the preface to the statement of IFRS, it is well accepted within the accountancy projection that IFRS do the following:

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- They prescribe the approved method of accounting and disclosure.
- Where one or more methods of accounting are acceptable, they prescribe one method which is preferred and called the benchmark treatment and the allowed alternative treatment and conditions under which that allowed alternative is applied.
- They prohibit, discourage and restrict use of methods which will not lead to a true and fair view of the financial statements.
- They increase comparability of financial statements. Application of appropriate IFRS reduces areas of uncertainty and subjectivity in financial statements.

It is extremely unlikely that financial statements would give a true and fair view when appropriate IFRS are departed from. When managers depart from the IFRS in preparing financial statements they must include a note to the financial statements that they have departed from the financial statements and they must justify that departure. Auditors can on their part refer to the departure in their audit report and clearly indicate whether or not they concur with the departure.

International standards on auditing (ISAs) are issued by International auditing and practices committee (IAPC) of the International Federation of accountants (IFAC) based in New York. IFAC is the worldwide organization for the accountancy profession. It is comprised of 155 professional accountancy bodies in 114 countries, representing more than 2.4 million accountants in public practice, education, government service, industry and commerce. IFAC's mission is to develop and enhance the profession to enable it to provide services of consistently high quality in the public. In addition to developing auditing standards through the IAASB, IFAC also develops education, ethics, and public sector accounting standards. Membership in IFAC automatically confers membership in International Accounting Standards Board (IASB). ISAs do not override a country’s regulations which may be government statutes or statements issued by regulatory or professional bodies in the country.

ISAs are prepared by IASB which has the responsibility of producing a single internationally acceptable set of high quality accounting standards.

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Advantages of auditing

- Dispute resolution. A partnership business with a complex profit sharing agreement may require an independent examination of those accounts to ensure accurate assessment and division of those profits.
- Significant changes in ownership and structure can be easily effected if past accounts contain unqualified audit reports. E.g. in mergers.
- Auditors have access to the corporate strategy of the company thus are able to give advice on gaining competitive advantage and on improvement of business efficiency.
- Borrowing of finances from third parties is enhanced with availability of unqualified audit report on the company’s financial statements.
- Auditing protects the interests of the shareholders who are separated from the management of their savings invested in the company.
- Auditing assists in prevention and detection of fraud and error in financial statements although this is not the primary objective of an audit.

Disadvantages of auditing

- Audit fees are normally high since auditors are highly qualified professionals hence small firms such as sole proprietorships may not afford their financial statements to be audited.
- The audit exercise interrupts the clients operations because client staff have to spend time in availing the required information to the auditors.
- Company secrets may leak to competitors since all company information is accessible to the auditors.

Financial accounting and Auditing

Financial accounting entails provision of information about a business or company in form of financial statements which are then made public. These statements are generally prepared on an annual basis and used by management and other interested parties to make decisions. The information contained in these financial statements must give a true and fair view of the state of affairs in the organization.

Auditing is a check carried out by an independent auditor to make sure that what a company is saying about its financial statement is true. Auditing therefore adds credibility to the financial statements by ensuring the availability of accurate and reliable financial information.

Differences between Auditing and Financial Accounting

- Auditing is an independent examination of company accounts and expression of an opinion whether they contain a true and fair view of company's state of affairs. Financial Accounting is the recording, classifying and summarizing events of an economic entity in order to assist management in decision making.
- While auditing is conducted once in a financial period and usually at the end, financial accounting is a continuous process throughout the financial period of a company.
- Auditing is governed by ISA while Financial Accounting is guided by GAAPs.

Similarities between Auditing and Financial Accounting

- Both auditing and accounting are statutory requirements i.e. that companies must maintain proper books of accounts at that their financial statement must be audited

Objectives & General principles of an Audit

ISA 200 (Objectives And General Principles Governing An Audit Of Financial Accounting) states that the objective of an audit of financial statement is to enable auditors give an opinion on financial statements taken as a whole thereby provide reasonable assurance that the statements give a true and fair view and have been prepared in accordance with relevant acco unting and other requirements.

The auditor's opinion is not a guarantee that the financial statements actually show true and a fair view but that in his or her opinion, they show a true and fair view as to the state of affairs of the company. (See True & Fair Below)

Users of Audited Financial Statements

- Present and potential investors. These risk capital providers and their advisors are concerned with the risk that is inherent in their investment. They need information to help them determine whether they should buy more shares, hold on to the shares they have or sell the shares they have.
- Employees. These and their representative groups such as trade unions are interested in information about the stability and profitability of their employers. They are also interested in information which enable them assess the ability of the company to provide adequate remuneration, retirement benefits and employment opportunities.
- Lenders. These are interested in information that enables them determine whether their loans and interests arising from the loans will be paid back when due.
- Suppliers and other trade creditors. These users are interested in information that enables them determine whether the amounts owing to them will be paid when due. Their interest in the company is of shorter period than lenders while they are dependent upon the continuation of the company as a major customer.
- Customers. These have interest in information about the continuance of the company especially when they have long term involvement and or are dependent as the company.
- Government. The main interest of the government is allocation of resources. It also requires information in order to regulate the activities of the enterprise, determine taxation policies and obtain national income statistics.
- Public. A company affects public in a variety of ways. A company may make substantial contribution to the local economy by employing people and obtaining supplies locally. Financial statements assist the public in information on trends and recent developments of the company in the economy .

  Others:

  - Lawyers
  - Competitors
  - Stock brokers
  - Statisticians
  - Financial journalists
  - Trade unions
  - Credit-rating agencies

Types of Audits

- Audits can be classified into two broadways.
- According to terms of engagement i.e. nature of work done.
- According to the approach to the work to be done/ timing.

According to nature of work done, audits may be either statutory of private.

Statutory audits

These are carried out as per the requirements of various statutes e.g. Companies Act Cap 486 requires that all public limited companies to have their financial statements subjected to an

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independent audit. The objective of the audit is to enable the auditor express an opinion whether the financial statements have a true and fair view of the company's state of affairs. The rights and duties of the auditor are laid down in the relevant statute. The powers of appointment of the auditors are vested on the shoulders.

Private audits

These are not governed by statutes. They are performed by independent auditors because the owners, members or interested parties require them carried out. Private audits are carried out for organizations such as non governmental organizations, partnerships and clubs and among others. Appointment of auditors is carried out as a private contract between the auditor and the relevant shareholder. The scope and objective of the work as well as rights and duties of the auditor are determined by the agreed terms between the auditor and the client. The auditor is not liable to third parties.

According to approach of the work to be done, audits can be continuous, interim or final.

Continuous audits

This is an approach whereby an audit is carried out throughout the financial period usually at predetermined intervals. This approach is ideal for large organizations with tight reporting deadlines e.g. multinational banks. The approach ensures accounts are kept up to date, errors and frauds are discovered in early stages and better audit reports are developed since more time is taken.

However, this approach is expensive considering amount of time taken, has frequent interruptions of client work and auditors' independence may be affected by their continuous presence at clients premises.

Interim audits

This is an audit carried out halfway through the financial period. It usually precedes the final audit and is a preparation for the final audit. It is ideal for dynamic businesses, cheaper compared to continuous audits and enhances keeping of up to date records.

Final audits

These are usually done at the end of the year as either a continuation of the interim audit for large and medium size companies or as a single audit for small companies at end of financial period.

Other types of audits

Procedural audits. These require examination of procedures or records for reliability and accuracy. They usually relate to company's internal control systems, laid down guidelines and procedures and records of the company.

Management audits. These involve investigation of the company's entire management to ascertain whether the directors are running the company in the most optimal way for the benefit of the shareholders. It improves quality and efficiency of management in addition to checking the budgetary system.

Balance sheet audits. This tests the strength of internal control system by working backwards to get the initial transactions using assertion methodology.

Internal Audit

Management upon realizing the advantages of an audit have established within the company, 'an independent activity to examine and evaluate the organizations risk management process and systems of control and to make recommendations for the achievement of the company's objective'. This activity is called internal auditing. The duties of internal audit personnel are:

- Reviewing the economic efficiency and effectiveness of the company's operations.
- Reviewing the company's compliance with external laws and regulations and internal policies and procedures.
- Reviewing and advising the management on development of key organizational systems and implementation of major changes.

The focus of internal auditing is adding value to an organization through improvement in risk control.

In 1999, the institute of internal auditors (IIA) defined internal auditing as 'an independent objective assurance and consulting activity designed to add value and improve an organization's operations, help it achieve its objective and improve the effectiveness of risk management, control and governance process.

Internal auditing and external auditing compared.

Aspect	Internal Auditing	External Auditing
Objectives	The main objective is to advice management on whether organization has sound internal control systems to protect it against loss.	The objective is to provide an opinion as to whether or not the financial statements show a true and fair view of the company's state affairs.
Legal basis	Internal auditing is not a legal requirement but corporate governance advises and recommends that a company should have an internal audit department.	It is a legal requirement for limited liability companies and public bodies to have their accounts audited.
Scope	It covers all areas of organization i.e. operational as well as financial.	It has a purely financial focus.
Approach	It is increasingly risk based. The approach is to assess risks, evaluate systems of control and test operation of the systems and finally make recommendations for improvement.	Its increasingly risk based as it only tests underlying transactions that form having of financial statements.
Responsibility	The responsibility is to advise and make recommendations on internal controls and corporate governance.	The responsibility is to form an opinion on whether financial statements show a true and fair view.

Scope & Objectives of Internal audit function

This depends on the size and structure of the entity and the responsibility assigned to it by management. Ordinarily these would include:

- Review of accounting internal control systems. The management is responsible for establishing internal control system. The system requires proper attention and continuous review, a function usually assigned to internal audit. Internal Audit function designs a plan on areas and control procedures that will be reviewed during the financial year.
- Carrying out examination of financial and operational information. This may include detailed testing of transactions and operation procedures.
- Review of the economic efficiency and effectiveness of operations including non financial controls of the entity.
- Review of company's compliance with external laws and regulation. The internal audit functions checks whether procedure are in place to ensure that all relevant laws and regulations are adhered to.
- Review of entity's compliance with management policies and other internal requirements.
- Carrying out independent investigations into company affairs as required by management e.g. investigation areas of suspected fraud or misuse of company's resources.

Similarities between internal audit and external audit

- Both auditors are concerned about the strength and proper functioning of the internal control system. The internal auditor is concerned it is his or her responsibility while the external auditor is concerned as he or she relies on the strength of internal control system to carry out systems based audits.
- Both auditors have as part of their duties to ensure that the company adheres to all relevant laws and regulations.
- Both auditors interested in ensuring that the company keeps proper books of records. The internal auditor uses the company accounts to appraise the functioning of the internal control system while external auditor uses them to collect audit evidence to corroborate his audit opinion.
- Both auditors are concerned about prevention and detection of errors and frauds. The internal auditor ensures errors or frauds are prevented and detected by having strong internal control system while the external auditor has the incidental duty of detecting and preventing material errors and frauds which would otherwise distort the true and fair view of the financial statements.
- Both auditors have interest in safeguarding company assets. The internal auditor through strong internal control system ensures safety of company's assets while external auditor must ensure that company assets are safeguarded against theft and misuse so that the true of fair view of financial statements is maintained.

External auditor's reliance on work of internal auditor

Before deciding on whether to rely on work of internal audit function with the intention of reducing audit procedures, the external auditor should evaluate the internal audit function to determine the scope of the function its independence and the extent to which its work can be relied on. In evaluating internal audit function, the external auditor considers the following factors:

- Organization status. Since internal audit function is part of the entity, it cannot be totally independent. To aid in its independence, the internal audit function should report to the highest level of management. The internal auditor should also be free from duties such as accounting functions which may bring about conflict of interest. The internal auditor should not have any restrictions upon him or her from management which could impair effectiveness of doing his or her work.
- Scope of the function. The external auditor should ascertain the nature and depth of coverage of internal audit assignments. Also to be considered are the management actions on the recommendations of internal auditor. In case the management does not follow up on the recommendations, the external auditor must reduce his reliance on work of internal audit function as this means it is weak.
- Technical competence. The external auditor should assess the competence experience, qualifications, technical training and proficiency of the staff members in the internal audit function.
- Due professional care. The external auditor should ascertain whether due professional care has been observed in doing the work of the internal audit function e.g. whether there were work plans, supervision and documentation of audit evidence in executing internal audit functions.
- Availability of resources. The external auditor should consider whether the internal audit function has adequate resources to enable it carry out its functions as expected e.g. adequate staff and time.

Advantages of Internal Audit function

- It reinforces application of internal controls thus enables the company to operate in an orderly and efficient way.
- It prevents and detects errors and frauds through periodic comparison of budgets, routine and surprise checks.
- Assists management in implementation of company policies through reporting on adherence or non adherence to laid down policies of the company.
- Assists external auditor in highlighting areas of weaknesses in internal control system. This reduces audit time for the external auditor and thus there is a saving on audit fees.
- Assists the company in achieving its objective by ensuring that all laid down rules, procedures and policies are followed e.g. adherence to budgets and forecasts assists in decision making.
- The internal audit function guards company's resources against theft and misuse through proper functioning of the internal control system and periodic verification of assets.

Limitations of an Internal Audit

- The cost of installing and maintaining an internal audit function is high and in particular for large companies as they may require highly qualified staff while for small companies the department may not be justifiable.
- If management ignores the recommendations of internal audit function, members of internal audit function may be frustrated as errors and frauds may continue being undetected.
- Management may deny the internal audit function its due independence by assigning it accounting duties or even management responsibilities.
- If company operations are few or has complex technical aspects may limit the proper functioning of the internal audit function.
- The internal audit department may fail e.g. if it points out problems without giving solutions or ignoring some departments within the company.
- The internal audit may lack the necessary support from top level management if top management views the function as not important.

Factors necessitating growth in Internal Audit

- Increase in business size. As business grow, it becomes more and more necessary to have a function that checks all the increasing levels of internal control and operation.
- Dynamic technology– the frequent changes in technology has made some companies to have their controls updated on a continuous basis. This calls for constant feed back on controls requiring updating through use of expert advice for internal audit function.
- Legislation and regulatory requirements. As the concept of corporate governance becomes necessary in business management, the need of internal audit has increased. Companies are now required by regulations to have audit committees to oversee operation of controls within the company and to which the internal audit function reports.
- Competition. High competition in business calls for efficient operations by companies so as to survive. This can be achieved through strong controls and cost effectiveness which is enhanced by internal audit.

Risk and Materiality (ISA 320 Materiality)

ISA 320 discusses the concepts of risk and materiality. An audit risk is the risk that an auditor may give an inappropriate opinion i.e. an opinion that contradicts the true nature of the financial situation of the company. Materiality plays a role in each of the following two stages.

a. Planning stage. (in planning what audit work should be done)
b. Reporting stage (in deciding what opinion to give.)

The international auditing and assurance standards board (IAASB) in its framework for preparation and presentation of financial statement defines materiality as follows; 'information is material if its omission or misstatement could influence the decision of users taken on basis of the financial statements.' Therefore materiality provides a threshold or cut off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

ISA 320 further states a number of audit principles as follows:

- The auditor should consider materiality and its relationship to audit risk when conducting an audit. If the auditor assesses the risk associated with an account balance or internal control system to be high, it will be reflected in a lower level of materially thus additional testing will be required.
- The objective of an audit is to enable the auditor express an opinion whether financial statements are prepared in all material respects and in accordance with the identified financial reporting framework. The auditor needs to establish an appropriate materiality level so that quantitatively, material misstatements which are likely to destroy the true and fair view of financial statements are identified.
- Materiality at planning stage is usually set at lower level than necessary in order to reduce risk of undiscovered misstatements and to deal with the problem of having to adjust materially at later date in light of evidence obtained.
- Materiality should be considered by the auditor when;
  - Determining nature, timing and extent of audit procedures
  - Evaluating effect of misstatements.

The auditor should plan sufficient audit procedures so that he or she has reasonable expectation of detecting material misstatements in financial statements. Any immaterial item will not affect the truth and fair view of the financial statement and thus can be ignored.

Materiality and judgment

Auditors consider the following before appropriately testing whether an item is material or not.

1. Qualitative aspects: these may include inadequate or inaccurate descriptions of an accounting policy.
2. Cumulative effect of small amounts: small errors at a month end procedure could individually be immaterial but continuous errors of this kind throughout the financial year could be material.
3. Relatively of materiality. A figure of Kshs. 100,000 may be absolutely immaterial for a large company but absolutely material for a small company. An amount must be considered in relation to:
   - Items on the overall financial statements level.
   - Items at individual account balance or transaction level

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- Legal and other disclosure requirements which may require disclosure regardless of the monetary value e.g. director's fees.
- The corresponding amount in the previous year.

4. The degree of latitude allowable in deciding on the amount attributable to a particular item. While some items such as director's fees are capable of an exact definition, others such as depreciation and allowance for doubtful debts are at best an intelligent estimate. In some countries e.g. US, the security exchange commission estimate materiality as follows;
   - Errors greater than 10% are material
   - Errors between 5% and 10% may be material
   - Errors below 5% are not material
5. In evaluating the true and fair presentation of financial statement, the auditor should assess whether the aggregate of uncorrected misstatements that have been identified in the audit is material. The auditor should reconsider all uncorrected misstatements and check whether this total is material.

True and fair view

The true and fair view is a concept of the Companies Act. However, the Companies Act does not define or even describe what is true and fair view. The companies Act requires that all limited liability companies to appoint an auditor whose task is to express an independent opinion as to whether financial statement show true and fair view of the financial performance and position of the company. True and fair view implies that the financial statements are not prejudicial to any user of the financial statements. Financial statements will present a true and fair view if:

- They contain in all material respects with the disclosure requirement of the Company Act and other relevant regulations.
- They contain material matter and not full of needless details.
- They are complete in every respect within the constraints of materiality and the inevitable estimation of some items.
- The values attributed to the items in the financial statements are reasonable amounts within a range in which if a major decision was taken on their basis the user would not make a material error.
- The information contained there in is presented and disclosed without bias and all relevant information for evaluation and decision making is available.

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Assertion Methodology

In preparing financial statements which show true and fair view of the company's financial position and performance, the management explicitly or implicitly makes certain assertions. These assertions are categorized as:

i Existence
ii Completeness
iii Occurrence
iv Rights & obligation
v Measurement
vi Valuation, presentation and disclosure.
vii Classification
viii Cut-off
ix Accuracy
x Allocation

Existence

This is the assertion that an asset or liability exists at a given date. It is either true or not true that an asset or liability reflected in the balance sheet was in existence at the balance sheet date.

Rights and obligation

This is the assertion that an asset or liability in financial statements pertains to the entity at a given date i.e. an asset is a right of the entity and a liability a genuine obligation of the entity.

Occurrence

This is the assertion that a transaction or event took place which pertains to the entity during the financial period or that a recorded event or transaction actually took place as recorded and it is a valid transaction pertaining the entity. It is either the transaction took place as recorded or not.

Completeness

This is the assertion that there are no unrecorded assets, liabilities, transactions or undisclosed items. It would suggest 100% completion and accuracy however, this is impossible under accrual basis of accounting. The users of the financial statements do not expect 100% completeness in financial statements but completeness within a certain range such that they can still make justifiable decisions. This assertion is therefore assessed for reasonableness as some transactions may be excluded if they are not material.

Valuation

This is the assertion that an asset or liability is recorded at an appropriate carrying value. It is the most crucial assertion of all the assertions. In arriving at appropriate carrying value of an asset or liability, the management considers.

1 Overall valuation basis. The management must consider the entity as a whole and make an assessment whether it is appropriate to apply the going concern assumption in preparing the financial statements. The basis of preparing financial statement when entity is going concern is radically different from preparing financial statement on basis that the entity is not a going concern.
2 Suitable accounting policies. In determining carrying amount of an asset or liability appropriate accounting policies must be followed. The accounting policies must be in line with the generally accepted accounting principles (GAAPs), appropriate to the circumstances of the entity, applied consistently, be in conformity with entity's industry practices and be adequately disclosed.
3 Desirable qualitative characteristics. The suitable accounting policy adopted must be applied after taking into consideration the qualitative characteristics of materiality, prudence and substance over form. Since it may subjective whether an entity is a going concern or not, the accounting policy adopted can be subsequently subjective thus the assertion of valuation can only be assessed for reasonableness.

Measurement

This is the assertion that a transaction or an event is recorded and proper amounts of revenue and expense are allocated to the proper period for proper reporting purposes. Whether a transaction brings into being an asset or liability, revenue or expense depends largely on the capitalization policy of an entity i.e. the guidance as to what items are revenue items and capital items.

The period in which a transaction took place may be influenced by management's desire to reflect a given financial position. However, where revenue or expense of an item is spread over more than one accounting period is called allocation rather than measurement and is a component of valuation.

Presentation and disclosure

This is the assertion that an item is disclosed, classified and described in accordance with the applicable financial reporting framework. The information in financial statements should be presented without bias, be relevant to the needs of the users and meet qualitative characteristics of understandability, relevance, reliability and comparability. This assertion is not assessed for truth but rather adequacy or reasonableness.

In conclusion, truth and fairness of financial statements can be assessed on these seven assertions i.e. the financial statements will reflect a true and fair view of company's financial position and performance if the seven assertions are used as guidelines in preparing the financial statements .

Classification

Are transactions recorded in appropriate accounts?

Cut-off

Are transactions recorded in appropriate period?

Accuracy

Are the amounts disclosed in the financial statements appropriate?

Allocation

Are account balances included in appropriate accounts?

CHAPTER SUMMARY

- The primary 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 annual accounts and report are primarily prepared by the directors to the shareholders.
- After examining the end year financial statements the auditor then forms his opinion as to whether the financial statements show a true and fair view and reports this to the shareholders.
- The appointment of the auditor is usually carried out as a private contract between the auditor and the relevant stakeholder. The scope and objective of the work is determined by the agreed terms between the auditor and the client. The auditors' rights and duties are also laid out in the contract.
- The companies Act requires that all limited liability companies' appoint an auditor whose task is to express an independent opinion as to whether the financial statements prepared by the directors show a true and fair view of the financial performance and position of a company.

QUIZ

1 List the objectives of an audit.
2 List the benefits of an audit to a public limited company.
3 List the properties of a statutory audit that are different from a private audit.

ANSWERS TO THE QUIZ

1. - The primary 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.
   - To give credibility to the financial statements. This arises from the fact that the accounts ave been subject to an examination by an independent person.
   - An audit may assist in the prevention and detection of errors and frauds.
   - The auditor's experience will enable him to make recommendations on ways of improving the accounting and internal control system.
2. Benefits of an audit to a public limited company
   + An audit protects the interests of the shareholders who are separated from the management of the company. This is especially the case for minority shareholders who have little say in the management of their company.
   + An audit being an independent examination of the financial statements gives credibility to the financial statements. The various users can therefore place reliance on them.
   + The auditors experience will enable him to make recommendations on ways of improving the accounting and the internal control system.
   + An audit assists in the prevention and detection of errors and frauds through the moral and deterrent effect.
3. Statutory Audits
   a). It is a requirement of an Act of parliament e.g. the Companies Act.
   b) The scope and objective of work is defined in the Act
   c) The report is addressed to the shareholders.
   d) Appointment of the auditor is stipulated in the Act (Sec.159). It can either be by shareholders, directors or registrar of companies.
   e) The auditor is liable to third parties.
   f) The auditor has full independence.

EXAM QUESTIONS

QUESTION ONE

Restmount Kenya Ltd. was formed on 1 October 2006 in order to export tea and coffee to European markets. The Directors are unsure as to their responsibilities and the nature of their relationship with the external auditors. The audit partner has asked you to visit the client and explain to the directors, the fundamental aspects of the accountability of the directors and their relationship with the auditor.

Required:

Explain to the directors of Restmount Kenya Ltd.

a. The need for an audit

b. Procedures for the appointment of an auditor of a public company under the Companies Act.

c. Directors responsibilities in relation to the accounting function of the Company.

d. Auditors' statutory responsibilities in relation to the audit of the company's financial statements.

QUESTION TWO

Your firm is the newly appointed external auditor to a large company that sells, maintains and leases office equipment and furniture to its customers and you have been asked to co-operate with internal audit to keep total audit costs down. The company wants the external auditors to rely on some of the work already performed by internal audit.

The internal auditors provide the following services to the company:

(i) A cyclical audit of the operation of internal controls in the company's major functions (operations, finance, customer support and information services)

(ii) A review of the structure of internal controls in each major function every four years;

(iii) An annual review of the effectiveness of measures put in place by management to minimise the major risks facing the company.

During the current year, the company has gone through a major internal restructuring in its information services function and the internal auditors have been closely involved in the preparation of plans for restructuring, and in the related post-implementation review.

Required:

(a) Explain the extent to which your firm will seek to rely on the work of the internal auditors in each of the areas noted above.

(b) Describe the information your firm will seek from the internal auditors in order for you to determine the extent of your reliance.

(c) Describe the circumstances in which it would *not* be possible to rely on the work of the internal auditors.

(d) Explain why it will be necessary for your firm to perform its own work in certain audit areas in addition to relying on the work performed by internal audit.

QUESTION THREE

List and describe SIX financial statement assertions, other than completeness, used by auditors in the audit of financial statements.

QUESTION FOUR

The purpose of an external audit and its role are not well understood. You have been asked to write some material for inclusion in your firm's training materials dealing with these issues in the audit of large companies.

Draft explanation dealing with the purpose of an external audit and its role in the audit of large companies, for inclusion in your firm's training materials.

CHAPTER TWO

THE AUDITOR AND THE COMPANIES ACT

CHAPTER 2
THE AUDITOR AND THE COMPANIES ACT

▶ CHAPTER OBJECTIVES

By the end of this chapter, you are expected to have covered;

- Appointment-companies Act provisions
- Qualifications of an auditor
- Removal of an auditor from office
- Resignation
- Rights and duties of an auditor
- Procedures before and after accepting appointment
- Professional Ethics
- International Standards on Auditing
- Legal and professional framework

▶ KEY TERMS

Engagement Letter- Before commencement of the audit, the auditor and the client should agree on the terms of the engagement. The agreed terms should be recorded in an audit engagement letter or other suitable form of contract.

Professional Ethics- These are rules of conduct that govern the behavior of an accountant

International Standards on Auditing- Within each country, local regulations govern to a greater or lesser degree, the practices followed by the auditors. Such regulations may either be of a statutory nature of in the form of statements issued by the regulatory or professional bodies in the country concerned. The international auditing standards are intended for international acceptance.

▶ EXAM CONTEXT

This chapter is tested on a regular basis due to its importance. Questions from this topic may mostly be application based whereby the student is given a scenario and asked questions from it. Ethics is increasingly becoming a key area in the running of companies and so students need to have a good understanding of it.

▶ INDUSTRY APPLICATION

Whatever is covered in this topic is very relevant in the auditing professional and is all applicable in all audit engagements. It guides the auditor as to his rights and the engagement letter. Also, audit professionals are expected to adhere to the highest standards of ethics and this topic gives the student the rules that are set out by the profession.

▶ INTRODUCTION

Before an auditor is appointed to an audit, there are numerous processes and procedures that must be completed first. The company needs to consider the qualifications of the auditor amongst other things. The auditor and the client also need to agree on the terms of engagement before hand and this is done through an engagement letter signed by both the client and the auditor. This is covered by ISA 210 on *Terms Of Audit Engagements* . The auditor is also expected to be aware of his rights and also the professional and ethical requirements that he needs to adhere to before he starts an audit engagement.

According to Section 159 of Companies Act, every company shall at each annual general meeting appoint auditors to hold office till the next annual general meeting. Notwithstanding the above, a retiring auditor however appointed shall be deemed to be reappointed without any resolution being passed subject to certain provisions. Section 159 (7) provides that the remuneration of the auditor shall be fixed by:

- The directors or the Registrar Of Companies .
- The company in annual general meeting or in the manner determined in the annual general meeting.

However appointed

The directors can appoint the first auditors of the company to hold office till the conclusion of the first annual general meeting. The directors can also appoint auditors to fill a casual vacancy in the office of the auditor. A casual vacancy arises when the auditor resigns before end of his or her term of office, dies or becomes disqualified as such by being deregistered. Should the directors and shareholders fail to exercise their right to appoint an auditor, the directors must notify the registrar of companies within seven days of that failure and the registrar will appoint an auditor to that company.

Subject to certain provisions

In an annual general meeting, one of the items of the agenda is the reappointment of auditors. If the matter is not discussed at that meeting, then the auditors are deemed to have been reappointed automatically. Similarly, if no intention to reappoint another auditor has been notified and the auditor has expressed desire to continue in office, an acclamation rather than resolution is sufficient for the auditor to be automatically reappointed.

Qualifications for appointment of an Auditor

A person shall not be qualified for appointment as an auditor of a company unless he or in the case of a firm, every partner in the firm is a holder of a practicing certificate issued pursuant to section 21 of the Accountants Act. In Kenya a person is issued with a practicing certificate if she or he fulfills the following:-

- A Certified Public Accountant (CPA)
- Member of Institute of Certified Public Accounts (ICPAK)
- Have post qualification experience in auditing environment for at least two years.

None of the following persons shall be appointed an auditor of a company

- An officer of a servant of the company. This is because if appointed auditors, employees or officers of the company would be auditing their own work and thus they may not be objective.
- An employee of an officer or servant of the company. A person who is a partner of or is in

the employment of an officer or servant of the company cannot be appointed auditor as he is too involved at personal and financial level to be seen to be as independent.

- A body corporate. These are excluded because auditor's principle function is to express an opinion on truth and fairness of the financial statements and only natural persons can express an opinion as they have a mind and a heart. In addition, users rely on auditor's opinion to make decisions and if the auditor's opinion is materially wrong, the users should be able to recover from the auditor the loss incurred to an unlimited extent. Most body corporates have limited liability, thus they cannot be appointed auditors.

Section 161 (3) states that a person shall not be qualified for appointment as auditor of a company if he is disqualified for appointment as an auditor of any other company which is that company's subsidiary or holding company.

In the case of a private company, a person who is an officer or an employee of the company can be appointed auditor of that company. This is because in a public company there is clear distinction between the shareholders and the management and therefore there is need to protect the shareholders from excesses of management. However, in private company, the shareholders and management tend to be the same people either of same family or close friends, thus the auditor cannot really protect somebody from himself.

Section 161 (1) deals with one characteristic with one characteristic an auditor must possess which is technical competence.

Section 161 (2) deals with the other characteristic an auditor must posses especially for public companies which is independence. The auditor must be free and be seen to be free from any influence from the directors in carrying out an audit.

Removal of auditors from office

According to section 160 of Companies Act, the shareholders and only the shareholders can remove the auditor from the office before his term in office expires. Only an ordinary resolution (over 50% majority) of the company in the annual general meeting is required to remove the auditor from office but a special notice of twenty eight days of the intended removal should be given to the company and the auditor .

Since the directors may want to remove the auditor because of disagreements on accounting policies or if the auditor threatens to expose their frauds, section 160 of the Companies Act seeks to give the auditor some protection from the directors. The defenses given to the auditor include:

- The right to receive a copy of the notice and the intended resolution at the meeting where his removal will be discussed.
- The auditor after receiving a copy of notice can prepare written representations explaining his position on the matter. The directors are under obligation to distribute these representations to all shareholders at the company's expense. If the directors feel that the auditor wants to publish defamatory material, they can obtain a court order which allows them not to distribute the representations.
- The auditor is entitled to attend the meeting at which his dismissal will be discussed and be can address that meeting on any matters concerning him as an auditor. If his representations were not distributed for a reason other than a court order, he can read them to the members at the meeting.

Even though a special notice is required for a meeting to dismiss the auditor, a special resolution is not necessary if the meeting is properly constituted. A simple majority of members present and voting is enough to remove the auditor from office.

STUDY TEXT

An auditor may resign from office as long as a notice in writing to that effect is deposited at the company's registered office. To be effective, the resignation must contain either:

- A statement to the effect that there are no circumstances connected with the resignation that should be brought to the attention of the creditors.
- A statement giving details of any circumstances leading to his resignations he believes should be brought to the attention of the shareholders.
- The Companies Act permits the auditor to request the directors to convene an extraordinary general meeting for considering the auditor's explanations of the circumstances surrounding his resignation.

Rights of auditors (Section 162)

- Right to access at all times the accounting records of the company. These records included shareholders register, memorandum of association, minutes of meetings and returns from branches of the company.
- Right to receive notice of general meetings, attend and speak during the general meetings.
- Right to require from officers and employees of the company any information and explanations deemed necessary for the purpose of the audit. This includes all information from client's books, vouchers and management representations.
- Right to require that subsidiaries and their auditors provide such information and explanations as deemed necessary for the audit of the holding company.
- Right to remuneration. The auditor should be paid audit fees when due and be reimbursed audit expenses incurred in connection with the audit.
- Right to legal and technical advice. An auditor has right to use work of an expert to get technical knowledge on areas he may require such.
- Right to send representations to shareholders in case there are attempts by the directors to dismiss him. The auditor also has the right to receive a twenty eight day notice of the meeting where his dismissal will be discussed and he can speak or read his representations at that meeting.

Duties of the auditor

- To report the shareholders on the financial statements laid before the company at the annual general meeting, whether in his opinion, the balance sheet gives a true and fair view of the company's financial position at the balance sheet date, the profit and loss account gives a true and fair view as to the financial performance of the company and whether the financial statements comply with the requirements of the relevant financial reporting framework.
- To state in his audit report whether he received all the information and explanations in his opinion were necessary for the audit, whether proper books of accounts have been kept, whether the accounts are in line with the underlying records and whether he received adequate returns from branches of the company not visited.
- To assist investigators into the company's affairs by providing his working papers, which are summaries of significant matters the auditor identified during the audit.
- To certify the profit and loss account and balance sheet in a prospectus and other statutory reports regarding numbers and shares sold by the company and cash received in respect to allotment of shares.
- To include in his report any required information about the director's remuneration which has been omitted from the financial statements.
- To consider if any information in director's report is inconsistent with the financial statements and to report the facts if there are any such instances.

Client Acceptance Procedures

Accepting Appointments as company auditor

Upon receipt of a request to accept an appointment as the auditor of a company, the auditor should:

- Ensure that he is professionally, legally and ethically qualified to act as auditor of that client. He should ensure that he is not contravened by any provisions of Companies Act regarding independence.
- He must ensure that he is not a servant or in partnership with a servant of the company and neither must he have any personal, family or business relationship with the prospective client.
- Establish whether his firm has the technical proficiency to undertake the audit. This includes whether the firm has adequate resources such as staff and time to undertake the assignment.
- Seek references about the status of the company and its management so as to assess the potential risk in associating with the prospective client. The information sought would include reputation of the company and of its directors.
- Communicate with the present auditor. The auditor should ask for permission from the prospective client to communicate with the outgoing auditor. If permission is denied, he should decline the appointment but if granted he should write to the outgoing auditor requesting all information which ought to be made available to enable him decide whether or not to accept the appointment. The outgoing auditor should also ask the client permission to communicate with the prospective auditor. If permission is denied, the outgoing auditor should inform the prospective auditor who should then decline the appointment. This process is called ethical clearance and is just not a matter of professional courtesy but aimed at enabling the auditor decide whether to accept appointment as well as enquire reasons for change of auditors.

After accepting the appointment;

- The auditor should ensure that the removal or resignation of the existing auditor is properly carried out in accordance with the Companies Act.
- The auditor should obtain a copy of the new resolution passed at the annual general meeting to appoint him as the auditor.
- The auditor should set up a letter of engagement for the new client company.

A member invited to undertake professional work additional to that already being carried out by another auditor who will still continue with his existing duties, should as a matter of professional courtesy notify the other auditor of the work he is undertaking. This notification need not be given if the client advances a valid reason against it.

The letter of engagement (ISA 210)

It is in the interest of both the client and the auditor that the auditor sends an engagement letter preferably before commencement of the engagement. The letter of engagement has the following purposes: -

- Helps avoid misunderstanding in respect to the engagement. Without written understanding, there may be an implied contract created by either auditors conduct or a provision in the articles of association which may not be in auditor's liking.
- Documents the auditor's acceptance of the appointment as well as the objective and the extent of the auditor's responsibility to the client.

- Confirms in writing any verbal arrangements between the client and the auditor.
- Provides the auditor with a medium through which he can clarify the client's and his respective responsibilities.
- The letter informs the client of other services that the auditor's firm can provide e.g. taxation or consultancy.
- Minimizes auditor's liability to third parties.

Principal contents of an engagement letter

- The objective of the audit of the financial statements.
- Management's responsibility regarding the financial statements.
- The scope of the audit including references to applicable legislation or pronouncements of professional bodies to which the auditor complies.
- The fact that because of the test nature of auditing and other inherent limitations of an audit together with inherent limitations of internal control system, there is an unavoidable risk that some material misstatements may remain undiscovered.
- The expectation of unrestricted access to whatever records and documentations.

Other matters included in engagement letter are:

- Expectation of receiving from management written confirmation concerning representations made by the auditor in connection with the audit.
- The basis on which audit fees are computed or any other billing arrangement.
- A request to the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

Audit of components

Where the auditor of a parent company is also the auditor of its subsidiaries, the factors that influence the decision whether to send a separate engagement letter include:

- Legal requirements of disclosure in the financial statements.
- Whether a separate audit reports are to be issued on the subsidiary and parent companies.
- Who appoints the auditors of the component?
- The extent of any work performed by other auditors
- Degree of ownership in the subsidiary by the parent company.
- Degree of independence of subsidiary's management.

Recurring audits

On recurring audits, the auditor should consider whether the circumstances require the terms of engagement to be revised and whether there is need to remind the client of existing terms of engagement. The auditors may decide not to send a new engagement letter each period. However, the following factors may make it necessary to send a new engagement letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change in senior management, board of directors or ownership.
- A significant change in nature or size of client's business.
- Where legal requirements dictate so.

Auditor's Liability and Negligence

Auditors are known to be competent and honest and therefore when they say that financial statements show a true and fair view, users of the financial statements will have faith in them and make decisions based on the information contained in the financial statements. Since auditors work is relied upon by other parties to make economic decisions, the auditor has a responsibility to do his work with reasonable care, skill and diligence. He must not certify what he does not believe to be true and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care and skill is very difficult to assess in any given case. However, it is clear that:

- An auditor may fail to exercise sufficient care and skill.
- As a consequence, some fraud or error may remain undetected. The fraud or error may be material and thus he will fail to detect that financial statements do not show a true and fair view.
- A user who relies on that work of the auditor may incur a financial loss.
- The financial loss incurred flows from failure to do his job properly and therefore the auditor may have to make good from his own resources, the loss suffered by the user of the financial statements.

Criminal law and the auditor

A member of ICPAK is guilty of professional misconduct if:

- He allows any person to practice in his name as an accountant unless such a person is a holder of a practicing certificate and he is in partnership with him or employed by him.
- He enters, for the purpose of or in the course of practicing as an accountant into partnership with a person who does not hold a practicing certificate or secures any professional business through the services of such a person.
- He discloses information acquired in the course of professional engagement to any person other than the client without the consent of the client or otherwise as required by law.
- He certifies or submits in his name or in the name of his firm, a report of an examination of financial statements and the examination of such statements and related records have not been made by him, a partner or any employee of his firm.
- He fails to observe and apply professional, technical, ethical or any other standards prescribed by ICPAK as guidelines for practice by members of the institute.
- He permits his name or that of his firm to be used in connection with an estimate of earnings contingent upon future transaction in a manner which may lead to the belief that vouches or guarantees for the accuracy of the forecast.
- He expresses his opinion as financial statements of any business in which he, his immediate family, his firm or any partner in his firm has an interest unless he discloses that interest when expressing his opinion.
- He fails to disclose in financial statements or otherwise, a material fact known to him the disclosure of which is necessary to ensure that the financial statements are not misleading.
- He fails to report a material misstatement known to him and therefore causes it to appear in financial statements with which he is concerned in a professional capacity.
- He is found to engage in fraudulent acts or acts which result into loss.
- He expresses an opinion on any matter with which he is concerned in professional capacity without obtaining sufficient information on which to base his opinion.
- He includes in any statement, return or form to be submitted to ICPAK knowing it to be false in any particular matter.

Negligence

Negligence is some act or omission which occurs because the person concerned failed to exercise that degree of a reasonable care and skill which is reasonably expected in the circumstances of the case. A liability refers to the fact that an auditor who is appointed to repost to the shareholders whether the financial statements show a true and fair view could be held liable for negligence if it is determined that he did not carry out his work with due professional care. There are no decided cases in Kenya against auditors,

This makes it difficult to precisely determine what circumstances the auditor could be held liable in and which parties could successfully bring an action against the auditor.

Auditor's liability falls under three categories:

- Civil and criminal liabilities.
- Liability to the client company under law of contract.
- Liability to third parties under tort o negligence.

1 Civil and criminal liabilities.

An auditor could be sued in a civil court if he breaches his position of trust and confidentiality. E.g. if he uses information acquired in course of an engagement for his financial gain or for benefit of another party. Regarding criminal liability, section 136 of the companies Act provides that an auditor shall be criminally liable if he willfully makes false statement in any report, certificate or financial statements with an intention to deceive or mislead.

2 Liability to the client company under law of contract.

The audit client company represents all shareholders acting as a body (in this respect, a company cannot be represented by a single shareholder). The auditor has a duty to report to the shareholders whether the financial statements show a true and fair view. The auditor therefore has a contract with the company. Under this contractual relationship, it is implied that the auditor will carry out his work with a reasonable degree of care and skill. The degree of care and skill required mainly depends on nature of work undertaken. Generally if the auditor has complied with the GAAPs and guidance from the ISAs, it would be difficult to prove that the auditor was negligent.

In the case of Kingston cotton mill, the judge considered the degree of care and skill required of an auditor and declared that it is the duty of an auditor to bring to bear on the work he has to perform, that skill, care and caution which a reasonably competent, cautious and careful auditor would use.

The auditor has no duty to an individual shareholder. A shareholder who makes an investment decision by relying on the auditor's report and suffers financial loss cannot claim for damages under the law of contract. Only if the company i.e. the entire body of shareholders has suffered a loss can such a case be brought under law of contract .

3 Liability to third parties under tort or negligence.

In this case third parties refer to anyone other than the client company who has used the auditor's report and wishes to make a claim for negligence. It therefore includes any individual shareholders in the company, any potential invertors and other providers of capital such as lenders and creditors. The difference between these parties and the client company is that such third parties have no contract with the auditor and therefore no implied duty of care.

For third parties to succeed in claiming for damages under negligence, they must prove that;

- A duty of care existed i.e. the auditor owed the third parties a duty of care.
- The duty of care was breached through auditor's negligence.
- They suffered a financial loss as a direct consequence of an auditor's negligence.

In Hedley Byrne and Company Limited versus Heller and Partners (1963), it was held that 'a duty of care exists where there is a special relationship between the parties. I.e. where the auditor knew or ought to have known that the financial statements would be made available and would be relied upon by a particular person.' The implication of this statement is that, for there to exist a duty of care, the third part must have been identified in some way to the auditor. E.g. where the directors inform the auditor that the financial statements would be used to obtain a loan, the auditor will have to owe duty of care to the bank in the same way he owes a duty of care to the client.

Ways of minimizing potential liability for professional negligence include:

- By not being negligent.
- Adhering to the requirements in ISAs, codes of professional conduct and utilizing sound professional judgment.
- Agreeing with the client duties and responsibilities of the auditor and the client in the engagement letter to avoid future misunderstandings.
- Defining in the audit report the precise work the auditor has undertaken.
- Stating in the engagement letter the purpose for which the report has been prepared and that the client may not use it for any other purpose.
- Identifying the authorized recipients of reports in the engagement letter in the report.
- Limiting or excluding liability by a term in the engagement letter or in the case of third parties a disclaimer in the report.
- Advising the client on the engagement letter on the need to ask for permission before using the auditor's name and withholding such permission when appropriate.

Professional Ethics

A member of a profession owes duty to the public including the employer, the profession itself and to other members of the profession. Professional ethics are rules of conduct that govern the behavior of an accountant. In Kenya, they are issued by institute of Certified Public Accountants of Kenya (ICPAK) in form of statements and explanatory notes. A professional accountant should act in a manner consisted with the good reputation of the occupation and refrain from any conduct which might bring discredit to the profession. The following are fundamental principles stated by ICPAK to ensure auditors are credible people before they give credibility to financial statements.

1. Integrity: A member should be straight forward, honest and sincere in his approach to professional work. A member must be aware of his role in the society and maintain high standards of conduct should not satisfy what he knows as untrue as true and should take caution not to mislead intentionally or unintentionally.
2. Professional independence: This is a fundamental concept to the accounting profession as a whole. It is essentially an attitude of mind characterized by objectivity and integrity. A member in public practice should be and should appear to be free in every professional assignment he undertakes, of any interest which might distract him from being objective. He must be impartial and must not allow prejudice or bias to affect his judgment. A member not in practice may be unable to be or seen to be free of any interest which might conflict to the proper approach of his professional work. However, this does not diminish his duty of objectivity in relation to that work.
3. Confidentiality: The guide to professional ethics states that information acquired in the course of professional work should not be disclosed except where consent has been

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acquired from the client, where there's public duty to disclose or where there is legal or professional duty to disclose such information. A member acquiring information in the course of professional work should neither use nor appear to use that information in his personal or third party advantages e.g. if a member is auditing a limited company and he realizes that the company has made a substantial increase in profits, it would be unethical to advise a friend to buy the shares of this company in anticipation of the expected increase in the share prices as a result of increase in profitability.

4. Technical competence: A member has duty to carry out his professional work with care and skill and in conformity with the professional ethical standards issued by ICPAK and by the laws of Kenya. A member should not undertake or continue professional work which he himself is not competent to perform unless he obtains such advice and assistance as will enable him to perform such work. To be competent a member should be fully conversant with accounting, book keeping, auditing, financial management, information technology, receivership, liquidation and bankruptcy law, taxation both personal and corporate and must be aware of the economic environment within which his clients operate. To be competent, he must also possess sound judgment. This is in professional as well as economic issues. He should be a good communicator.

Auditor's independence is an important factor in establishing the credibility of an audit opinion. Therefore, ICPAK has given guidance in the best conduct code in situations where the auditor's independence may be impaired. These are:

a) Fees

It is undesirable for a practice to receive a significant proportion of recurring fee income from one client or group of connected clients. A new or old practice is exempted from his provision because in the case of a new practice, he has not yet built a sufficient client base and an old practice may be in decline. Therefore, when a member finds himself with such a client, he does not resign immediately but first look for opportunities to reduce the significance of that client by looking for more work.

Where practice is deriving a significant portion of its professional fees from one client, the practice will be hesitant to do anything that could result in losing the client i.e. an auditor may be hesitant to qualify his report for fear of losing such a client.

b) Personal and family relationship

A family of personal relationship can affect objectivity therefore an accountant should take step to ensure that this does not interfere with his objectivity in approach to auditing e.g. a problem may arise when a person in practice has a mutual business with an officer of the client company or has close friendship with one of the officers.

c) Beneficial shareholding

A practice should ensure that he does not have as an audit client, a company in which a partner in practice, the spouse or minor child of such partner is the beneficial holder of shares nor should it employ on the audit, any member of staff who is a beneficial holder of such shares. Shares in an audit client may be involuntarily acquired e.g. where a partner inherits such shares or marries a shareholder. In such cases, the shares should be disposed off at the earliest practicable date. If the company's articles of association require that the auditors should have a minimum number shares, then the member should take minimum number allowed. The shares cannot be used by the member in an annual general meeting to vote on the appointment of the auditor and his remuneration.

d) Trustee shareholding

A practice should not have as an audit client a company, if a partner in the practice or the spouse of a partner is a trustee of trust holding shares in that company and the holding is in excess of 10% of the issued share capital of the company or of the total assets comprised in the trust.

e) Practice loan

A practice should not make a loan to a client or guarantee a client's borrowings or accept a loan from a client or have a borrowing guaranteed by a client. This does not apply to a practice having a current account with a client commercial bank or a similar financial institution. A firm may however accept a loan from a client if it is in that client's ordinary course of business to give loans. Loan therefore should not be accepted on terms more favorable than those available to others.

f) Goods and services

Acceptance of goods or services from a client may be a threat to independence. This should not be accepted by a partner, his spouse or minor child or by the staff of practice except on terms no more favorable than those available to the generality of the client's employees. Acceptance of undue hospitality poses a similar threat.

g) Commission

Where advice is given to client in such that if acted upon it would result in a commission being earned by the practice or anyone on it, special care should be taken to ensure that the service is in fact in the best interest of the client. The client should be informed in writing both on the fact that commission would be received and as soon as practicable the amount and terms of such commission.

h) Conflict of interest

- Provision of other services to clients. A member should be alert to the danger posed to his independence by providing accounting and other services which place him in an executive position to his client. A member should use different staff for those services and also ensure that the client takes full responsibility for that work.
- Competing clients: A member should frankly disclose to both clients and advice them to choose another auditor and then disengage one of the appointments. However, he can also advise to resolve the conflict. An example of competing clients would be where a practice advises one client upon the figures on which to base a tender for a contract and if knowingly became involved in advising another rival company tendering for the same contract.
- Receiverships and liquidation: If a company a member is auditing goes into receivership, the member should not accept an appointment as a receiver manager unless at least two years have elapsed. Where a practice, his partner or his employee has during the previous two years has had a continuing professional relationship with the company which goes into liquidation, he should not accept an appointment as liquidator of that company.
- Previous employment: A member who has been an employee of a company having left that employment should not accept appointment as an auditor of that company until at least two years have elapsed.

Additional steps to enhance auditor's independence

- Rotation of partners. There should be mandatory rotation of audit partners responsible for audit of a company after a set maximum number of years. A primary objective of the rotation would be to guard against the possibility of the auditor and his staff becoming too close to senior management and thus consequent impairment of auditor's independence.

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- Having another appropriately qualified and experienced person the firm to review the work performed by the engagement partner and his team.
- Prohibiting undertaking of consulting work for existing audit clients. An accounting firm may establish departments each with its own staff in respect to audit engagement, consultancy services, tax services, human resource services and risk management. The staff responsible for consultancy have no contact with the staff responsible for the audit.
- Peer review. This refers to the process through which institute of certified public accountants (ICPAK) establishes a committee to review audit procedures and quality control policies for members while conducting an audit. Such reviews would be aimed at evaluating whether the audit work performed meets the minimum quality standards set by the profession and whether the audit opinion expressed is supported by the work done and evidence gathered.
- Enacting stringent laws, that seek to protect the auditor from being removed from office e.g. because of issuing a qualified audit opinion. Under the current provisions of the Companies Act, only a simple majority of shareholder is required to remove the auditor from office. Clearly there is need for more protection for the auditor.
- Enhancing the role of the audit committee. An audit committee is a committee set up with clearly defined role in setting policies for the awarding of non-audit work to the auditor and not only recommending the appointment of the auditor each financial year but also fixing their remuneration. The capital markets authority (CMA) requires that all companies listed in the Nairobi Stock Exchange (NSE) must have an audit committee. The purpose of such a committee is to guard and promote the independence of the auditors. The committee consists of mainly non-executive directors to enhance their effectiveness and independence.

Advertising and Publicity

A member should not advertise professional services or skills in such a way as to show himself to be more qualified than other practicing accountants.

A member may place an advertisement under the following circumstances:

- When acting on behalf of the client.
- When acting in fiduciary or similar capacity.
- When seeking staff or salary employment.

A member may have paid announcements in the press for opening a new office, changing the name, address or membership of his firm or for member's appointment. Publicity given to member's activity both professional and otherwise is acceptable as it is publicity for the professional activity of a firm.

From the ethical guidance, it is unethical for an accountant to seek professional work by advertising his services. One cannot therefore place an advertisement in the media claiming he is a superior service provider than other accountants.

Advertisements should not contain comparisons with other members or firms, contain testimonies or endorsements or bring the firm, members or the accountancy profession discredit or dispute.

Although advertisements may refer to the basis on which fees are calculated and where they contain any statements concerning the hourly rate charged by the firm, care should be taken to avoid giving the impression that lower quality performance is provided than that expected from professional persons.

Obtaining professional work

A member should not in any circumstances obtain or seek professional work for himself or for another party in unprofessional manner e.g. bargaining.

A practicing member should not give any commission, fee or reward to a third party in return for introduction to a client. However, a partner who brings in business can be paid commission by his own practice.

No member in practice shall comply with any request from a firm or company who is not a client of that firm to submit a quotation for audit fees unless the existing auditors are aware that such a request has been made by their client.

Charging Professional Work

Fees should not be charged on a percentage or similar basis except where it is authorized by the law or is generally accepted practice for certain specialist work e.g. construction work. Also, no instructions should be accepted on a contingency basis e.g. bonus of 3% on profits. This is because auditor's judgment should not be impaired by hope of a financial gain. If fees were computed as a percentage of the net profit, the auditor would be hesitant to propose to the management audit adjustment that would result to reduction of the audit fees derived from the assignment.

- In practice the most common mode of determination of audit fees is to compute them on the following considerations:
- The skill and knowledge required for the type of work involved. If the work required an expert, the fees would be higher
- The seniority of the person engaged in the work i.e. audit partners, managers, seniors and assistants.
- The time necessarily engaged on each person on the work.
- The nature of responsibility which the work entails.

Corporate Governance

The Capital Markets Authority (CMA) developed guidelines for good practices by public limited companies in Kenya in response to the grave importance of governance issues in both emerging and developing economies and for developing growth in domestic and regional capital markets.

Corporate governance concerns the way a company is operated and directed. It has the following key aspects:

- The role of the board of directors and the audit committee.
- The overall control and risk management framework.

Principles of good corporate governance

There are a number of principles essential for good corporate governance practices. The following have been identified as representative of critical foundations and virtues of good corporate governance practices.

a. Directors.

Every company should be headed by an effective board of directors to offer strategic guidance, lead and control the company and be accountable to shareholders.

The board of directors should discharge the following responsibilities regarding corporate governance.

STUDY TEXT

- Define company mission, strategy, goals ad objectives.
- Oversee the corporate management and operations, review management accounts, approve the company expenditures and review the performance of the organization.
- Review on a regular basis the adequacy ad integrity of the company's accounting and internal control system including compliance with applicable laws and regulations.
- Establish relevant committees and delegate mandates to run the affairs of the company. In addition, it should establish an audit committee.

b. Director's remuneration.

This should be sufficient to attract and retain directors to run the company efficiently and it should be approved by the shareholders. The executive director's remuneration should be competitive and linked to performance.

c. Board balance.

The board should be composed of a balance of diverse skill and expertise in order to ensure that no individual or group of individuals can dominate the board's decision making process.

For listed companies, the board should have at least a third of independent non executive directors. An independent director is one who:

- Has not been employed by the company in an executive positioning in the last five years.
- Is not associated with any advisor or consultant of the company or member of the company's senior management or a significant customer or supplier of the company.
- Has no personal service contract with the company or a member of the company's senior management.
- He is not employed by a public limited company in which an executive officer of the company serves as a director.
- He is not a member of the immediate family of any person named above.
- Has not had any of the relationships described above with any affiliate of the company.

d. Appointments to the board.

There should be a formal and transparent procedure in appointment of directors to the board. All persons offering themselves for appointment as directors should disclose any potential areas of conflict that may undermine their position in service as directors.

e. Re-election of directors.

All directors except the managing director should be required to submit themselves for re-election at regular intervals or at least every three years. Executive directors should have a fixed service contract not exceeding five years with a provision for renewal subject to regular performance approval by the shareholders.

f. Role of the chairman and the chief executive.

There should be a clear separation of roles and responsibilities of the chairman and the chief executive. This should ensure a balance of power and authority and provide checks and balances such that no individual should have unquestionable powers over decision making.

g. Approval of major decisions by shareholders.

The shareholders should participate in major decisions of the company. The board should therefore provide shareholders with information such as major disposal of company assets, plant restructuring, mergers and acquisitions and organization plans.

h. Best practices in audit committees

An audit committee is an independent committee established by the board and mainly composed of at least three non executive independent directors with written terms of reference which deal clearly with its authority and duties.

Objectives of the audit committee

- Increasing public confidence and credibility and objectivity of published financial statements.
- Assisting directors in meeting their responsibilities in respect of financial reporting.
- Strengthening the independence position of a company's external auditor by providing an additional channel of communication.

Attributes of audit committee members

- Members of the audit committee should have the following attributes;
- Broad business knowledge relevant to the company's business operations.
- Keen awareness on the interests of the investing public.
- Familiarity with basic accounting principles.
- Objectivity in carrying out their mandate with no conflict of interest.

Functions of an audit committee

- Act as an effective overseer of the financial reporting process and company internal control system. E.g. it should be involved in review of company's internal control procedures.
- Reviews quarterly, semi-annually and yearly financial statements of the company focusing particularly on any changes in accounting practices, significant adjustments arising from the audit, the appropriateness of the going concern assumption adopted in preparation of the financial statements and whether the financial statements comply with IFRSs and other relevant regulations.
- Consider the appointment of the external auditor, the audit fees charged and any questions regarding resignation or dismissal of the external auditor.
- Discuss with the external auditor before the audit commences the nature and scope of the audit and ensure that the work is properly coordinated.
- Review management evaluation of the factors related to independence of the external auditor. Both the audit committee and the management should assist the external auditor in preserving his independence.
- Discuss problems and reservations arising from the audit and any matters that the external auditor may want to discuss.
- Review any communication between the external auditor and management. Such communication should include management letter issued after the conclusion of the audit.
- The committee considers any related party transactions that may arise within the company and ensure that related party transactions are appropriately disclosed in the financial statements in accordance with ISA 24 Related Party Disclosures.
- Consider major findings of any internal investigations undertaken and the management's response to the findings.
- The committee has exclusive authority to investigate any matter within its terms of reference and management must provide access to the necessary information and any resources required.
- Considers other issues as defined by the board of directors including regular reviews of the capacity and effectiveness of internal audit function.

The audit committee is established to give additional assurance to the various stakeholders on issues regarding the quality and reliability of financial information used by the board and financial statements issued by the company. The committee maintains a direct line of communication between the board of directors and the external auditor.

Relationship between the audit committee and the internal audit function

The management of the organization should establish an internal audit function which should be independent of the activities that they audit as the internal audit work should be done with objectivity, proficiency and due professional care. The audit committee performs the following roles regarding the internal audit function;

- Review of the scope, functions and resources of the internal audit function and ensures that it has the necessary resources and authority to carry out the work.
- Review the internal audit function work programme and the internal audit report and where necessary ensure that appropriate action is taken on recommendations made.
- Review any appraisal or assessment of the performance of the members of the internal audit function.
- Approve any appointment or termination of senior staff members of the internal audit function.
- Ensure that the internal audit function is independent of the activities of the company and it operates with objectivity, skill and due care.
- Determine effectiveness of the internal audit function and undertake all steps possible to promote its independence.

Relationship between the audit committee and the board of directors

The board of directors establishes the audit committee. However this committee should be independent of the board to be able to exercise its responsibilities.

Some of the members of the board may be appointed members of the audit committee, usually non executive members.

The audit committee reviews or provides an oversight over some of the responsibilities exercised by the board. E.g. the audit committee could review significant accounting policies chosen by the board to ensure that such policies are appropriate to the organization and result to credible financial information.

The audit committee enhances and improves communication between the external auditor and the board and between the board and the internal audit function.

Advantages of the audit committee

- It contributes to improvement of quality of financial statements and credibility of the financial reporting process.
- Assists the directors meeting the responsibilities in respect to financial reporting.
- Strengthens independence position of the external auditor by providing additional channel of communication.
- Promotes effectiveness of internal audit function by ensuring that the function has authority and resources t carry out its responsibilities and also ensures its recommendations to the management are implemented.
- Increases public confidence in credibility and objectivity of published financial information including audited interim financial statements.
- Improves communication between directors, the eternal auditor and the management.

Disadvantages of the audit committee

- It leads to fear that its purpose is to catch the management out and by so doing, cause divisions in the board. All directors are equal and some should not be seen as supervising others. However, the audit committee acts on behalf of the main group of directors and reports to it.
- Non executive directors may be overburdened with detail and may get into management responsibilities and possibly cause conflict. There is a thin line between management and supervision.
- Audit committees are ineffective and powerless as they cannot enforce their recommendations or report directly to shareholders.
- Appointment of non executive directors is heavily influenced by the executive hence 'yes men' may be appointed.
- Audit committee incurs time and costs unless it is justified that the benefits outweigh costs.
- The committee may encourage prudence and risk aversion which can hamper initiative and executive flair.
- Non executive directors may lack the technical skills and the know-how and in turn be rendered incompetent.

CHAPTER SUMMARY

- The first auditors of a company may be appointed by the directors at any time before the annual general meeting, and the auditors so appointed shall hold office until the conclusion of that meeting.
- A person or firm shall not be qualified for appointment as auditor of a company unless he or, in the case of a firm, every partner in the firm is the holder of a practicing certificate issued pursuant to s.21 of the Accounts Act
- An auditor may resign from office as long as a notice in writing to that effect is deposited at the company's registered office.
- The auditor and the client should agree on the terms of the engagement. The agreed terms should be recorded in an audit engagement letter or other suitable form of contract.
- The auditor gives credibility to financial statements and to do this he must be credible himself.

QUIZ

1. List the professional ethics that the auditor is expected to adhere to.
2. What is the purpose of an engagement letter?

ANSWERS TO THE QUIZ

1. Integrity, Competence, Confidentiality, and independence.2. The purpose of an engagement letter
- The letter defines the scope of work to be carried out and the respective responsibilities of the auditor and the client under the engagement. This helps in avoiding misunderstandings between the client and the auditor as regards to the scope of the work to be carried out and the respective responsibilities of both parties.
- The letter documents and confirms the auditor's acceptance of the appointment
- It explains the forms of any reports to be issued under the engagement

2. To educate the client on:-
    1. His duty to maintain proper books of accounts and to prepare financial statements that show a true and fair view.
    2. His duty to prevent errors and frauds.
    3. His duty to provide all the necessary information
    4. That the audit should not be relied upon to detect errors and frauds.
    5. To explain the the audit will be carried out on a test basis.
    6. Basis of charging his fees.
    - Minimise auditor's liability to third parties.
    - Commit client to his obligations in an audit.

EXAM QUESTIONS

QUESTION ONE

Your firm has been approached by the directors of UB Bank Ltd. a newly formed commercial bank to undertake the audit for its first complete financial year ended 31 December 1996. Your manager has assigned you the responsibility for leading the team. You have had various discussions with the directors about the timetable and the respective responsibilities of management and the auditor. You have drafted a letter of engagement and have sent it to the managing director for approval and acceptance but the management has not yet responded to your letter.

Required:

a) Explain why a letter of engagement is sent before any new audit appointment is accepted.
b) Set out the main contents of a letter of engagement.
c) Itemize the actions you would take in response to the non-reply by the management to your draft engagement letter.
d) State when it might be necessary to re-draft an engagement letter and have it re-affirmed by the client's management.

QUESTION TWO

The objectivity of the external auditor may be threatened or appear to be threatened where:

i. There is undue dependence on any audit client or group of clients.
ii. The firm, its partners or staff have any financial interest in an audit client.
iii. There are family or other close personal or business relationships between the firm, its partners or staff and the audit client.
iv. The firm provides other services to audit clients.

Required:

a) For each of the four examples given above, explain why the objectivity of the external auditor may be threatened, or appear to be threatened, and why the threat is important.
b) Describe requirements that reduce the threats to auditor objectivity for each of the four examples given above.

QUESTION THREE

a) Describe the matters to consider within your firm and the other procedures that must be undertaken before accepting the appointment as auditor to a new client.
b) Explain why it would be inappropriate to commence the audit before consideration of the matters and the procedures referred to in (a) above have been completed.
c) Explain the purpose of an engagement letter and list its contents.

QUESTION FOUR

You are a recently qualified Chartered Certified Accountant in charge of the internal audit department of ZX, a rapidly expanding company. Turnover has increased by about 20% p.a. for the last five years, to the current level of Kshs50 million. Net profits are also high, with an acceptable return being provided for the four shareholders. The internal audit department was established last year to assist the board of directors in their control of the company and to prepare for a possible listing on the stock exchange. The Managing Director is keen to follow the principles of good corporate governance with respect to internal audit. However, he is also aware that the other board members do not have complete knowledge of corporate governance or detailed knowledge of International Auditing Standards.

Required:

Write a memo to the board of ZX that:

a) Explains how the internal audit department can assist the board of directors in fulfilling their obligations under the principles of good corporate governance.
b) Explains the advantages and disadvantages to ZX of an audit committee.

QUESTION FIVE

a) Explain the situations where an auditor may disclose confidential information about a client.
b) You are an audit manager in McKay & Co, a firm of Chartered Certified Accountants. You are preparing the engagement letter for the audit of Ancients; a public limited liability company, for the year ending 30 June 2006.Ancients has grown rapidly over the past few years, and is now one of your firm's most important clients. Ancients has been an audit client for eight years and McKay & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 December 2005 remains unpaid. Audit personnel available for this year's audit are most of the staff from last year, including Mr. Grace, an audit partner and Mr. Jones, an audit senior. Mr. Grace has been the audit partner since Ancients became an audit client. You are aware that Allyson Grace, the daughter of Mr. Grace, has recently been appointed the financial director at Ancients. To celebrate her new appointment, Allyson has suggested taking all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year.

Required:

Identify and explain the risks to independence arising in carrying out your audit of Ancients for the year ending 30 June 2006, and suggest ways of mitigating each of the risks you identify.

CHAPTER THREE

AUDIT PLANNING, CONTROL & RECORDING (ISA 300)

CHAPTER 3
AUDIT PLANNING, CONTROL & RECORDING (ISA 300)

▶ CHAPTER OBJECTIVES

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

- Define audit planning and explain its objectives, advantages scope and timing.
- Discuss the sources of information on client's nature of business.
- Explain the purposes of the audit planning memorandum and the audit program.
- Explain audit planning procedures and the problems in developing and implementing an audit plan.
- Explain quality control procedures at an individual audit level and their objectives.
- Appreciate the need for working papers, their advantages and disadvantages.

ISA 300 Planning an Audit of Financial Statements:

Planning refers to developing a general strategy and a detailed approach for expected nature, timing and extent of the audit. The auditor should plan his work to enable him conduct an effective audit in an efficient and timely manner. The form and nature of the planning required from audit will be affected by the size and complexity of the organization, the commercial environment in which it operates and the methods of processing transactions and reporting requirements to which the organization is subject.

Advantages of good audit planning

- Establishes the intended means of achieving the objective of the audit.
- Assist in the direction and control of the audit work.
- A good plan assists in the proper utilization of audit assistants and in coordination of work done by other auditors and specialists.
- Helps ensure that attention is devoted to important areas of the audit. The planning process identifies potential problematic areas e.g. areas with weak internal controls where more detailed substantive testing should be carried out.
- Helps ensure that work is completed expeditiously through more efficient use of time and proper allocation of work to audit staff.
- Ensures proper division of work between the interim and the final audit avoiding repetition of work already done.
- Takes into consideration times when information needed for audit proposes is available and when the client is not very busy. This encourages cooperation by ensuring less disruptions of client's work.

INTRODUCTION

Audit planning is a vital stage of the audit process covered under ISA 300. Every audit should be planned so that the engagement will be performed in an effective manner. The main aim is to reduce audit risk to an acceptably low level.

DEFINITION OF KEY TERMS

Audit planning covers the development of an overall plan for the expected coverage and conduct of the audit.

Quality control refers to the various policies and procedures put in place by the auditor to ensure that all audits conducted by the audit firm meet the quality standards set out by the accounting profession and the firm's own quality standards.

Peer review -described as an independent review of a firm's accounting and auditing practices.

Working papers -evidence is recorded in the form working papers of which are prepared by the auditor or obtained during the audit. The working papers are retained by the auditors in connection with the performance of an audit.

EXAM CONTEXT

This is an important area of the syllabus and the examiner may question it.This chapter is tested on a regular basis due to its importance.

INDUSTRY CONTEXT

Audit planning is essential for every audit to direct the work of the auditor for him to allocate resources. It is therefore inevitable to conduct an audit effectively without an audit plan.

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Scope of Audit Planning

Audit planning covers the development of an overall plan for the expected coverage and conduct of the audit. The audit plan is recorded in a planning memorandum.

An audit programme is then developed which shows the nature, timing and extent of audit procedures to be applied at every level of audit testing. In order to plan his work adequately, the auditor needs to understand the nature of client's business, its organization, its methods of operation and the industry in which it operates. This is to enable the auditor appreciate which events and transactions are likely to have significant effect on the financial statements.

Sources of information on client's nature of business

ISA 315 states that the auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting.

In performing an audit on financial statements, the auditor should have or obtain knowledge of client's business sufficient to enable him identify and understand events, transactions and practices that in the auditor's judgment may have significant effect on the financial statements or the audit report. Prior to accepting an engagement, the auditor should obtain a preliminary knowledge of the industry and of ownership, management and operations of the entity to be audited. After accepting to act as the company's auditor, further and more detailed information would be obtained. Obtaining the required knowledge of the business is a continuous and cumulative process. The following may be used as sources for that information.

- Previous experience with the entity and the industry.
- Discussions with people within the entity.
- Discussion with internal audit personnel and review of internal audit reports.
- Discussion with other auditors and with legal and other advisors who have provided services to the entity.
- Journals and publications of the industry.
- Visits to the entity's place of business and plant facilities.
- Documents such as minutes of meetings, annual financial reports, operations and system manuals and budgets.

The auditor should ensure that audit assistants in an engagement also obtain sufficient knowledge of clients business to enable them carry out delegated work.

Audit planning memorandum

The planning memorandum sets out the audit approach, how, whom and when each item in financial statements will be audited timing requirements of the audit and staff usage with time budget for each set of audit work. It generally contains the following.

- A summary of terms of engagement required to set out the nature of the audit work.
- A job timetable giving provisional dates of the timing of the audit.
- Records of any changes about the client since last audit e.g. changes in management structure.
- Background information about the client.
- Details of key client contacts.
- Extent of reliance expected on internal control system.

Audit Programme

An audit programme describes how the audit approach is to be implemented. Auditors develop an audit programme for each material accounts balance or account balance assertions. It is prepared in line with the planning memorandum and generally documents the audit objectives and procedures that will be carried out at the specific areas the auditor is interested in.

The following is an example of an audit programme designed to gather evidence in the control testing stage as to the effectiveness of operation of a client's bank reconciliation procedures.

Client: Mugutho Ltd.

Year end: 31 / 12/2006

Control testing: Bank reconciliation

Prepared by: ……………………

Received by: ……………………...

Audit procedure	Timing	Extent	Responsibility
Inquiry whether the bank reconciliations are prepared independent of maintenance of the cash book.	Interim visit	July reconciliation	Audit assistant
Inspect evidence of performance of bank reconciliations by client staff. Ensure that the person performing the reconciliations signed and dated the reconciliations. Ensure the reconciliations were done by the person proposed at the appropriate time and the supervisor signed the reconciliation as evidence of his review.	Final visit	September and October reconciliations	Audit assistant.

Problems in developing and implementing audit plan.

- A company may have many clients with similar year ends. This will make allocation of time and audit staff difficult.
- Abrupt changes in the client's business will call for more audit time outside the planned time. This especially happens when the client converts from manual accounting system to a computerized system such changes weaken the internal control system in the short term and call for more audit time than was previously planned for.
- Lack of co-operation from client e.g. providing information and explanations in good time is normally difficult for the client. This will be the major challenge for the auditor especially with a client who does not have proper accounting and internal control system.

- Staff turnover in an audit firm. This inevitably interferes with the audit plan because it gives rise to unplanned staff shortages.

Audit planning procedures

In planning the audit of a new client, the auditor should carry out the following procedures.

1. Carry out a preliminary review of the client. This will involve obtaining a good understanding of the nature of the client's business.
2. Discuss with management to obtain an understanding of the management structure and a general feel of the current operating circumstances of the client and any factors that affect client's accounting and internal control system.
3. Communicate with previous auditor of the client and obtain from him all the information that is relevant to the audit of the new client.
4. Seek to obtain a preliminary understanding of the nature of the clients accounting and internal control system. This assists determine the extent to which the auditor will rely on the client's internal control system.
5. Consider any accounting standards and legislations that could have an impact on the audit of the new client.
6. The audit senior should check the nature and timing of reports and other communications of the client so that such timings can be accommodated in the audit plan. E.g. dates of the AGM, stock takes and when management reports are ready.
7. The audit senior should determine the number of audit staff required, their experience and any special skills required and the timing of the audit visit.
8. Prepare an audit planning memorandum that summarizes the scope of the work under the engagement and the strategy to be followed to meet the client's needs.

Quality control (ISA 220)

The quality of the work carried out by the auditor is of fundamental importance. This is especially so in the light of potential of being sued for negligence. The auditor remains personally responsible for the work he carries out and the opinion he issues. The only way of reducing the risk of being sued is to ensure that work performed by the firm is of the highest quality possible.

Quality control refers to the various policies and procedures put in place by the auditor to ensure that all audits conducted by the audit firm meet the quality standards set out by the accounting profession and the firm's own quality standards.

Objectives of quality control

- To meet professional requirements. Audit staff employed by the firm should adhere to the principles of independence, objectivity, confidentiality and professional behaviour.
- Skill and competence. The audit firm should be staffed by personnel who have attained and maintained the technical standards and professional competence required to enable them fulfill their responsibilities with due care.
- Assignment. Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
- Delegation. There should be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

- Consultation. Where necessary, consultation within and without the firm should be carried out with those with appropriate knowledge.
- Acceptance and retention of clients. An evaluation of prospective clients and a review on an ongoing basis of existing clients should be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly and the integrity of the client's management should be considered.
- Monitoring. The firm should continuously monitor the adequacy and operational effectiveness of quality control policies and procedure's.

The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies are understood and implemented.

Quality control policies and procedures at individual audit level

i. Delegation. Audit work should be delegated by the reporting partner to staff who have appropriate experience, training, proficiency and independence. This will provide reasonable assurance that such work will be performed with due care by persons having he required technical competence.

ii. Direction. Audit assistants to whom work is delegated should be given appropriate instructions. This involves informing audit assistants of their responsibilities and objectives of the procedures they are to perform. It also involves informing them of matters such as nature of client's business and the possible accounting and auditing problems.

iii. Supervision. This involves monitoring the progress of the audit to consider whether assistants have the necessary skills and competence to carry out their assigned tasks, establishing whether assistants understand the audit instructions and resolving any differences of professional judgment between personnel. Supervision also entails identifying and addressing any significant accounting and auditing questions raised in course of the audit and ensuring that work is being carried out in accordance with the overall audit plan and audit programme.

iv. Review Work performed by each staff member should be reviewed by a person of equal or higher competence to ensure that work has been performed in accordance with audit programme, has been properly documented and that audit objectives have been met.

Peer Review

Peer review may be described as an independent review of a firm's accounting and auditing practices. It is intended that the review be done by practitioners upon fellow practitioners hence the term peer review. The work of the review is limited to:

- Professional aspects of the practice.
- Overall total quality control policies.
- Professional aspects of firm's accounting and auditing practices like maintenance of working papers and custody of financial statements.

Objectives of Peer Review

- To promote compliance with professional standards and other technical pronouncements.
- To provide reasonable assurance to users of financial statements that professional standards have been complied with in performance of audit and related services.
- To promote uniform application of generally accepted methods of professional practice.
- To gain increased user confidence in the reliability of audited financial statements.
- To establish a mechanism of continuous quality improvement in professional practice and a self regulatory framework for policies and procedures.
- To enhance the status and image of accounts to the public through assurance of compliance and quality in performance of audit and related services.
- To help ensure that auditors are competent and independent and to identify potential problems in this regard at an early stage for necessary corrective actions.
- To help identify weaknesses in the audit process and provide technical assistance for professional development.

Reasons for introducing Peer Review

- There is desire on the part of professional bodies worldwide to ensure that members apply and observe professional standards.
- The institute of certified public accountants of Kenya (ICPAK) deems it appropriate to ensure adherence to existing technical standards through this mechanism of monitoring compliance.
- It is better for professional bodies to be self regulating than being regulated by the governments.

Audit Recording (ISA 230-Documentation)

The auditor must record or document all the information gathered as audit evidence in forming an opinion on the financial statements. The evidence is recorded in the form of working papers which are prepared by the auditor or obtained during the audit. The working papers are retained by the auditors in connection with the performance of an audit. Audit working papers should always be sufficiently complete and detailed to enable an inexperienced auditor having no previous connection to the audit to ascertain work that was performed to support the conclusion reached. The auditor should record all relevant information known to him at the time, the conclusion reached based on that information and the views of management.

The need for good working papers

- The reporting partner needs to satisfy himself that the work delegated by him has been properly performed. This is only possible by reviewing detailed working papers prepared by the audit staff who perform the work. This also aids in supervision and review of work done by audit assistants.
- Working papers provide details of problems encountered together with evidence of work performed and conclusion reached. They can also serve as a good reference point for future audit.

- Preparation of working papers enables to auditor to adopt a methodical approach to his work.
- Working papers assist in planning and performance of audit in future financial periods.
- If sued for negligence, the auditor can use the working papers as evidence for work done.
- Working papers can be used for training of audit staff. They contain audit programme and specimen schedules which audit assistants can refer to when conducting the audit.

Auditing guidelines do not define precisely, the form of working papers but it indicates what might typically be contained therein.

- Information of continuing importance to the audit such as letter of engagement and memorandum of association.
- Planned audit approach as contained in the planning memorandum
- Auditors assessment of client's accounting system, his review and evaluation of internal controls
- Details of work carried out, not as of errors or exceptions noted and action taken together with conclusion drawn by audit staff.
- Evidence that the work of staff has been properly reviewed.
- Record of relevant balances and other financial info that is subject to the audit.
- Analysis of significant ration and trends
- Copies of communications with other auditors, expects and other third parties.
- Letters of representation received form management.

Working papers are divided into the current audit file (CAF) and the permanent audit file (PAF)

The permanent audit file

This contains documents and matters of continuing importance which are required for more than one financial period.

It contains:

- Statutory material governing the conduct of the audit e.g. for companies, the companies Act Cap 486 and for quoted companies in Nairobi Stock Exchange, the NSE booklet of regulation are required.
- Rules and regulations of the entity e.g. articles of association or a partnership deed.
- Copies of documents of continuing importance and relation to the auditors e.g. minutes of meetings that recorded the appointment of the auditor, guarantees and indemnities entered into.
- Address of registered office and all other premises with a short description of the work carried at each of those premises.
- Organizational chart showing the principal departments and subdivision thereof and names of officials and their responsibilities showing clearly the lines of authority.
- A list of directors, their shareholding and service contracts.
- A list of company's advisors, bankers, lawyers, stock brokers and valuers.
- An outline of history of the organization reserves and share capital.
- Accounting policies used on material areas such as stock and depreciation.

The current audit file

This file contains matters pertinent to the current year's audit and contains:

- A copy of the accounts being audited which must be signed by the directors.
- A file index showing contents of the file.

- A detailed description of internal control system in form of flow charts, questionnaires or any other form of suitable documentation.
- Audit programme showing the audit objective and planned audit procedures for each of the areas to be audited.
- A schedule of each item in the balance sheet showing the balance at beginning of the year, changes during the year and balance at the end of the year. The schedule also shows details of work performed on each balance, the result and conclusion made.
- A schedule of the items in the profit and loss account. It will show the details of work performed on each balance the result and conclusion reached.
- A check list for compliance with statutory disclosure requirements and accounting standards.
- A record of questions raised during the audit and those raised in the previous audit.
- A schedule of important statistics such as net profit margin, liquidity ratios and composition of sales.
- A record or an abstract form minutes of all director's meetings and of any internal committee whose deliberations are important to the auditor.
- The management letter setting out weakness of the internal control system.
- Letters of representation obtained from client's management.

Standardized working papers

This refers to a predetermined format of presenting and documenting audit findings formulated by individual audit firms e.g. check lists and specimen letters which are filled with standard wording and gaps left to fill in the relevant details of the client.

Advantages of standardized Working Papers

- This improves the efficiency with which working papers are prepared because they will be used for many clients
- They act on guidelines for instructions to audit staff and facilitate delegation of work.
- They provide a means to control the quality of audit work by ensuring that minimum quality standards are maintained.
- Ensures that all relevant issues in the audit are addressed.

Disadvantages

- It is not appropriate to follow mechanically, a standardized approach to the conduct and documentation of audit work as the auditor in some cases will need to exercise his own judgment.
- The initiative of auditor staff may be restricted because the need to exercise judgment in preparing working papers is eliminated.
- The client staff may become familiar with the method and perpetuate fraud in areas not covered by the standard working papers.
- The audit work becomes very mechanical with use of standardized working papers.

EXAM QUESTIONS

QUESTION ONE

Audit planning process allows the audit senior to acquire adequate knowledge about the entity. This process ensures an effective control and review of audit work.

Required;

a) Explain the auditor's planning process when planning for an audit of a new client.
b) How does audit planning assist in the conduct of an audit?
c) Explain the following controlling procedures in a well planned audit:
   - Direction and supervision of work
   - Review and co-coordination of work
   - Quality controls

QUESTION TWO

You are an audit senior responsible for understanding the entity and its environment and assessing the risk of material misstatements for the audit of Rock for the year ending 31 December 2004. Rock is a company listed on a stock exchange. Rock is engaged in the wholesale import, manufacture and distribution of basic cosmetics and toiletries for sale to a wide range of stores, under a variety of different brand names. You have worked on the audit of this client for several years as an audit junior.

Required:

(a) Describe the information you will seek, and procedures you will perform in order to understand the entity and its environment and assess risk for the audit of Rock for the year ending 31 December 2004.
(b) You are now nearing the completion of the audit of Rock for the year ending 31 December 2004. Draft financial statements have been produced. You have been given the responsibility of performing a review of the audit files before they are passed to the audit manager and the audit partner for their review. You have been asked to concentrate on the proper completion of the audit working papers. Some of the audit working papers have been produced electronically but all of them have been printed out for you.
Describe the features of those working papers that show that they have been properly completed.

QUESTION THREE

ISA 230 Audit Documentation (Revised) establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

Required:

a) List the purposes of audit working papers. (3 marks)
b) The time is now towards the end of the audit, and you are reviewing working papers produced by the audit team. An example of a working paper you have just reviewed is shown below.

Client Name Specs4You Co

Working paper Payables transaction testing

Year end 30 April 2007

Prepared by ……………………..

Reviewed by ……………………

Audit assertion: To make sure that the purchases day book is correct.

Method: Select a sample of 15 purchase orders recorded in the purchase order system. Trace details to the goods received note (GRN), purchase invoice (PI) and the purchase day book (PDB) ensuring that the quantities and prices recorded on the purchase order match those on the GRN, PI and PDB.

Test details: In accordance with audit risk, a sample of purchase orders were selected from a numerically sequenced purchase order system and details traced as stated in the method. Details of items tested can be found on another working paper.

Results: Details of purchase orders were normally correctly recorded through the system. Five purchase orders did not have any associated GRN, PI and were not recorded in the PDB. Further investigation showed that these orders had been cancelled due to a change in spectacle specification. However, this does not appear to be a system weakness as the internal controls do not allow for changes in specification.

Conclusion: Purchase orders are completely recorded in the purchase day book.

Required:

Explain why the working paper shown above does not meet the standards normally expected of a working paper.

QUESTION FOUR

International Standard on Auditing 300, *(Planning an Audit of Financial Statements*) states that an auditor must plan the audit.

Explain why it is important to plan an audit.

STUDY TEXT

CHAPTER FOUR

THE ACCOUNTING AND INTERNAL CONTROL SYSTEMS (ISA 400)

CHAPTER 4

THE ACCOUNTING AND INTERNAL CONTROL SYSTEMS (ISA 400)

CHAPTER OBJECTIVES

By the end of this chapter, the student is expected to have covered:

Definition of accounting system, internal control and control environment.

Types of internal control.

Advantages and disadvantages of internal control systems to the auditor and to the client.

Limitations in application of internal control system.

Tools and techniques used to assess the strengths or otherwise of internal control system. (Evaluation of ICS)

Internal Auditing

INTRODUCTION

This topic covers the internal control systems and the internal audit. When carrying out the audit, the auditor first needs to carry out an evaluation of the internal control systems and evaluate its operating effectiveness and its efficiency. This will help the auditor to ascertain the degree of reliance he or she is going to place on the controls and hence the level of the level of tests the needs to be carried on the final balances. To ascertain the effectiveness of these controls, the auditor carries out tests of control. The tests of control will also help the auditor have a better understanding of the entity. Internal control is covered by the International Standard on Auditing (ISA) 315 on *Understanding the entity and its environment and assessing the risk of material misstatement.*

Internal audit is normally set up by the management to help in the risk assessment process and to ensure the company adheres to good corporate governance. This function can either be carried out in-house whereby the employees of the company employed as the internal auditors or it can be outsourced. Internal auditing is covered by the International Standard of Auditing (ISA) 610 on *considering the work of internal auditing.*

ISA 400 defines an accounting system as the series of tasks and procedures by which transaction are procedures as a means of maintaining proper financial records. The accounting system identifies, assembles, analyses, defines, records and summarizes transactions of an entity the mgt requires complete and accurate accounting and other records to assist in executing their responsibilities which are:

- Safeguarding the company assets an preventing fraud and error
- Selecting suitable accounting policies and applying them consistently
- Ensuring that the company keeps proper accounting records as per the Companies Act.
- Delivering to the government agency, court or stock exchange a copy of the company's

STUDY TEXT

auditor financial statements within the specified period after year-end.

- Stating whether applicable accounting standards have been followed subject to any material departure disclosed and explained in the financial statements.
- Prepare the financial statements on a going concern basis unless it is appropriate to presume that the company will continue operations.
- Setting up an internal control system to enable all the above responsibilities to be carried out as required.

ISA 400 defines internal control system as all the policies and procedures adopted by management to in achieving objectives as far as practicable. The objectives of an internal control system are: -

- Orderly and efficient conduct of business.
- Adherence to management policies.
- Safeguarding of company assets.
- Prevention and detection of fraud and error.
- Accuracy and completeness of accounting records.
- Timely preparation of reliable financial information.

▶ KEY TERMS

Accounting system: Refers to the systems and procedures that management has put in place to ensure that the company maintains proper books of accounts.

Control environment: This refers to the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity.

Internal audit: This is a control function set up by management to review the accounting and internal control systems.

Internal Control: An internal control systems consists of all the policies and procedures (internal controls) adopted by management of an entity to assist in achieving management's objective

Tests of control:

▶ EXAM CONTEXT

For internal control, the questions are normally scenario based whereby the student is expected to highlight the controls that are missing in a particular system and recommend the controls that should be in place. This means that the student should be well versed with the internal controls so as to be able to pick them out in a scenario or a lack of them. It is important for the student to know how internal audit complements external audit since the examiner may ask the difference between the two.

▶ INDUSTRY APPLICATION

In every business enterprise, the management design controls to assist them in the achievement of company objectives. Once you have completed this topic, the prospective employer expects the student to have an understanding of the controls that are operational in the company. This will

Component of accounting and internal control system

These are:-

1. Risk assessment
2. Control environment
3. Control procedures

1. Risk assessment

Audit risk means the risk that the auditor may give an inappropriate audit opinion i.e. the auditor may report that the financial statements show a true and fair view while in reality they are materially misstated. Audit risk is composed of:

a) Inherent risk
b) Control risk
c) Detection risk

a) Inherent risk

This is the risk that the account balances are transactions could be materially misstated assuming that there were no internal control system. Inherent risk could increase a result of an adverse attitude of managers on the internal control system i.e. if they view internal control system as unimportant.

b) Control risk

This is the risk that a material misstatement could occur in an account balance or clan of transactions which will not be prevented or detected in a timely manner by the entity's accounting and internal control system.

c) Detection risk

This is the risk that the auditor's tests of balances and transactions will not detect a material misstatement that exists in an accounts balance or class of transactions. This implies that detection risk is the only component of audit risk under the auditor's control.

Risk based audit

This audit uses a model called audit risk model. If inherent risk and control risk are assessed to be high, then to remain within an overall acceptable audit risk, the level of acceptable detection risk must be low meaning that the level of tests of balances and transactions must be relatively high. If inherent and control risks are assessed to be low, then the level of acceptable detection risk may be higher leading to relatively lower level of tests of balances and transactions. Therefore the assessment of inherent and control risk is an essential part in deciding the overall approach to an audit.

For the audit model, audit risk equals inherent risk multiplied by the control risk and detection risk.

Advantages of audit risk model

- Helps eliminate over or under auditing because the nature, extent and timing of audit

STUDY TEXT

procedures performed is determined by the risk assessment carried out.

- The results appear more rational and defensible than if the model was not used. i.e. incase the auditor is called upon to support his decisions in a court of law, he can justify the level of reliance on the internal control system and the amount of substantive tests carried out
- Helps allow work to be delegated to junior members of audit staff who will be able to carry on without having to rely too much on their own judgment.
- The increased use of computer in business has made the calculations of audit risk easier leading to more efficient and effective audit.

Disadvantages

- The model gives an impression of accuracy which is unrealistic as in practice its difficult to put a quantitative value on inherent risk.
- For the model to be useful, the number of items being tested need to be sufficiently large to allow for valid statistical conclusions to be made. This rule out the use of the model in many small audits.
- The model has a danger of adapting an overly mechanistic approach and that the auditor may lose his 'feel' for the audit assignment.
- It requires proper knowledge of the burden to be able to assess the audit risk.
- A wrong assessment of inherent and control risk will lead to over or under auditing.

2. Control Environment

ISA 400 refers control environment as being the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance to the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment i.e. one with tight budgetary control and an effective internal audit function can significantly complement specific control procedures. Thus the control environment sets the tone of the entity by influencing the control consciousness of people. It may be viewed as the foundation of other components of internal control.

Factors influencing the control of environment

- The function of the board of directors or the audit committee. The control environment is significantly influenced by the effectiveness of the board of directors or the audit committee. This effectiveness is determined by the extent of its independence from management, experience and status of members and the extent to which it raises and pursues difficult matters with management and also its relationship with internal and external auditors.
- Management philosophy, style and ease with which managers could override controls. Management philosophy refers to whether the management likes taking risk in business or has a conservative approach. This has an impact on the overall reliability of financial statements. If they are risk takers, losses are likely and may want to hide them. If they are conservative to risk, there may be no business hence low profits and this may lead to falsification of financial statements.
- The implementation of organizational structure and methods of assigning authority and responsibility. This determines how well employees understand the limits placed

upon their powers and responsibilities. The objective is to separate responsibility for authorizing a transaction, keeping records for the transaction and custody of assets acquired from the transaction.

- Personnel policies and procedures. Employees should be recruited on basis of skills and knowledge essential for the performance of their jobs and if necessary, be trained

3. Control procedures

These are the policies and procedures in addition to the control environment, which the management has established to achieve the entity's specific objectives. The mix of types of controls implemented by mgt will depend on the control objectives and the size of the entity.

a) Organizational plan chart

Companies should have proper organization plans. An organized plan shows clearly the various departments within the company, their functions and persons charged with ensuring that such functions are fulfilled. They seek to ensure that the entity is properly departmentalized preventing duplication of duties across departments and boosting accountability within the entity. Delegation and limits of authority should be well and clearly defined.

b) Segregation of duties.

This refers to separation of various duties and responsibilities such that one person cannot process and record a complete transaction from beginning to the end without being checked by another person. E.g. in purchase of fixed assets, an individual should not authorize the purchase, place the order, receive the assets, record the transaction and keep custody of the assets. To minimize risk of error and or intention the following should be performed by different individuals and departments as much as practicable.

- Initiation of transaction. This is where if an item is found to be out of stock and a requisition is made.
- Authorization Different levels of management should be given limits as to what they can authorize or to what extent they can commit company resources.
- Execution. Person's independent from those who authorize the transactions should execute them.
- Recording. Segregation of duties also includes an internal check which refers to the activities of one person being complementary to those of another person.

c) Physical controls

These are security measures concerned with the custody of company's assets by limiting access to authorized people only. Direct physical controls include keeping assets under lock and key, employment of security guards, building fences and use of closed circuit cameras. Indirect physical controls include use of a fixed asset movement registers and use of computers to record utilization of company vehicles.

d) Authorization and approval.

Transactions that commit the organizations resources should be subject to authorization and approval by a responsible official. The limits for authorization should also be specified.

e) Arithmetic and accounting control.

These are controls within the accounting function which check that transactions are authorized and accurately recorded. These are aimed at ensuring completeness and accuracy of the accounting records. The key features are;

- Use of pre numbered documents in processing transactions.
- Issuing of documents in sequence when processing transactions.
- Monitoring movement of documents by use of a register in which all the people in possession of specific documents have signed that they are possession of those documents.
- Production of exception reports e.g. where a local purchase order (LPO) has been raised and the order has not been fulfilled by the supplier.
- Reconciliation of different accounts and the related control accounts e.g. bank reconciliation. Reconciliations would only be effective if prepared by independent persons and non reconciling items resolved in a timely manner.

f) Personnel.

The proper functioning of any system is dependent on the competence and integrity of those operating it. The company must therefore recruit competent staff with integrity and intelligence. Staff should be assigned responsibilities that match their capability and undergo training where necessary.

g) Supervision.

Transactions and their recording should be subjected to supervision by competent and responsible officials. Supervision is necessary because it gives the chance of correcting errors and also because lower level employees generally tend to be indiscipline if not closely supervised.

h) Management controls.

These are controls exercised by management in addition to daily routines of the system. They include comparison of actual performance with budgets review of management accounts e.g. budgets and internal audit function.

i) Rotation of duties.

Duties should be rotated between personnel at the same organizational level e.g. payroll staff and credit control staff. Staff should be encouraged to take annual leave to provide an opportunity for their work to be checked by an independent person.

j) Routine and automatic checks.

These are conducted on routine duties and operations to ensure that they are operating efficiently. Such checks are conducted on surprise basis to minimize errors and frauds. Examples may include surprise cash counts and physical inspection of fixed assets.

k) Internal audit

This is a control function set up by management to review the accounting and internal control system. Internal audit carries out continuous evaluation of operating effectiveness of the internal control policies and procedures. The findings and recommendations are then reported to management.

I) Limitations of internal control system

No internal control system however elaborate can by itself guarantee efficient administration and completion and accuracy of the recorded nor can it be proof against fraud. This is due to the following inherent limitations of accounting and internal control systems;

a. Cost-benefit analysis. Management has to ensure that the benefits expected from an internal control system outweigh the cost of installing and maintaining the internal control system. As a result certain important controls may not be put in place due to the costs involved e.g. a small company may not have the resources to employ efficient staff to ensure segregation of duties.
b. Limited coverage. Most internal controls tend to be directed towards routine transactions rather than non routine transactions leaving room for fraud and error as the non routine transactions will not be subjected to the appropriate controls e.g. if stock is damaged by fire and needs to be replaced immediately, there will be no controls available for such an emergency.
c. Human error. Human beings are prone to carelessness, distraction, mistakes of judgment and misunderstanding instructions. This undermines the effectiveness of the internal control system because the most important component of internal control system is people.
d. Abuse of responsibility. Senior managers could override controls thereby creating negative perception of the internal control system to the lower level employees.
e. Corruption. A member of management or employee could circumvent controls through collusion with persons within or without the company e.g. where an internal control on purchasing requires a quotation to be submitted, an employee can leak the prices in the quotations to his preferred supplier in exchange for a kick back.
f. The possibility that procedures may become inadequate due to changes in conditions of the burden e.g. expansion of business without corresponding increase in number of staff may require some staff member to perform more tasks than previously. This dilutes the extent of segregation of duties.

An example of internal control system over sales and debtors

When designing internal controls, it is important to identify the various stages followed in processing the transaction and controls that address the issues that arise in each of the stages.

a. Customers should be approved before a credit facility is granted. The credit limit granted should be formally authorized after seeking references on the customer's ability to pay. Such references are normally provided by banks suppliers and credit reference bureaus.
b. Customers should be approved for sales only when the customer's credit limit has not been exceeded. The sales personnel should ensure that they have up to date records of customers' outstanding balances.
c. Goods only be dispatched against a valid and an authorized sales order.
d. All dispatches of goods and return inwards should be accurately recorded
e. All dispatches should be involved. This can be achieved by checking copies of the sales order to the dispatch records the use of sequentially numbered documents would ensure that all sales are invoiced.
f. Invoices and credit notes should be accurately prepared from approved price list and all discounts or price deduction should be properly approved. Price list and all trade discounts and price deduction should be properly authorized.

g. Creditors' notes and other adjustments should only be prepared against authorized return inwards or other appropriate documents. To prevent fraud, there should be proper segregation of duties such that the person who authorizes a sale is not able to authorize the issue of a credit note or other adjustments.
h. All bad debts written off should be properly authorized and recorded. Persons involved with original authorization of sales and granting credit to customers should not be involved in the authorization of bad debts write offs.
i. Stock's records should be accurately updated with all sales and sales returns
j. All transactions should be accurately posted to the ledger
k. Sales ledger balances should be regularly reconciled to sales ledger control balances to ensure completeness and accuracy of the ledger.
l. Sales ledger balances should be periodically aged and reviewed by the credit control staff. Overdue accounts should be identified and followed up for collection. The aged list of debtors would assist management and the auditor in assessing adequacy of bad debt provisions.

Key objectives in sales and debtors internal control system

- Credit should be extended to credit worthy customers.
- Goods should not be dispatched without an invoice being raised.
- Overdue accounts should be promptly followed up.
- Receipt from cash sales should be properly controlled.
- No unauthorized credit entries should be made to debtors account balances.
- There should be sufficient segregation of duties between sales function and credit control function in the entity

Ascertaining, Evaluating, recording and confirming internal control system

The auditor will need to ascertain, evaluate, record and confirm the internal control system to be able to determine the effectiveness of its component controls and to decide on the extent of his reliance thereon.

Ascertaining

This refers to the auditors attempt to identify and understand the internal controls that management has put in place. This is carried out in the following ways:-

- Utilizing clients accounting and control manuals which describe the accounting and internal control system.
- Obtaining and relying on system records and description prepared by internal audit for organizations with inter audit functions.
- Interviewing procedures being performed e.g. stock taking in order to clearly understand the nature of the controls involved.
- Relying on prior year's system notes which can be obtained from the previous auditor's working papers.

The auditor's objective in evaluating the internal control system 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 compliance tests that the internal controls are effective in ensuring the completeness and accuracy of accounting records and the validity of entries therein, he may limit the extent of substantive testing. Because of the inherent limitation of even the most effective internal control system, it will be impossible for the auditor to rely solely on its operation as a basis of his opinion on the financial statements.

Recording

Having identified the controls that management has put in place, it is important to create documented records of the internal control system. This will enhance the auditor's understanding of the system and provide documentary evidence of work done. The following are methods used in recording the system.

- Flow Charts: These are diagrammatic representations of the company's procedures and processes and are designed to show the movement of documents and information through the accounting system from initiation of transactions to final recording in the books of accounts. Standardized symbols are used to represent the flow of documents and information through the system. This use of visual description eliminates use of lengthy narratives in explaining the system.
- Questionnaires. These comprise a list of questions designed to determine whether the internal control system has desirable controls that cover each of the major transaction cycles. The questions are structured such that the client will be required to respond by giving either a yes or no answer. There are two types of questionnaires:

  i. Internal control questionnaires (ICQ). These are lists of questions that are designed to establish whether the company has put in place desirable controls to ensure that the affairs of the company are carried out in an orderly and efficient manner.
  ii. Internal control evaluating questionnaires (ICEQ). These are lists of questions that seek to establish whether specific errors or fraud could occur rather than establishing whether certain desirable controls are present. E.g. is there reasonable assurance that sales are properly authorized? Yes / No.
- Narratives. These refer to recording of the internal control system in narrative form or explanatory notes. They are preferable for simple systems where all the transactions and documentation are handled by one person only. They require little formal training of staff and are best suited to small and simple system description or to explain peripheral aspects of a larger system not dealt with by other techniques. Narratives are too easy to record but difficult to change.

Confirming

Having recorded the system, the auditor then needs to confirm whether the system recorded exists, is operational and that the auditor has correct understanding of the system. This is done by use of walk through tests. A walk through test refers to the process where the auditor selects the particular transaction and traces it through the accounting information system from the time it was first captured and input as data to its final recording in the financial statements. The purpose of walk through tests may be either for auditor to identify specific control procedures or to confirm an existing understanding of internal control procedure in the internal control system.

Evaluating

Having recorded and confirmed the internal control system, the auditor will commence his evaluation. The auditor evaluates the client's internal control system in order to decide whether the system is suitably designed and constitutes a reliable basis for preparation of financial statements. Evaluation is normally carried out simultaneously with recording. Evaluation will be assisted by the use of documentation designed to help identify the internal controls on which the auditor may wish to place reliance. The auditor uses internal control evaluation questionnaires (ICEQ) in evaluating the system based on key control questions.

Examples of key control questions that could be applied in evaluating internal control system for sales and debtors are:

- Can goods be dispatched without being involved?
- Can goods be sold to a bad credit risk?
- Can sales be invoiced but not recorded?

For wages and salaries

- Can employees be paid for work not done?
- Can bonuses or commissions be wrongly paid?
- Can pay as you earn (PAYE) and other statutory deductions be inflated by inclusion of ghost workers?
- Can wages and salaries be paid at the wrong rates?

Tests of Control

After the system has been evaluated as being suitably designed the auditor then plans to carry out tests of control which are also called compliance tests. Compliance tests are procedures performed to obtain audit evidence about the effectiveness of the:

- Design of the accounting and internal control system i.e. whether it is suitably designed to prevent and correct material misstatements.
- Operation of the internal controls consistently throughout the financial period.

The Auditor carries out tests of control to determine whether these controls have worked effectively throughout the financial period and can be relied upon to ensure complete, accurate and reliable accounting records.

Some of the procedures performed to obtain an understanding of the accounting and internal control system may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of the internal controls relevant to certain assertions and consequently serve as tests of control.

Tests of control include:

- Inspection: Documents supporting transactions and other events are inspected to gain assurance that internal controls have operated properly.
- Inquiry: Inquiries about internal controls which have no audit trail need to be done e.g. inquiring whether appropriate security measures are undertaken during payment of wages.
- Re-performance of internal controls. E.g. reconciliation of the bank accounts to ensure clients bank accounts to ensure clients bank reconciliation statements is accurately prepared.
- Observation. This entails observing control procedures being performed e.g. physical counting of stock will enable the auditor confirm that the exercise is being conducted properly. Such observation will provide evidence that a control is operating effectively as designed. When obtaining audit evidence about the effectiveness of internal controls, the auditors considers how they were applied and the consistency with which they were applied. The concept of effective operational controls recognizes that some deviation from prescribed control may occur. This may be due to changes in key personnel, human error and significant fluctuation in the volume of transactions.

Actions taken when internal control system is identified as weak

- The auditor should bring to the attention of the management all the weaknesses he has identified and discuss with them the possible remedies and corrective measures immediately.
- The auditor should consider changing his audit approach by increasing the level of detailed substantive testing. This is because the weaknesses imply that the system is not operating as designed and therefore cannot be relied upon.
- The auditor should increase the sample size i.e. test as many entries as is considered necessary to avoid any error or fraud undetected.
- The auditor should record significant weakness in the management letter and give his recommendations to management on how the weaknesses can be corrected.
- If the internal control system is extremely weak such that he cannot depend upon it to apply any test, then he should qualify his report or at best give a disclaimer opinion.

The extent of reliance on internal control system by the auditor will depend on factors as: -

- His past experience with the company's internal control system. Any fluctuation in volume of business transactions
- Changes in line managers or top management officials.
- Changes in accounting policies and practices.
- Changes in size of the company.

Management Letter

Although the statutory reporting requirements of the Companies Act only calls for the auditor to make a report to the members as to whether the financial statements show a true and fair view. In addition to this, auditors provide management with a summary of their findings concerning strengths and weaknesses of accounting and internal control system as well as material issues arising from review of the financial statements. This summary is called the management letter.

Purposes of management Letter

- Enables the auditor to give his comments on the accounting records that he has examined during the course of the audit. Areas of weakness in internal control system which my result to material errors will be highlighted and brought to management's attention together with advice as to their improvement.
- Provides management with other constructive advice regarding areas where efficiency may be improved.
- Communicates matters arising during the audit so that there is a written record of all such matters. Incase of litigation, the auditor may rely on the management letter for defense.
- Ensures auditor's comments on the accounting on the internal control system reach those responsible members of management who have powers to act on the findings.

A report to management will normally be a natural way of adding value to the client and the auditor should incorporate the need to report in the planning of the audit. Before documenting the weaknesses in management letter, the auditor should discuss these with the appropriate officials. This eliminates the possibility that the auditor may have misunderstood. The operation of the system and will also enable the company make quick corrective actions. The management letter should be addressed to the board of directors or the audit committee.

The timing of the management letter will vary. It will often be useful to complete the compliance tests before its submission, so that weaknesses in internal control system may be included. However, serious weaknesses discovered should be reported immediately. This may make it necessary to submit more than one management letter.

The management letter acts as effective feedback that assists management in running the company more efficiently and thus promotes constructive relationship between the auditor and management which may be useful in future audits. The management letter should be both objective and constructive. The auditor should request for comments from management as to all the matters rose indicating what actions management intends to take regarding the matters raised.

CHAPTER SUMMARY

- The auditors need to be aware of the entity and its environment and the controls that are operational in a system so that they can be able to determine the level of reliance that they are going to place on the operating effectiveness and efficiency system and thus determine the amount of testing that they need to carry out.
- The auditor should comprehend the risks that face the entity and how the management manages those risks and how they affect the financial reporting and how the risks may affect cause material misstatements and thus the scope of his work.
- The auditor must understand the information system that operates within the entity and most importantly how the financial reporting system works.
- The external auditor needs to assess the internal auditor's impact on the control environment and how much reliance can be placed on his work.
- The internal audit department may be run by employees of the company or the function may be outsourced.
- The internal audit department is set up by the management to help the management achieve company's objectives and to reinforce corporate governance.

QUIZ

1. What is the difference between internal audit and external audit?
2. List the five elements of internal control.
3. What are the factors that are responsible to the growth of the internal audit function?
4. List the approaches used to record the internal control system by the auditor.
5. Differentiate control environment from control procedures

ANSWERS TO THE QUIZ

1. Differences between external audit and internal audit.
- Scope of work: For an internal auditor the scope is determined by management whereas for an external auditor it is laid down by statutes and professional requirements of the institute (ICPAK).
- Approach: An internal auditor may have many aims in his work including an appraisal of the efficiency of the internal control system and management information system. The external auditor is primarily concerned with the truth and fairness of accounts.
- Responsibility: The internal auditor is answerable only to management. The external auditor is responsible to shareholder and the public at large.

2. Internal control has five elements:
- The control environment
- The entity's risk assessment process.
- The information system.
- Control activities.
- Monitoring of Controls.

3. i. Increase in size of business

ii. Dynamic business
iii. Legislation and regulatory requirements
iv. Competition
v. Evolution of IT

4. Flow charts
- Narrative descriptions
- Questionnaires

EXAM QUESTIONS

QUESTION ONE

List down internal control procedures for raw material purchasing system of a large manufacturing firm

QUESTION TWO

Rhapsody Co supplies a wide range of garden and agricultural products to trade and domestic customers. The company has 11 divisions, with each division specializing in the sale of specific products, for example, seeds, garden furniture, and agricultural fertilizers. The company has an internal audit department which provides audit reports to the audit committee on each division on a rotational basis.

Products in the seed division are offered for sale to domestic customers via an Internet site. Customers review the product list on the Internet and place orders for packets of seeds using specific product codes, along with their credit card details, onto Rhapsody Co's secure server. Order quantities are normally between one and three packets for each type of seed. Order details are transferred manually onto the company's internal inventory control and sales system, and a two part packing list is printed in the seed warehouse. Each order and packing list is given a random alphabetical code based on the name of the employee inputting the order, the date, and the products being ordered.

In the seed warehouse, the packets of seeds for each order are taken from specific bins and dispatched to the customer with one copy of the packing list. The second copy of the packing list is sent to the accounts department where the inventory and sales computer is updated to show that the order has been dispatched. The customer's credit card is then charged by the inventory control and sales computer. Bad debts in Rhapsody are currently 3% of total sales.

Finally, the computer system checks that for each charge made to a customer's credit card account, the order details are on file to prove that the charge was made correctly. The order file is marked as completed confirming that the order has been dispatched and payment obtained.

Required:

a) In respect of sales in the seeds division of Rhapsody Co, prepare a report to be sent to the audit committee of Rhapsody Co which:
   i. Identifies and explains four weaknesses in that sales system.
   ii. Explains the possible effect of each weakness.
   iii. Provides a recommendation to alleviate each weakness.

(b) Explain the advantages to Rhapsody Co of having an audit committee.

QUESTION THREE

ISA 400 (Risk Assessments and Internal Control) deals with internal control objectives and internal controls. ISA 500 (Audit Evidence) deals with audit objectives and audit procedures. A proper understanding of internal controls is essential to auditors in order that they understand the business and are able to effectively plan and execute tests of controls and an appropriate level of substantive procedures.

You are the auditor of a small manufacturing company, Dinko, that pays its staff in cash and by bank transfer and maintains its payroll on a small stand-alone computer.

Required:

(a) For the payroll department at Dinko, describe the:
   i. Internal control objectives that should be in place.
   ii. Internal control environment and internal control procedures that should be in place to achieve the internal control objectives.

(b) For the payroll charges and payroll balances (including cash) in the financial statements of Dinko:
   i. Describe the external auditor audit objectives.
   ii. List the tests of control and substantive procedures that will be applied in order to achieve the audit objectives identified in (b) (i) above.

QUESTION FOUR

Ajio is a charity whose constitution requires that it raises funds for educational projects. These projects seek to educate children and support teachers in certain countries. Charities in the country from which Ajio operates have recently become subject to new audit and accounting regulations. Charity income consists of cash collections at fund raising events, telephone appeals, and bequests (money left to the charity by deceased persons). The charity is small and the trustees do not consider that the charity can afford to employ a qualified accountant. The charity employs a part-time bookkeeper and relies on volunteers for fund raising. Your firm has been appointed as accountants and auditors to this charity because of the new regulations. Accounts have been prepared (but not audited) in the past by a volunteer who is a recently retired Chartered Certified Accountant.

Required:

a. Describe the risks associated with the audit of Ajio under the headings inherent risk, control risk and detection risk and explain the implications of these risks for overall audit risk.
b. List and explain the audit tests to be performed on income and expenditure from fund raising events.

QUESTION FIVE

You are the audit manager for Parker, a limited liability company which sells books, CDs, DVDs and similar items via two divisions: mail order and on-line ordering on the Internet. Parker is a new audit client. You are commencing the planning of the audit for the year-ended 31 May 2005. An initial meeting with the directors has provided the information below.

The company's turnover is in excess of Kshs85 million with net profits of Kshs4 million. All profits are currently earned in the mail order division, although the Internet division is expected to return a small net profit next year. Turnover is growing at the rate of 20% p.a. Net profit has remained almost the same for the last four years. In the next year, the directors plan to expand the range of goods sold through the Internet division to include toys, garden furniture and fashion clothes. The directors believe that when one product has been sold on the Internet, then any other product can be as well.

The accounting system to record sales by the mail order division is relatively old. It relies on extensive manual input to transfer orders received in the post onto Parker's computer systems. Recently errors have been known to occur, in the input of orders, and in the invoicing of goods following dispatch. The directors maintain that the accounting system produces materially correct figures and they cannot waste time in identifying relatively minor errors. The company accountant, who is not qualified and was appointed because he is a personal friend of the directors, agrees with this view, The directors estimate that their expansion plans will require a bank loan of approximately Kshs30 million, partly to finance the enhanced web site but also to provide working capital to increase inventory levels. A meeting with the bank has been scheduled for three months after the year end. The directors expect an unmodified auditor's report to be signed prior to this time.

Required:

Identify and describe the matters that give rise to audit risks associated with Parker .

CHAPTER FIVE

AUDIT EVIDENCE (ISA 500)

CHAPTER 5
FRAUD & ERROR (ISA 240)

CHAPTER OBJECTIVES

By the end of this chapter the student is expected to have covered the following:

I. Definition of errors and types of errors
II. Frauds, defalcations and other irregularities
III. Detection, correction and prevention
IV. Errors and frauds in specific areas in a business.

INTRODUCTION

When the auditor is carrying out his work, he comes across deviations or misstatements in the financial statements. These misstatements may be due to an unintentional error or one that was committed with intent thus. The misstatements may also be due to non compliance with laws and regulations or due to fraud. During the planning of the audit, the auditor should expect to detect material misstatements in the financial statements due to fraud or error if any. This chapter is covered by ISA 240 on *The Auditor's Responsibility To Consider Fraud In An Audit Of Financial Statements .*

When planning and performing audit procedures, evaluating and reporting the results thereof, the auditor should consider the risk of misstatement in the financial statements resulting from fraud or error. The objective of an audit is to report o whether the financial statements are free from material misstatements. This implies that if there are material misstatements as a result of fraud or error and the auditor fails to detect and report on this, then his opinion would be wrong.

STUDY TEXT

KEY TERMS

Error: It is an unintentional mistake in the financial information, which can occur any time during processing and recording of transactions.

Fraud: This refers to intentional misrepresentation of financial information by one more individuals among management, employees or third parties.

Irregularity: is the deliberate distortion of information together with the related misappropriation of assets.

EXAM CONTEXT

This is topic can either be tested on its own or in a context of another question. It can also be a scenario whereby the student is expected to distinguish between a fraud and an error.

Error

An error is an unintentional mistake in presenting the financial information which can occur at anytime during processing and recording of transactions. These include

- Mathematical or clerical mistakes
- Overnight or misrepresentation of facts
- Misapplication of accounting policies

Types of errors

I. Errors of commission. These are errors that do not show in the trial balance because it still balances. This is where the correct amount for a transaction is recorded but in the wrong person's account e.g. for debtors the correct class of accounts may be used but the wrong personal entries entered.

II. Errors of omissions. This is where transactions are completely omitted from books of accounts.

III. Errors of principle. This is where an item is entered in the wrong class of account e.g. a fixed asset is debited to the expense account.

IV. Compensating errors. This is where errors cancel each other out. The errors occur usually on opposite sides of the accounts i.e. on credit and debits sides with equal amounts and are totally independent from each other.

V. Errors of original entry. These occur when the original figure is incorrect and the double entry system is still observed.

VI. Complete reversal entries. These occurs where correct accounts are used but each items shown on wrong side of the account e.g. crediting sales in debtors account and debiting sales account.

Fraud

A fraud is an intentional misrepresentation of financial information by one or more individual among management, employees and third parties involving use of deception to obtain unjust or illegal advantage. The main difference between a fraud and error is that a fraud is intentional and aimed at either misleading people or misappropriating company assets. There are two types of intentional misstatements i.e. misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of company assets. Fraudulent financial reporting involves management's override of controls that otherwise appear to operating efficiently.

Common types of fraud include:

- Manipulating, forgery, alteration or falsification of accounting records or supporting documents from which financial statements are prepared.
- Misappropriation of company assets e.g. using a company vehicle for private undertakings, stealing physical assets and embezzling receipts.
- Misapplication of accounting policies e.g. classifying a capital expenditure and revenue expenditure.
- Inappropriate adjusting assumptions and changing judgments used to estimate account balances. E.g. the management may insist on providing a 5% provision for bad and doubtful debts even where past debt collection history shows that the actual default rate is about 15%.

- Suppression or omission of effects of a transaction on accounting record e.g. placing a genuine debtor well known bad debts in the balance sheet thus misrepresenting the financial position of the company.

Fraudulent financial reporting may be committed because management is under pressure from outside or inside the entity to report unrealistic profit levels. A perceived opportunity for fraudulent financial reporting or misappropriation of company assets may exist when an individual believes that an internal control can be overridden. This could be because an individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

The distinction between fraud and error is of little importance so far as audit procedure are concerned. This is because the audit procedure used to detect errors is the same used to detect fraud. The only difference may arise where the auditor may be required by law to disclose certain illegal acts to the regulatory authority.

Responsibility for detection of fraud and error

The primary responsibility for the detection and prevention of fraud and error rests with the management of the company. This responsibility is fulfilled through the implementation and continuous operation of adequate system of internal controls. Such system reduces but does not eliminate the possibility of fraud and error. The auditor on his part seeks reasonable assurance that fraud and error which may be material to the financial statements has not occurred or if it has occurred, the effect is properly reflected in the financial statements. At this point, the auditor should plan his work so that he has reasonable expectation of detecting material misstatements in the financial information resulting from fraud and error. It is important to emphasis that the auditor cannot be held responsible for failing to detect errors and frauds. However, he is expected to carry out his work in a manner that he is in a position to detect material errors and frauds. Failure to detect such material errors implies that the financial statements are materially misstated.

Expectations gap

This is the gap that exists between external auditor's understanding of their role and duty and the expectations of various users of the financial statements and the general public regarding the process and the outcome of the external audit. I.e. the expectation by users of financial statements that auditor should detect and prevent error and fraud as a duty, while actually it is not his duty but of the directors.

The public may conceive the auditor's role as including;

- Protecting the company against fraud and irregularities
- Providing early warning of future insolvency i.e. certifying the company as a going concern.
- Providing useful general assurance of the financial wellbeing of the company and its continued profitability.

Most users of financial statements believe that the auditor has prepared the statements and should therefore be in a position to explain the performance results of the company. Some other users of the financial statements do not understand the audit opinion issue.

Possible means of reducing the expectations gap include:

Expanding the audit report to include more information explaining what auditors actually do. ISA 700 (Audit reports on financial statements) now requires auditors to include a paragraph explaining the nature and scope of the audit conducted and also explaining the respective responsibility of management and auditor in relation to preparation of the financial statements.

It has also been suggested that the role of the auditor should be broadened especially in areas of fraud. ISA 240(fraud and error), requires that the auditor should report to the users of the financial statements if there is material misstatements as a result of fraud and any other irregularities.

There should be attempts to improve the knowledge and understanding of auditor's role and responsibility through public education.

Risk of fraud and error

In addition to weaknesses in the accounting and internal control system, events which also increase risk of fraud and error are:

- Questions regarding the integrity and competence of management. Where management is not honest and could misappropriate company assets, the risk of fraud and error increases.
- Unusual pressure within the company e.g. pressure on organization to attain a certain level or profitability. This could tempt the managers to manipulate the financial statement so as to achieve the set profit level.
- Unusual transactions. Such could be carried out with intention of manipulating the financial performance of the company e.g. a very large purchase of stock at the year end to increase level of closing stock and subsequently increase profits.

Difficulties in obtaining sufficient, appropriate audit evidence especially where management is reluctant to provide the necessary information to the auditor.

If circumstances indicate possible existence of fraud and error, the auditor should consider the potential effect of financial statements. If the effect is material, the auditor should perform additional procedures to dispel the suspicion. Where fraud or error is confirmed, the auditor should satisfy himself that the effect of fraud or error is properly reflected in the financial statements or the error corrected. The auditor should communicate his findings to management on timely basis if:

- He believes fraud may exist even if the potential effect would be immaterial.
- Fraud or error is actually found to exist.

Inherent limitations of an audit

An audit is subject to the avoidable risk that some material misstatements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. The risk of not detecting misstatements resulting from fraud is higher than the risk of not detecting material misstatements resulting from errors. This is because fraud involves acts designed to conceal it such as forgery and deliberate failure to record transactions. When the audit reveals evidence to the contrary, the auditor is entitled to accept representations from management as truthful and documents as genuine. However, the auditor should plan and perform his work with professional skepticism, recognizing that conditions or events may be found that indicate that fraud or error may exist. Existence of a strong internal control system reduces the probability of misstatements in the financial reporting occurring due to fraud or error but there is always a risk that the system may fail to operate as designed.

The following procedures could be applied as general leads to where fraud or error may have occurred.

- Comparison of the company's current balance sheet with those of previous years.
- Calculation of profitability, leverage, activity and performance ratios for the current and previous years.
- Using search inquiry to pose questions to management and accounting staff.
- Auditing in depth to establish the audit trail. This facilitates checking a transactions recording process from initial to final stage.
- Using surprise checks and visits.
- Comparing budgeted and actual results of the company and investigating any variances noted.

Errors and frauds in specific areas in business

This is the method by which the deficiencies of cash are concealed for sometime. When cash is received from some debtor, it is not recorded in the cash books and is misappropriate. Later on, when cash is received from any other debtor, his account is not credited but the account of the first debtor is credited and cash is debited, again later on, when cash is received from their debtor, his account is not credited but that of the second debtor in credited and cash is debited.

This process goes or the fraud is discovered. This method of fraud is know as short banking or delayed accounting of money received or lapping. This is method by which the past defalcations are covered up by the present receipt. If remittances are received by means of cheques, then cheques will have to be split up. This proves is known as splitting cheques. Because by encashing the cheques, less amount id credited to the debtor and rest amount is misappropriated.

We can detect such frauds with the help of auditors. The auditor should find out what is the internal check system regarding cash. If there is any weak point, he must probe into the matter. The cashier should not have access to ledger. Auditor should check the counterfoils of the receipts with the cash book paying particular attentions to the dates.
http://www.blurtit.com/q478776.html

(a) Sales & debtors

Potentials errors

- Goods dispatched without being invoiced, services rendered without being invoiced, goods in transit or a consignment not recognized in books.
- Goods being sold to bad credit risk customer.
- Overdue accounts without follow up.
- Sales invoiced but not recorded in the books.
- Cash sales not being recorded.
- Improper crediting of debtor account.

Implications

- Understated sales, wrong management accounts, loss of assets of the company and accounts without true and fair view.

STUDY TEXT

- Bad debts
- Misappropriation of cash, exposure to theft and loss of interest due to delayed banking.
- Unreliable records and disputes between the company and customers.

(b) Purchases and Creditor.

Potential errors

- Liabilities being set up for goods not received or not authorized
- Liabilities being incurred but not recorded.
- Making payments without proper documents and authorization.
- Misallocation of funds to the wrong general ledger accounts
- Goods being returned without being recorded.

Implications

- Loss of company resources because of paying for goods never received.
- Understanding of liabilities hence disputes with suppliers.
- Paying for services and goods not received
- Overstatement of expenses and creditors.
- Misstatement of various expense accounts hence unreliable records.
- Overstatement of purchases

(c) Wages

Potential errors

- Dummy workers in the payroll or fraudulent double payment of workers, payment for work not done and unclaimed wages being misappropriated.
- Occurrence of payroll errors.
- Improper deductions being made or being misappropriated
- Inflation of the payroll in other ways.

Implications

- Overvaluation of stocks because using wrong labour costs.
- Overstatement of stocks
- Misstatement of various expense accounts
- Unreliable records.

How is internal control system helps prevent and detect fraud and error

- Supervision. This serves to prevent fraud or error by boosting the awareness of senior employees who will refrain from committing fraud and error by virtue of constant review of operations.
- Physical controls. These limit access to the assets of the company thus preventing them from damage, misuse or theft.
- Segregation of duties. This boosts automatic checks, accountability and supervision at all stages of processing transactions, minimizing chances of error and fraud.

- Arithmetic and accounting controls. Proper recording of transactions according to the principles of ISAs will prevent errors and frauds such an manipulation of accounts.
- Personnel. Engaging qualified, competent and efficient personnel will reduce chances of errors. The company's staff should be motivated and properly remunerated to prevent temptations of fraud.
- Routine and automatic checks. These minimize fraud by boosting awareness that work will be continuously checked, accountability will be increased and importance of being honest will be emphasized.

CHAPTER SUMMARY

Error is an unintentional mistake in the financial information, which can occur any time during processing and recording of transactions. These include:

- Mathematical or clerical mistakes;
- Oversight or misrepresentation of facts;
- Misapplication of accounting policies.

Fraud refers to intentional misrepresentation of financial information by one more individuals among management, employees or third parties.

Irregularity is the deliberate distortion of information together with the related misappropriation of assets. An irregularity becomes a fraud when it involves criminal deception that is seeking unjust advantage leading to misleading information.

The primary responsibility for the prevention and detection of fraud rests with management. The auditor is and cannot be held responsible for the prevention of fraud and error.

QUIZ

a. Define an error and a fraud.
b. List the different types of errors.
c. List the ways in which internal control systems are used to prevent fraud.

ANSWERS TO THE QUIZ

1. **Error** is an unintentional mistake in the financial information, which can occur any time during processing and recording of transactions.
   Fraud this refers to intentional misrepresentation of financial information by one more individuals among management, employees or third parties.
2. Errors of commission:
   - Errors of omission
   - Error of principle:
   - Compensating errors:
   - Error or original entry
   - Complete reversal of entries
3. This is achieved through;
   - Management supervision
   - Physical Controls
   - Segregation of duties.
   - arithmetic and accounting estimates
   - Personnel
   - Control of documents
   - Rotation of duties

EXAM QUESTIONS

QUESTION ONE

Fraud and error present risks to an entity. Both internal and external auditors are required to deal with risks to the entity. Required:

a) Explain how the internal audit function helps an entity deal with the risk of fraud and error.

b) Stone Holidays is an independent travel agency. It does not operate holidays itself. It takes commission on holidays sold to customers through its chain of high street shops. Staff are partly paid on a commission basis.

Well-established tour operators run the holidays that Stone Holidays sells. The networked reservations system through which holidays are booked and the computerised accounting system are both well-established systems used by many independent travel agencies.

Payments by customers, including deposits, are accepted in cash and by debit and credit card. Stone Holidays is legally required to pay an amount of money (based on its total sales for the year) into a central fund maintained to compensate customers if the agency should cease operations.

Describe the nature of the risks to which Stone Holidays is subject arising from fraud and error.

QUESTION TWO

The responsibilities of internal and external auditors in relation to the risk of fraud and error differ.

Explain the responsibilities of external auditors in respect of the risk of fraud and error in an audit of financial statements

QUESTION THREE

Compare the responsibilities of the directors and auditors regarding the published financial statements

CHAPTER SIX

MATHEMATICAL TECHNIQUES

CHAPTER 6
AUDIT EVIDENCE (ISA 500)

▶ CHAPTER OBJECTIVES

By the end of this chapter, the student should be well versed on the following:

i. Definition of audit evidence
ii. Reliability of audit evidence
iii. Obtaining audit evidence
iv. Management assertions
v. Methods of obtaining audit evidence
vi. Audit sampling
vii. Representations by management

▶ INTRODUCTION

The objective of an audit of the financial statement is for an auditor to express an opinion of the financial and state whether they present a true and fair view of the financial statements. In order for the auditor to do so he needs to gather sufficient and reliable audit evidence. The work of an auditor is used by many users and hence before he comes up with his conclusion he needs to have gathered sufficient audit evidence on which to base his opinion so that whatever decision those users come up with, is the right one. This chapter covers the gathering of that evidence, the methods used and the reliability of that evidence to the auditor amongst many other things. Audit evidence is covered by ISA 500 *Audit Evidence.*

▶ KEY TERMS

Audit evidence - refers to the information obtained by the auditor in arriving at the conclusions on which the audit opinion on the financial statements is based.

Substantive procedures - these are audit tests carried out to test the accuracy and validity of the accounting records.

Sufficient appropriate audit evidence- Sufficiency is the measure of the quality of audit evidence while appropriateness is the measure of the quantity of the evidence

Reliability of audit evidence- this refers to the credibility of the source of the evidence

Audit sampling- involves the application of substantive or compliance procedures to less than 100% of items within an account balance or class of transactions to be enable the auditor obtain and evaluate some characteristics of the balance and form a conclusion concerning that characteristic.

STUDY TEXT

▶EXAM CONTEXT

This chapter forms one of the core elements of audit is sure to get tested on a regular basis. It may not form a question on its own but it will for sure be tested with other parts of the paper. A

▶INDUSTRY CONTEXT

In-order for an auditor to form an opinion on the financial statements, he needs to gather sufficient appropriate evidence on which to base his opinion. The procedures for gathering evidence outlined in this chapter are used on a day to day basis by the auditors, hence, by going through this chapter the student gets a feel on how the auditor goes about the process of gathering the audit evidence.

6.1 AUDIT EVIDENCE

Audit evidence refers to the information obtained by the auditor in arriving at the conclusions on which audit opinion on the financial statements is based. Audit evidence comprises of source documents and accounting records underlying the financial statements. The accounting records generally include:

- Records of initial entries and supporting records
- Records of electronic fund transfers, invoices, contracts and cheques.
- General and subsidiary ledgers, journal entries and other adjustments to the financial statements not reflected in the journal entries
- Records such as work sheets and spread sheets supporting cost allocations, computations and reconciliations.

Other information the auditor can use as audit evidence are:

- Minutes of meetings
- Confirmations form third parties
- Analysis reports
- Comparable data about competitors.
- Control annuals.
- Information obtained by auditor from audit procedure such as observation and enquiries.

The sources and amount of evidence needed to achieve the required level of assurance is determined by the auditor's judgment. The auditor's judgment will be influenced by the materiality of item being examined, the relevance and reliability of evidence available from each source and cost involved in obtaining it. Audit evidence is obtained through an appropriate mix of tests of controls and substantive procedures where internal control system is considered weak; evidence may be obtained entirely from substantive procedures.

Substantive tests are procedures carried out to test the accuracy and validity of accounting records. They are of two types i.e. analytical review procedure and test of detail.

Qualities of audit evidence

ISA 500 requires that 'the auditor should obtain sufficient audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.'

What do we mean by:

a) Sufficiency
b) Appropriate

Sufficient means that there needs to be enough evidence. What is enough is a matter of professional judgment.

Appropriate break down into:

a) Relevance.
Relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on financial statements. It therefore refers to the ability of the evidence to assist the auditor in testing management assertions.

b) Reliability
Reliability of audit evidence refers to the credibility of that evidence the credibility is influenced by its source and its nature

Use of assertions in generating audit evidence

When preparing financial statements the management makes certain implicit or explicit assertions about the financial affairs of the company.

Consequently, when the auditor is obtaining evidence from a substantive procedure, he is concerned about testing or substantiating the truth of these assertions. The assertions are categorized as follows;

1. Assertions about hinting of transactions and events for the period under audit i.e.

- Occurrence transaction and events that have been recorded have occurred and pertain to the entity.
- Completeness
- Cut off. Transactions and events have been recorded in the appropriate accounting period
- Accuracy Amounts and other data relating to the recorded transactions have been recorded appropriately.
- Classification. Transactions and events have been recorded in the correct period

2. Assertions about account balances at the year end.

- Existence. Assets or liabilities exist at a given date
- Rights and obligations
- completeness
- valuation and allocation

3. Assertions about presentation and disclosure.

- Occurrence and rights and obligation. Disclosed events and transactions and other matters have occurred and pertained to the entity
- Completeness All disclosures that should have been included e.g. compositions of director's fees.
- Measurement and valuation. Financial and other information are disclosed fairly and at appropriate amounts

STUDY TEXT

- Classification and understandability. Financial information is appropriately presented and described, and disclosures are clearly expressed

The auditor may use the assertions described above or may express them differently provided all aspects described above have been covered .

Methods of obtaining audit evidence

The auditor may rely on sufficient appropriate evidence obtained by substantive testing to form his opinion. Alternatively he may be able to obtain assurance from presence of a reliable internal contrast system and therefore reduce the extent of substantive testing the auditor obtains evidence in performing compliance and substantive procedures using the following methods.

a) Inspection.

This consists of examining records, documents or tangible assets. The reliability of the evidence obtained from inspection depends on nature, source and effectiveness of the internal control system. Inspection of tangible assets provides evidence with the respect to the existence but not to their value and ownership.

b) Observation

This involves looking at procedures being performed by others e.g. stock counting by client personnel.

c) Inquiry and confirmation.

Inquiry consists of seeking information from knowledgeable persons inside and outside the company. It ranges from formal written inquires addressed to the third parties to oral inquiries addressed to persons within the entity. The information may be new to the auditor or may corroborate evidence from other sources. Confirmation is the response to inquiry to corroborate information contained in financial statements e.g. debtors circularization.

d) Recalculation and re-performance

This involves checking the arithmetic accuracy of source documents and accounting records or performing independent computations e.g. re-computing amount of provision for depreciation and comparing this against that computed by client.

e) Analytical procedures.

This is the analysis of relationships such as between items of financial data to identify consistency and predicted patterns or significant fluctuations, unexpected relationships and results of investigations thereof.

Analytical procedures (1SA 520)

Nature and purpose of analytical procedures

They are mainly used at 3 stages of the audit:

- As part of the planning process
- At the final review stage
- As substantive procedures

Analytical procedures are involved in evaluation of financial statements information by a study of relationships among financial and non financial information. A basic premise underlying the application of analytical procedures is that logical or plausible relationship among data may be expected to exist and continue in the absence of conditions to the contrary. Therefore the auditor can use these relationships to obtain evidence of the financial statements amounts. A simple analytical procedure is to compare revenue and expenses amounts for the current year to those of prior periods noting any significant differences. Essentially, the process of performing analytical procedures consists of four steps.

- Develop an expectation of account balance or ratio
- To determine the amount of difference from expectation that can be accepted without investigation
- Comparison of company's account balances or ratios with the expected.
- Investigate and evaluate significant ratio differences from the expectation

1. Developing an expectation.

A variety of types of information are available to the auditor to develop an expectation for analytical procedures including;

- Financial information for comparable priority periods.
- Anticipated results such as budgets and forecasts.
- Relationships among elements of financial information within a period e.g. level of debtors and credit sales.
- Information derived from similar firms in the same industry e.g. industry wage average.
- Relationships between financial and non financial data e.g. wage expenses and a number of employees. In establishing these relationships, the auditor may use shillings amount, physical quantities ratios or percentages.

To increase the precision of the analytical procedures, separate relationships may be computed for each department or product line. Industrial averages provide a potentially rich source of information in developing expectation for analytical procedures, since industry statistics may alert auditors to classification error, improper application of accounting principles or other misstatements in specific items in client's financial statements. However there may be problems of lack of comparability among companies and inability to obtain current industry data.

Methods of developing expectation on account balances and ratios

a) Trend analysis. This includes review of changes in an account balance over time e.g. review of clients sales for the past six years may reveal a growth rate of 5%. This information could assist auditor in developing an expectation of sales for the current year.

b) Ratio analysis. This involves comparison of relationships between two or more financial statement account balances or comparisons of an account balance to non financial data e.g. revenue per sale order. The typical financial ratios are liquidity, profitability, leverage and activity ratios.

Because ratio analysis involves examination relationships between two or more variables and may involve industrial data, it is often a richer analysis than trend analysis. There are two basic approaches to ratio analysis;

- Horizontal analysis. This involves review of client's ratios and trends over time
- Cross sectional analysis. This involves comparisons of ratios of similar firms at a given point in time.

2. The amount of acceptable difference.

The amount of acceptable difference between the expectation and the financial statements balance that can be accepted without investigation is determined primarily by the amount that is considered to be a material misstatement However; this amount must be consistent with the degree of assurance from the procedure. When trend or ratio analysis is used, the auditor typically uses professional judgment to specify an absolute amount of difference or percentage difference that will result into investigation.

3. Comparison of the account balance or ratio with the expected balance or ratio.

Once the auditor has determined the expectation and amount of acceptable difference, he makes the actual comparison to determine where significant difference lies.

4. Investigation and evaluation of significant differences.

The auditor must investigate any significant differences and his expectation and the client's financial statements balance or ratio to determine whether they represent misstatements. This involves reconsidering the methods and factors used in developing the expectation. Inquiry to management can be useful in this regard. Management explanations however must be ordinary be supported with other audit evidence. If the explanations are not tallying with other audit evidence, the editor will often be required to expand his tests of related financial amounts to determine whether or not they are materially misstated.

Timing of analytical procedures

ISAs require the application of analytical procedures at the planning and overall review stages of the audit. The auditor may also decide to use them during the audit on substantive tests to provide evidence as to the reasonableness of specific account balances. Analytical procedures performed in planning the audit are used to determine the nature, timing and extent of audit procedures that will be used to obtain evidence about specific accounts. They are also used in understanding the client's business at the planning stage.

Analytical procedures must be used as part of the overall review stage of an audit to assist the auditor in assessing the adequacy of the evidence gathered and the validity of conclusions reached. At the final review stage of an audit, the analytical procedures generally include reviewing the financial statements and re-computing ratios if necessary to identify any unusual or unexpected balance or that have not been previously identified and explained.

Where the auditors are not required to use analytical procedure as substantive tests, they are usually most efficient tests of certain assertions .e.g. performing analytical procedures is the most efficient way to evaluate competence of various revenue and expense accounts.

Extent of analytical procedures

Auditors must consider cost and likely effectiveness of analytical procedures in determining how much they may be used for a particular audit A primary measure of the effectiveness of analytical procedures is its precision. Precision depends on a number of factors including the predictability of the relationship, the techniques used to develop the expectation and the reliability of the underlying data used. Monthly data is more precise than yearly data.

Management representations ISA580

a) Oral representations.

Throughout an audit the auditors ask many questions to the officials and employees of Client Company. Oral inquires are made on an endless range of topics from the location of records and document, reasons for unusual account procedures and probability of collecting overdue accounts receivable. In making inquires, the auditor should consider the knowledge, objectivity, experience, responsibility and qualifications of individuals being questioned and use carefully structured questions to address relevant issues. Client replies should be carefully evaluated as appropriate and followed up with additional questions.

Generally, oral client representations are not sufficient themselves but they may be useful in disclosing situations that require investigation or in corroborating other forms of evidence e.g. after making careful analysis of all accounts receivable, the auditor normally discusses with the credit manager, the prospects of collecting specific accounts.

b) Written representations.

The auditor must also obtain written representations from the client in accordance with provisions of ISA 580. At conclusion of the audit, the auditor obtains from the client a written representation letter. This letter summarizes the most important oral representations made by management during the audit. Many specific items are included in this representation letter e.g. management represents that all liabilities known to exist are reflected the financial statements. The representations generally fall into the following broad categories;

- All accounting records, financial data and minutes of director's meetings have been made available to the auditor.
- The financial statements are complete and were prepared in conformity with generally accepted accounting principles.
- Management believes that adjusting entries brought to the attention by the auditor and not recorded are not material individually or collectively.
- All items requiring disclosures such as contingencies, illegal acts and related parties transactions have been properly disclosed.

ISA 580 requires the auditor to obtain representations letter on every engagement and provide suggestions as to its form, content and guidance on how it is to be used as audit evidence and actions to be taken if client refuses to provide representations. These letters are dated as of the date of the auditor's report ordinarily the last day of field work and are usually signed by both the client chief executive officer and the chief accountant. A client representations letter should never be used as a substitute for performing other audit procedures. The financial statements already constitute written representations by the client hence representation letter does little more than assert that the original representations were correct.

Purposes of representations letter

- To remind the client's directors of their primary responsibilities for the financial statements.
- Documents in the audit working papers, client responses to the significant questions asked by the auditor during the engagement.
- At times a representation letter may be the only evidence available in respect to management future intentions e.g. whether a maturing debt is classified as a current or long term liability will depend on whether management has both the ability and intent to refinance the debt.

Management may be unwilling to sign letters of representation or pass minutes required by the auditor. If management declines, the auditor should inform the management that he will himself prepare a statement in writing setting out his understanding of any representations that they have been made during the course of the audit and send this statements to management with a request for confirmation that the auditor's understanding of the representations is correct.

If management disagrees with the auditor's statement of representations, discussions should be held to clarify the matters in doubt and if necessary a revised statement prepared and agreed. Should management fail to reply, the auditor should follow up the matter to ensure the position as set out in his statement is correct

In rare circumstances, the auditor may be completely unable to obtain written representations which he requires e.g. because of the refusal by management to cooperate or because management declines to give proper representations required on the ground of its own uncertainty regarding that particular issue. In such circumstances, the auditor may have to conclude that he has not received all information and explanations required and consequently may need to consider qualification his audit report an ground of limitation in scope of the audit.

ISA 620 Using the work of an expert

The auditor should obtain sufficient appropriate audit evidence that the work of the expert is adequate for the purpose of the audit.

An expert is a person possessing specialized skills, knowledge and experience in another field other than auditing and accounting. From his experience, an auditor only has general knowledge on matters outside his profession and is not expected to have the skills of a person trained or qualified to work in another profession .Consequently, the auditor may need the advice of another expert for example, a pharmacist when verifying stock in the laboratory or lawyers in arriving at the legal interpretation of legal cases against a client.

Situations where the auditor may require work of an expert

- The legal interpretation of contracts, laws and regulations
- Valuations of certain types of assets e.g. precious stones, minerals and buildings
- Actuarial valuation e.g. for pension funds
- When measuring the work to be completed in construction contracts.

In deciding whether to use the work of an expert the auditor should consider.

- The materiality of an item being examined in relation to the financial statements as a whole.
- The nature and complexity of the item including the risk.
- The audit evidence available in respect with the item.

Factors considered before relying on the work of the expert

The auditor should consider;

- The skills and competence of the expert. The auditor should consider this by examining the expert's professional qualifications, licenses or membership of an appropriate professional body. The experience and reputation of the expert in the field in which the auditor is seeking evidence is very important.
- Objectivity and independence of the expert.. The auditor should consider whether the expert is independent from the client. The risk of independence being impaired increases where the expert is employed by the client. In such cases he owes his loyalty to the client because there exists a financial relationship.

- The source of the data used by the expert in arriving at his opinion. If the source of the data can be regarded as reliable, then the auditor can reasonably use the work of the expert as audit evidence.
- The assumptions and methods used. The auditor should consider whether the methods used by the expert in arriving at his opinion are appropriate to the circumstances. He should also obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and the results of his other audit procedures.

Communication with the expert

When consulting an expert the auditor should cover:

- Objectives and scope of his work
- An outline of the item the auditor expects to be covered in the report.
- The intended use of the expert work by the auditor and disclosure to third parties as to the expert's identity and extent of involvement
- Clarification of the expert's relationship with the client.
- The confidentiality of the client information.
- Assumptions and the methods the expert intends to use. These will be evaluated for reasonableness by the auditor.
- Recording of any further information as audit evidence.

CHAPTER SUMMARY

The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

Audit evidence refers to the information obtained by the auditor in arriving at the conclusions on which the audit opinion on the financial statements is based. Audit evidence comprises source documents and accounting records underlying the financial statements and corroborating information from other sources.

Substantive procedures are audit tests carried out to test the accuracy and validity of the accounting records. Substantive procedures are mainly of two types i.e. analytical review procedures and tests of details.

Audit Sampling involves the application of substantive or compliance procedures to less than 100% of items within an account balance or class of transactions to be enable the auditor obtain and evaluate some characteristics of the balance and form a conclusion concerning that characteristic.

The two main approaches that can be applied in sampling are:

- Judgmental sampling:
- Statistical sampling

QUIZ

1. What is audit evidence?
2. List the ways of gathering audit evidence.
3. List qualities of a good sample.

ANSWERS TO THE QUIZ

1. It refers to the information obtained by the auditor in arriving at the conclusions on which the audit opinion on the financial statements is based. Audit evidence comprises source documents and accounting records underlying the financial statements and corroborating information from other sources.
2. - Inspection
   - Observation
   - Inquiry and Confirmation
   - Computation
   - Analytical procedures.
3. - It should be random
   - It should be representative
   - Protective
   - Unpredictable

EXAM QUESTIONS

QUESTION ONE

The Auditors Operational Standard requires the auditor to obtain 'relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom.

Required:

a. What is audit evidence?
b. Explain the meaning of the following terms;
   - Relevant audit evidence
   - Reliable audit evidence
c. Explain whether the following types of audit evidence meets the standards of relevancy, reliability and sufficiency as required by the auditor's operational standards regarding:
   - Written confirmation of a trade debtor circularized at year end
   - Work-in-progress stocks identified during the annual physical stock count
   - Solicitor's letter confirming pending legal action

QUESTION TWO

The external audit process for the audit of large entities generally involves two or more recognizable stages. One stage involves understanding the business and risk assessment, determining the response to assessed risk, testing of controls and a limited amount of substantive procedures. This stage is sometimes known as the interim audit. Another stage involves further tests of controls and substantive procedures and audit finalization procedures. This stage is sometimes known as the final audit.

Describe and explain the main audit procedures and processes that take place during the interim and final audit of a large entity.

QUESTION THREE

Curdco is a company that runs a chain of fast food restaurants. The company has a centralized operating style and managers of individual restaurants have very limited decision-making powers on day-to-day operational matters. The company's centralized administration is responsible for the buying of food, the payment of staff, the maintenance and cleaning of restaurants by staff employed by a national agency, and all other matters relating to the running of the business. The company has good internal controls over purchasing. Inventory counts are conducted at each restaurant at the year-end. Your firm has recently been appointed as auditor to Curdco.

Required:

a. List the account headings you would expect to find in Curdco's schedule of accounts payable and accrued expenditure.
b. Describe and give reasons for the audit tests you would carry out to obtain audit evidence for Curdco's accounts payable and accrued expenditure.
c. Explain the difficulties faced by auditors, and the decisions that auditors have to make, in conducting direct confirmations of accounts payable.

QUESTION FOUR

There are a number of different methods of obtaining audit evidence. Methods include:

- Analytical procedures.
- Audit sampling
- Tests of controls.
- Detailed testing of transactions and balances.
- Computer assisted audit techniques (CAATs)

These methods overlap and may be used for different purposes during an audit of financial statements.

Required:

a. Explain the advantages and disadvantages of each of the five methods of evidence gathering listed above.
b. Describe the relationship between the five methods of evidence gathering described above.

QUESTION FIVE

(a) Explain the purpose of a management representation letter.
(b) A suggested format for the letter of representation has been sent by the auditors to the directors of a client company. The directors have stated that they will not sign the letter of representation this year on the grounds that they believe the additional evidence that it provides is not required by the auditor.

Required:

Discuss the actions the auditor may take as a result of the decision made by the directors not to sign the letter of representation.

CHAPTER SEVEN

AUDIT SAMPLING (ISA 530)

CHAPTER 7
AUDIT SAMPLING (ISA 530)

▶ CHAPTER OBJECTIVES

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

i. Explain the meaning and need or reasons for audit sampling.
ii. Explain key terms in audit sampling such as sampling risk, non sampling risk, tolerable error and expected error.
iii. Identify circumstances where audit sampling is inappropriate.
iv. Explain the stages in audit sampling and the main approaches to sampling.
v. Identify situations where an auditor is required to use work of an expert and factors considered before relying on such work.

ISA 530 (audit sampling and other selective testing procedures) defines auditing sampling as application audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor obtain and evaluate audit evidence about some characteristics of the items selected in order to form or amidst in forming a confusion concerning the population.

▶ INTRODUCTION

ISA 530 (audit sampling and other selective testing procedures) defines auditing sampling as application audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor obtain and evaluate audit evidence about some characteristics of the items selected in order to form or amidst in forming a confusion concerning the population.

▶ EXAM CONTEXT

Audit sampling is an important area in the auditors work and the examiner is likely to question it as part of other areas we have studied.

▶ INDUSTRY CONTEXT

Audit sampling is a key aspect of obtaining sufficient appropriate evidence. A sample must be chosen which enables the auditor to get the evidence he needs. This is done on a day to day basis by the auditors during their work.

STUDY TEXT

TERMS AND DEFINITIONS

Population

The population is the entire set of data from which the auditor wishes to sample in order to reach a conclusion e.g. all items in an account balance or class of transactions .The individual items that make up a population are called sampling units. The essential feature of population is that it must be homogenous i.e. must be composed of similar or uniform sampling units.

Sampling risk

Because auditors do not examine all the items in the population when applying audit sampling, there is a risk that is that the conclusion they draw may be different from which they would have drawn had they examined the entire population. This risk is called sampling risk. The auditor should use rational basis for planning, selecting and testing samples to ensure that he has reasonable assurance that sample used is to representative of the population.

Non sampling risk

This risk arises from factors that because the auditor to reach an erroneous conclusion for any reason not related to sample size e.g. use of inappropriate audit procedures leading to failure to identify an error. This risk can be minimized by improving training and review procedures.

Tolerable error

This refers to the maximum error in the population that the auditor is willing to accept and still to conclude that the results from the sample have achieved the audit objective. Tolerable error is considered during planning stage and for substantive procedures, is related to auditor's judgment on materiality. The smaller the tolerable error expected in a balance, the larger sample size must be.

Confidence level

This refers to the degree of confidence the auditor requires that shows the results of the sample to be indicative of actual error in the population.

Stratification

This is the process of dividing population into sub populations so that items within each subpopulation are expected to have similar characteristics in certain aspects e.g. High value items should be grouped separately from low value items.

In cases where auditors are concerned with discoveries of overstatement errors and consider that the largest monetary errors are likely to occur in the larges items, they will stratify the population by value and then direct their audit procedures on items with largest individual values.

Expected errors

If the auditor expects errors in the population, a larger sample size than when no error is expected ordinary needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free.

Reasons for sampling

i. A complete check for all transactions and balances a business is no longer possible owing to the numerous numbers of transactions.
ii. Time factor. Examining all the transactions will take a lot of time. The cost of doing this will be prohibitive because audit fees are largely based on amount of time spent on assignment. Also a complete check will take so long that the accounts will be ancient history before users saw them.
iii. The objective of an audit is to express an opinion as to whether the financial statements show a true and a fair view. It is possible for the auditor to obtain the assurance without examining all transactions. The use of sampling with properly set out objectives and properly constructed tests allows more valid conclusions to be reached than when many transactions as possible are tested. This is because detailed testing is done on a sample.
iv. A complete check would bore the audit staff so much that their work would become ineffective and errors would remain unidentified.

Cases where sampling is inappropriate

i. When population is small, statistical sampling will create an unacceptable margin of error. If the population is not sufficiently large, then statistical methods are invalid. Instances where transactions or balances are small in number but material in relation to financial statements e.g. directors fees should never be sampled and any transactions involving a large capital expenditures.
ii. Any situation where the auditor is put on high alert a result of earlier tests or information is received indicating material fraud in a certain accounting areas.
iii. For statutory disclosure items such as director's salaries, a full audit check is desirable because materiality consideration does not apply in this case.
iv. Where population is not homogenous and requires stratification, it is not possible to select a representative sample.
v. When the population has not been maintained in a manner suitable for audit sampling e.g. if sales invoices are filed according to customer name as opposed to a numerical order.

Stages in audit sampling

a) Planning the sample

When planning how to carry out sampling, the auditor considers the following:

i. Objectives of tests and combinations of audit procedures which are likely to achieve the objectives e.g. objective to verify compliance of the debtors balances.
ii. The population and sampling units should be appropriate to the objectives of sampling e.g. if auditors objective is to test overstatement of debtors, an appropriate population would be a list of total debtors.
iii. Definition of errors is substantive testing and deviation in compliance testing. Before performing testing on a chosen sample, the auditor should define clearly test results and conditions that will be considered errors or deviations by reference to audit objective. For substantive testing, the auditor should project errors found in the sample to population and consider the effect of projected errors on a particular test objective.

b) Determination of sample size.

The auditor needs to determine the appropriate size of the sample on which audit procedures will be applied. Sample size is determined by;

i. The tolerable error. The larger the tolerable error, the smaller the sample size required for a given test.
ii. Auditor's assessment of the inherent risk. The higher the assessment of inherent risk, the larger the sample size is required. Higher inherent risk implies that there is a greater risk of an account balance being misstated and this may be reduced by testing a larger sample.
iii. Auditor's assessment of control risk. A higher control risk implies that little reliance can be placed on effectiveness of operations of internal controls and the sample size needs to be increased.
iv. Auditor's required confidence level. The greater the degree of confidence level the auditor requires, the larger the sample size needs to be so that the results of the sample are in fact representative of the actual amount of error in the population.

c) Selecting items to be tested.

The sample selected should be a true representative of the population so that the auditor can draw conclusions about the entire population. All sampling units should have an equal chance of being selected. Common sampling methods are;

i. Random sampling. This is done by use of random number tables or use computers to select sampling units
ii. Systematic selection. In this type of sampling, units in the population are divided by the sample size to give sampling intervals e.g. if the population to be sample has 600 items and sample size is 50, the sampling interval will be 12. One of the first 12 items will be

selected as the starting point and thereafter, every twelfth item will be selected i.e. if the first item selected is third item, every 15th, 27th, 39th and so on items will be picked. However, the auditor needs to determine that sampling units within the population are not structured in a way that sampling intervals corresponds to a particular pattern in the population.

iii. Haphazard selection. The auditor selects a sample without following structured techniques. The auditor should avoid conscious bias and predictability in selecting items in attempt to ensure that all items in the population have a chance of being selected. This technique is not suitable for statistical sampling.

iv. Block selection. This involves selecting a group of continuous items within the population e.g. all sales transactions for August. Block sampling cannot be ordinarily used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics therefore the sample selected may not be representative of the population.

d) Testing. After selecting the sample items the auditor should carry out the predetermined test on each item.

e) Evaluating results of the test.

The following procedures should be followed.

i. The auditor should estimate the expected error or deviation rate in the whole population by projecting the results of the sample to the population. This is then compared with the tolerable error.

ii. The auditor should assess the risk of an incorrect conclusion. In general, expected error is rarely a precise measure of the actual error in the population. Actual error may be greater or smaller than projected error. The auditor most therefore consider on the basis of his sample results and relevant evidence from other sources, the possible levels which actual error or deviation might take.

Main approaches to audit sampling

a) Judgmental sampling

This is also called non-statistical sampling. It involves using experience and knowledge of client's business and circumstances to select and taste a sample without using any mathematical of or statistical tools. The auditor does not rely on probability theory and uses judgment in making sampling decisions.

Advantages of judgmental sampling

i. It is well understood and refined by experience

ii. Opportunity to use expertise and knowledge in selecting sample units i.e. no special knowledge and statistics is required. The auditor simply uses his judgment in making sampling deacons

ii. No time is wasted on the mechanics of statistical tools. The time which could have been spent on constructing sample and computing mathematical implications of results obtained is spent on auditing sample units.

Disadvantages of judgmental sampling

i. Unscientific. The approach does not form a strong basis of defense. It is difficult to justify why the auditor selected some items and left out others.
ii. Wasteful as large simples need to be selected. This is because in effort to reduce the sampling risk, the auditor attempts to select as many items as possible as opposed to statistical sampling where sample size is determined using probability theory.
iii. Samples may not be representative of the population and thus results cannot be projected to the population.
iv. There is danger of personal bias in selecting samples.

b) Statistical sampling.

This involves two steps;

i. Use of random selection to pick a sample.
ii. Use of probability theory to determine the sample size, evaluate quantitatively the sample results and measure sampling risk. Statistical sampling differs from non statistical sampling in that the auditor uses probability theory to measure the sampling risk and evaluate the sample results.

Advantages of statistical sampling

i. It is scientific and defensible. The auditor can justify the items selected because these are selected randomly.
ii. Elimination of personal bias. The sample selected is unbiased which increases reliability of audit evidence.
iii. Small samples are selected which improve the efficiency of the exercise. This is because probability theory helps determine a precise sample size.

Disadvantages of statistical sampling

i. It is difficult to extract samples especially if documents are not sequentially numbered.
ii. The need to follow a predetermined statistical report may reduce initiative and the need to apply judgment by the auditor.
iii. The result may be misunderstood if audit staff are not properly trained on use of the techniques.
iv. It may not be suitable for all applications. Probability theory works best for large populations and therefore cannot be applied for small populations.
v. It is expensive because extensive staff training is required and the use of information technology.

Factors considered before adopting statistical sampling

i. The number of clients to whom a technique as appropriate. This is because the set up and training costs are high.
ii. Whether large population exists. Statistics is the science of large numbers. Where organizations are small with few transactions, a statistical approach is inappropriate.
iii. Adequate controls must exist where they are no controls it is impossible to use statistical techniques because of increased statistical errors
iv. The population being tested must be homogenous.

v. Sampling units must be separately identifiable and therefore sequential numbering is essential.
vi. The expectation of the error must be low i.e. the internal control system of organization must be reliable.
vii. The risk factors. The level of risk allowable and the degree of risk attached to an item being tested must be considered.

Qualities of a good sample

i. It should be representative of the population. The sample should be representative of the differing items in the whole population.
ii. The size of the sample should be appropriate given the various risk considerations i.e. where the expected error is high, a large sample is chosen.
iii. Unpredictable. The client should not be able to know in advance which items will be examined.

Sampling methods

1. Estimation sampling for variables.
2. Estimation sampling for attributes.
3. Acceptance sampling.
4. Discovery sampling

1. Estimation sampling for variables

This method seeks the estimate the total value of some population e.g. total value of debtors, stock or loose tools. The procedure is to extrapolate estimate or form an opinion using the facts that are valid for one situation (sample) supposing that they will be valid in the new situation. This estimate can be compared with the book value and if any difference is within the materiality limits pre-established, the auditor has evidence for the book value of the item.

2. Estimation sampling for attributes

This method seeks to estimate the proportion of a population having particular characteristic e.g. overdue debts or damaged inventory.

3. Acceptance sampling

This method seeks to discover the error rate in a population to determine a maximum error rate. Its uses include;

i. Whether a control can be relied upon. If non compliance is greater than the acceptable rate, the control will not be relied upon and other audit tests will have to be applied.
ii. Used to test whether stock calculation can be relied upon. If the error rate is greater than some acceptable proportion, the auditor will have to request the client to redo the calculations.

4. Discovery sampling

This method extends acceptance sampling to an acceptance level of zero. E.g. a system with controls exists in an investment trust company to ensure that all bonus issues are recorded. Even if one bonus has not been recorded, the auditor will be unable to accept the controls and will have to seek other evidence. This method requires a large sample. A form of discovery sampling is monetary unit sampling.

Monetary unit sampling

Monetary unit sampling is appropriate for use with large variance population e.g. debtors or stock where individual units have widely different sizes or values. This method is suited to a population where errors are not expected and it implicitly takes into account the auditor's concept of materiality.

Procedure of monetary unit sampling

i. Determine the sample size taking into account the size of the population and the minimum acceptable error rate.
ii. List the items of population e.g. list of debtors could be as

Debtor	Amount (Sh)	Cumulative amount
TMK& Co.	500	500
AQ & Sons	20	520
T Ltd	1,450	1,970
W Co.	4,420	6,390
	:	:
		240,000
Total	240,000	

iii. Assume that the total numbers of debtors is 1500. If sample size chosen is 100 items, then a random start of say Shs 1000 can be chosen and every Shs 2100th item thereafter i.e. using systematic sampling with random start. The idea is that the population of debtors is not 1500 but Shs 240000 with single units of Shs 1. Therefore, we chose to sample to be picked from the cumulative shillings amount.
iv. At the end of the process, evaluate the result which might be a conclusion that the auditor is 95% confident that the debtors are overstated by more than Shs. X where X is the materiality factor chosen.
v. If the conclusion is that the auditor finds that the debtors are overstated by more than Shs X, then he may take a large sample or investigate the debtors fully.

Disadvantages of monetary unit sampling

i. Does not cope easily with errors of understatement. A debtors balance which is understated will have a smaller chance of being selected than if it was correctly valued hence there is a reduced chance of selecting that balance and discovering the error.

ii. It can be difficult to select samples where a computer cannot be used e.g. where the accounting system of an organization is manual. Manual selection will involve adding items cumulatively through the entire population which is very tiring.

iii. It is not possible to extend a sample if the error rate turns out to be higher than the expected error. In such cases an entirely new sample must be selected and evaluated.

iv. Monetary unit sampling is useful especially in testing for overstatements where significant understatements are not expected i.e. when dealing with debtors, fixed assets and stock it is clearly not suitable for testing creditors where understatement is the primary characteristic to be tested.

EXAM QUESTIONS

QUESTION ONE

a. What is audit sampling
b. Distinguish between audit risk and sampling risk
c. What conditions are necessary to carry out sampling?
d. What are management representations and when does the auditor seek such representations?
e. What should the auditor consider before relying on the work of an expert?

QUESTION TWO

In the context of ISA 530 (Audit Sampling and Other Means of Testing), explain and provide examples of the terms 'sampling risk' and 'non-sampling' risk.

Briefly explain how sampling and non-sampling risk can be controlled by the audit firm.

QUESTION THREE

Tam Co is owned and managed by two brothers with equal shareholdings. The company specialises in the sale of expensive motor vehicles. Annual revenue is in the region of Kshs70,000,000 and the company requires an audit under local legislation. About 500 cars are sold each year, with an average value of Kshs140,000, although the range of values is from Kshs130,000 to Kshs160,000. Invoices are completed manually with one director signing all invoices to confirm the sales value is correct. All accounting and financial statement preparation is carried out by the directors. A recent expansion of the company's showroom was financed by a bank loan, repayable over the next five years.

The audit manager is starting to plan the audit of Tam Co. The audit senior and audit junior assigned to the audit are helping the manager as a training exercise.

Comments are being made about how to select a sample of sales invoices for testing. Audit procedures are needed to ensure that the managing director has signed them and then to trace details into the sales day book and sales ledger. 'We should check all invoices' suggests the audit manager 'How about selecting a sample using statistical sampling techniques' adds the audit senior. 'Why waste time obtaining a sample?' asks the audit junior. He adds 'taking a random sample of invoices by reviewing the invoice file and manually choosing a few important invoices will be much quicker.'

Required:

a. Briefly explain each of the sample selection methods suggested by the audit manager, audit senior and audit junior, and discuss whether or not they are appropriate for obtaining a representative sample of sales invoices.
b. Define 'materiality' and explain why the auditors of Tam Co must form an opinion on whether the financial statements are free from material misstatement

QUESTION FOUR

Audit sampling is a technique for drawing conclusions about the characteristics of a population by testing a sample drawn therefrom. Internal and external auditors use it for both tests of controls, and substantive testing.

Required:

Describe the following:

i. Judgment sampling and statistical sampling;
ii. A representative sample;
iii. Tolerable error;
iv. Two different methods of selecting a representative sample;
v. The extrapolation of errors.

CHAPTER EIGHT

SUBSTANTIVE TESTING

CHAPTER 8
SUBSTANTIVE TESTING

▶ CHAPTER OBJECTIVES

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

i. Define various audit tests and explain their appropriateness and exceptions.
ii. Appreciate the meaning, usage and procedure of vouching audit.
iii. Give practical examples of audit tests for various elements of the income statement and the balance sheet.
iv. Explain the application of management assertions in audit tests.
v. Explain the circumstances and process of debtor's circularization.
vi. Explain the types of post balance sheet events giving examples of each.
vii. Discuss the management's and auditor's use of post balance sheet events

▶ INTRODUCTION

Substantive tests are those tests carried out by auditors to confirm the assertions of the management. These assertions include: existence, rights and obligations, occurrence, completeness, valuation, measurement and presentations and disclosure.

They are tests to detect material misstatemens in the financial statements.

▶ DEFINITION OF KEY TERMS

Cut-off tests which involve selecting goods, received notes raised before the year-end and ensuring that the related invoices have been included in the purchases daybook before year-end as well as individual creditors' accounts. If no invoices have been received to match those goods received notes than a reasonable liability should have been set up.

▶ DEBTORS' CIRCULARIZATION

This is a procedure by which the auditor obtains corroborative evidence regarding the existence,ownership and the value of debtors appearing in the financial statements. This is done by writingdirectly to the debtors and requesting written confirmation to be sent directly to the auditor.

Post Balance Sheet Events- This involves transactions that are entered into before the balance sheet date with the sole purpose of altering the appearance of the balance sheet.

▶ EXAM CONTEXT

The examiner expects students to know the underlying assertions being tested.

▶ INDUSTRY CONTEXT

The auditor always encounters substantive testing during the audit where he tests debit items for overstatement and credit items for understatement. Therefore this is an important area for the auditor for him to obtain sufficient appropriate evidence to support the financial statement assertions.

Substantive Tests:

Compliance tests provide the auditor with indirect evidence, the auditor therefore cannot on the strength of compliance test alone reach a conclusion as to whether or not a balance is fairly stated. The auditor therefore carries out substantive testing to obtain more assurance on the reported balances.

Substantive tests are those tests balances and transactions and other procedures such as analytical review, which seek to provide audit evidence as to the completeness and accuracy and validity of information contained in the records and or the financial statements. Substantive tests are those tests carried out by auditors to confirm the assertions of the management i.e. existence, rights and obligations, occurrence, completeness, valuation, measurement and presentations and disclosure.

Exceptions of substantive tests:

In substantive tests transactions speak for themselves therefore any error or deviation is measured for its materiality or effect on the financial statement or the recorded balance.

Compliance test give indirect evidence to the auditor and if the conclusion from them id positive then it assures the auditor that there were measures in place to minimize misstatements. This then reduces the extent of detailed substantive testing . It is possible to carry out a purely substantive audit and make a valid conclusion without any reliance on any internal controls.

After the substantive test the auditor can conclude that proper records have been kept and that the accounting system is adequate and is a reliable basis for the preparation of financial statements.

Directional Tests:

A general assumption that audit firm have is that companies overstate assets and understate liabilities. It is also has to do with double entry system e.g. creditors and purchases. If one is correct then most likely the other is correct also.

The techniques used are:

Review payments after balance sheet date and matching them against related invoices specifically noting dates on invoices to ensure that the invoice was accounted for in the correct accounting period.

Cut-off tests which involve selecting goods, received notes raised before the year-end and ensuring that the related invoices have been included in the purchases daybook before year-end as well as individual creditors' accounts. If no invoices have been received to match those goods received notes than a reasonable liability should have been set up.

Comparison of the present list of creditors with the previous year's list and investigations being carried out on those creditors on the list of the previous year missing from current years list to confirm that they are properly excluded through settlement during the year under review.

Reviewing reconciliation of creditors' statements with the creditors' individual ledger accounts ensuring that any reconciling items are valid and genuine.

Reviewing lending contracts or agreements for breach of contract accusations to determine where claims would be made against the company.

Reviewing correspondence with professional advisers e.g. lawyers for claims that they may have made against the company but not recorded.

Balance sheet ratios that are usually considered :-

a) Fixed Assets (FA):

The utilization of FA's is usually worked out. This is:

$$\frac{\text{Turnover}}{\text{FA (NBV)}}$$

To determine how much sales are generated for every shilling invested in FA's. It is normally called the FA turnover ratio.

Global depreciation ratio is worked out which involves taking the NBV of the FA's divided by the depreciation charge in the profit and loss account. The resultant figure gives a rough estimate of the average remaining useful life if the assets. Too big a figure indicating that maybe the rates of depreciation used are too low.

b) Stocks:

The percentage increase is calculated and is compared with the corresponding percentage increases in purchases. If the two increases do not correspond, it may indicate that the provision for obsolescence is inadequate.

The stock turnover ratio is also worked out. To ensure that we're comparing like with like, the cost of sales figure is used and not the sales figure. A slowing down turnover ratio may also indicate that the provision for obsolescence is also inadequate therefore it would appear that the demand for the products of the organization may be diminishing.

c) Debtors:

The percentage increase in debtors is worked out and this is compared with the percentage increase in turnover. It is usually being expected that an increase in turnover ordinarily should have a corresponding increase in debtors. Debtors to sales ratio is also worked out to determine the number of day's sales are debtors. This number of days is compared with the normal allowed credit period. It measures the effectiveness of credit control and consequently the adequacy provision for bad and doubtful debts.

d) Liquidity ratios are then worked out

The most common of which are:

i. The current ratio
ii. The acid test ratio

e) For cash at bank an additional measure is consideration of the overdraft limit for the trade creditors.

The percentage increase is worked out and compared with the increase in the cost of sales. Also the number of day's purchases in creditors worked out of measure the difference between credit taken and credit allowed by supplies.

f) The gearing ratio

This is worked out of measure the company's exposure or the cost of external capital to the organization.

Vouching Audit

Vouching is checking the authenticity of recorded transactions. It is proving that the transactions occurred, they are complete correctly measured and they relate to the correct period if they are of a revenue or expense nature.

Usage of vouching

- In very small audits when the number of transactions are not too large.
- In audits whose internal control is weak or non-existent.
- In certain types of specialized audits such as that of trusts or estates.

Method:

The vouching audit involves a consideration of each entry in the books and vouching the available evidence to support each entry. The evidence usually consists of documents and papers and should satisfy the auditor that:

- The transaction was authorized by management.
- The transaction came within the aims and objectives of the organization.
- The transaction was correctly and adequately described by the entry in the books.
- The entry is correctly incorporated in the final procedures.

NOTE: The above is the guideline for all vouching procedures.

Practical Illustrations

Interest paid

a) Ensure that transaction was authorized

- The authority for payment of interest should be obtained prior to payment. This stems from the authority to acquire the loan.
- The auditor should examine the minutes of Board of Directors (BOD) or the Minutes of Annual General Meeting (AGM) for proper authorization to obtain the loan and to service it. The authorization should be expressly indicated and it should refer to the loan in question and differentiate it from any other.

b) Ensure that the transaction came within the aims and the objects of the organization.

The auditor should check the reason for obtaining the loan(s) and ensure that they are in accordance with the aims of the organization.

Obtain the loan agreement and check for:

- Amount
- Interest
- Period for interest to be paid
- Any other matters of default

None should be prejudicial to the shareholders interest.

c) Ensure the transaction was correctly and adequately described by the entry in the books.

- Re-compute the interest and ensure it is correctly calculated.
- Check the recording of this interest in the ledger.
- Obtain the counterfoils of the cheques paid for this interest.
- Trace the item in the bank statement.

d) Ensure entry is correctly incorporated in the final accounts

- Check the amount recorded in the profit and loss account to ensure that item is properly recorded as an expense and it relates to the correct period.
- Check that the amount and date are the correct ones.

Interest received

a) The auditor should check the investment which has borne such an interest and check the authority for its acquisition. This can be found in the minutes of the BOD or the AGM. (This is similar to number one of interest paid.)

b) The auditor should obtain the investment contract and check:

- The amount invested
- The interest or that particular investment
- The period of investment
- Any other matters

c) Ensure that this transaction was properly recorded.

- Compute the interest or the investment
- Check the recording in the ledgers
- Check the mode of payments; cash or cheque.
- Trace item to the bank statement and cashbook.

d) Ensure that the item is properly reflected in the profit and loss account i.e. that the amount is correct and it relates to the correct period.

Dividend received

a) Check authority for purchasing the shares because the dividend is received on shares owned. This should be in accordance with the investment policy of the organization.
b) Obtain the registrar of investment check for:
   - Number of shares owned
   - Rate of dividend
   - Types of shares owned
   - Date of acquisition
   - The auditor can also check press reports that have news on declaration of dividends and their payments.
c) Ensure dividends received are properly reflected in the accounts and in particular check the cut-off for dividends received.
   - Dividends may relate to the current period but may be received in another financial period do the auditor should ensure that they are recorded in the period they relate to.
   - Check the recording of the shares bought or sold cum-div (with dividend) or ex-div (without dividend) and ensure that it is properly recorded in the ledgers.
   - Check the mode of payment of dividend and ensure proper recording. Compare the cash book and the bank statement.
   - Check the recording of this item in the profit and loss account.

Rent received

a) Check the minutes of the BOD and/ or AGM to ascertain authority for obtaining the property and for renting the property out.
b) Obtain the lease agreement to check for:
   - Property rented and the amount of rent
   - The rental period e.g. 10yrs, 20yrs
   - Frequency of obtaining rental payments e.g. monthly, quarterly
   - Terms of maintenance of the property could be maintained by the landlord or tenant
   - Ensure that these are in agreement with the organizations objects
c) Check the ledgers for proper recording of the rent this refers to both the amount received and the period to which it relates. The auditor should also check the reasonableness of the rent on the rented property. He could do this by getting an opinion of an expert i.e. a valuer. Trace the item to the cashbook and bank statement
d) Ensure that the profit and loss account has the correct amount and item is for the correct period.

Vouching audits of different types of business

There are innumerable types of business and all of them have accounts prepared and most of them have their accounts audited. Every type of business has its audit problems but the sheer number different types of business make it impossible to discuss these problems in other than a general way. For exam purposes it is normally possible to apply a general approach to an audit which will conform to the specialized guidelines giving a general knowledge about the enterprise and some imagination.

These guidelines were given at the beginning of this lesson.

Insurance premiums received

This pertains to insurance companies. A premium is money paid to an insurance company to provide a cover against a risk.

a) Obtain the authority for accepting the cover. This should be from the appropriate official and if necessary from a BOD resolution.
b) Obtain copies of the policies given and check
 Various insurance covers
 Date when insurance premiums are due
 Penalties for default
 These should be in accordance with the insurance company's policies regarding insurance covers.
c) Calculate the premiums and compare this amount to the amount received.
 - Check the period which relates t the premiums received and check that the premiums received is correctly shown.
 - Check the recording of the premium in the ledgers.
 - Obtain copies of standing orders from the insured and ensure that entries therein agree with those in ledgers and check for:
 - Schedule of standing order
 - Number of polices
 - Date due
 - Any defaults-check the entries in the ledger for this.
d) Obtain bank reconciliation and compare it to the cash book and check the insurance statement for proper recording of this item .

Subscriptions received

This relates to clubs or non-profit making organizations.

a) Obtain authority for admitting the members whose subscriptions are being audited. The auditor should obtain the constitution of the club or organization.
b) The auditor should obtain the constitution of the club and check:
 - Maximum number of members and the type of members
 - The subscription from each member
 - Provision for default
 - The auditor should then check the actual number of members and the rates they have paid
c) Obtain the ledger and ensure that subscription paid have been entered properly both in amount and the period to which they relate. He should compare the amount in the ledgers with the rates, which should be paid by each member in the various categories.
d) Obtain the cash book and compare it to the bank statement. Ensure that there is good reason for variances. Check that it is properly recorded in the income statement.

Hire purchase instalments received

a) Authority from the BOD minutes or AGM or proper official with the authority for granting hire purchase terms to customers.
b) Obtain hire purchase agreement and check for:
 - Value of asset
 - Hire purchase price
 - Hire purchase installments
 - Provision for default
 - Ensure the hire purchase terms are in agreement with the policy of the organization

c) Find out the amount of installments and when they should be paid and get the ledgers recording of these installments. Ensure that capital payments are separated from revenue payment. The auditor should calculate the amounts and compare them to those that are recorded.

d) Check the recording of these items in the cashbook and the bank statement to ensure that the two are in agreement. Check the profit and loss for proper recording.

Audit of Salaries and Wages

The audit of salaries and wages is a little different from the audit of other expenses or payments of an enterprise. The difference is that the audit procedures lay emphasis on checking the strength of the internal control system. This therefore means that to carry out a proper audit one should have a very good understanding of the features of a strong internal control system for payment of salaries and wages.

Some of the frauds which can be perpetrated by the employees and which the auditor should look out for include:

- Dummy/ghost workers: these are workers who do not exist.
- Fraudulent double payment for employees: this could be done by giving different names for the same person.
- Payment for work not done and unclaimed wages being misappropriated
- Inflating payroll by wrong increments or showing increment when it is not due.
- Improper deductions being made or being misappropriated.
- Manipulation of commission.

The auditor should check the following areas carefully:

- Time workers-who come in shifts who work for certain number of hours a day
- Piece workers-employed to do certain job
- The preparation of wages
- The payment of wages
- Dummy workers
- The recording of salaries and wages and also employee records

Audit tests for salaries and wages

- Test the internal control system of payment of wages. Check if there is possibility of this system detecting ghost or dummy workers or any similar fraud.
- Check the procedure of employment and dismissal of employees, which should be authorized by a responsible officer.
- Verify that there is proper recording of wages.
- For time basis check time records.
- Check authorization of overtime.
- Verify authority for deductions and ensure proper recording.
- Check castings of wages.
- Ensure all stages of preparation of payment of wages are properly authorized.
- Check total of wages paid to control account.
- Test a number of entries of payments to employees and ensure that they were received by employees.
- Reconcile signature of original employment to that signed on receipt of the wages

Verification of assets & liabilities

Verification is proving the authenticity of a recorded balance. This is achieved through attempting to prove the assertions made by management in preparing financial statements.

ISA 500 paragraph 12 "when obtaining audit evidence from substantive procedures, the auditor should consider the sufficiency and appropriateness of audit evidence from such procedures together with any evidence from tests of control to support financial statement assertions"

The auditor must substantiate all the relevant management assertions for each outstanding account balance. He must obtain evidence that the accounts give true and fair view.

Management assertions

Financial statement assertions are assertions by management, explicit or otherwise that are embodied in the financial statements. They are categorized as follows:

- Existence
- Rights and obligations
- Occurrence
- Completeness
- Valuation
- Measurement
- Presentation and disclosure

The auditor must determine which financial statement assertions are relevant to each account balance and formulate appropriate audit procedures to substantiate these assertions. This implies that not all the seven above mentioned assertions are relevant for all account balances but rather the auditor has to determine which ones are relevant to what account balance. This calls for exercise of judgment. For e.g. for debtors the auditor would be interested in proving:

- The completeness
- The existence
- The valuation

Whereas for plant and machinery the auditor would be interested in proving:

- The existence
- Ownership rights
- Valuation
- Completeness
- Presentation and disclosure

This implies that the audit procedures applied in verifying these two balances will be different. Liabilities are normally valued at cost unless they involve interest for late payments.

Verification of non-current assets

In an average company, the non-current assets that will be encouraged are: freehold land and buildings, plant and machinery, motor vehicles and fixtures, furniture and fittings. The verification process is similar in all these. Therefore, we shall look at freehold property and plant and machinery.

Freehold land and buildings

Audit objectives

- To verify that there was proper authorization to acquire the land and the buildings
- That land and building exist
- That the company has legal ownership rights over these assets
- That these assets are valued at an appropriate amount
- That these assets are properly presented and disclosed in the financial statements according to the relevant financial reporting standards such as international accounting standard No. 16, 17 or 40

Audit procedures

To be able to meet the above objectives, the auditor carries out the following audit procedures:

a) Cost and authorization

This is verified by inspecting to the appropriate documentation such as the sale agreement and surveyors certificates. To verify whether the acquisition was authorized the auditor can inspect the minutes of the board of director's meetings at which such the green light was given acquire the assets in question.

b) Existence

This can be verified through physical inspection of the land or the building.

c) Ownership rights

This can be verified by inspecting the title documents. The auditor should also ensure that such title documents are in the name of the company and are free from ant charges e.g. the land title deed should not be charged as security for loan. If this is the case then such information should be disclosed in the financial statements.

d) Valuation

Freehold land should be disclosed at cost. Leasehold lend should be amortized over the life of the lease. Generally buildings should be carried at the depreciated historical cost or at depreciated revalued amounts.

The auditor should ensure that:

- The depreciation policy adopted is appropriate i.e. the rate applied and the estimated useful life.
- Where buildings or land has been revalued that this is carried out by a qualified and reputable valuer and the revaluation seems reasonable.
- That the land and buildings are evaluated for impairment and where necessary written down to the impaired value.

e) Presentation and disclosure

For purpose presentation fixed assets should be split into appropriate classes. The following information should be disclosed:
Depreciation policy
Useful life's
Total depreciation charge for the period
Additions of new assets or disposals during the period
Any assets that are charged in favour of another person.

Plant and machinery

Audit objectives

- The auditor will be aiming at proving the following assertions

STUDY TEXT

1. Proper authorization to acquire the asset
2. Valuation
3. Existence
4. Ownership rights
5. Presentation and disclosure

Cost

The significant plant and machinery acquired during the year is vouched supporting documentation such as supplier's invoices, cashbooks, approved budgets etc.

Authorization

Check in the director's minutes or AGM minutes for proper authorization for acquisition of the asset.

Valuation

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 largely related to time then reducing balance method would not be appropriate but straight line method. Check appropriateness of the useful life. Where the assets have been revalued the auditor should ascertain that an independent and qualified valuer carried out this revaluation.

Existence

Existence should be checked by physical inspection. The problem arises that items of plant & machinery are mobile, numerous, portable and valuable. It becomes difficult therefore for the auditor to be assured that the value attached to the plant and machinery represents plant and machinery that actually exist at balance sheet date. To ensure the existence of plant and machinery, it is necessary to have a Fixed Asset Registrar.

Fixed asset registrar

For it to be independent the person maintaining it must have no responsibility for: the asset purchase, maintenance, custody or disposal.

- Ordering or authorizing the purchase of fixed assets.
- The custody of the fixed assets.
- Authorizing the disposal of fixed assets.
- Maintaining general ledger accounts.
- Custody of readily realizable assets.

The register contains 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 date of purchase.
v. The estimate useful life and residual value
vi. Accounting policy for depreciation
vii. Accumulated depreciation
viii, The gain or loss on disposal
ix. Capital allowances

When the register is reconciled to the general ledger the auditor can check the asset for physical existence by reference to the number and locations recorded.

Beneficial ownership

For plant and machinery, it is usually implied and unless there is clear evidence t the contrary, proof of purchase and possession will suffice as evidence of ownership.

Presentation

This is similar to freehold property

Motor vehicle

Similar considerations should govern verification of motor vehicles as those that govern plant and machinery. The only issue here is existence and ownership.

Existence

If we cannot see the vehicle prove evidence should suffice e.g. if we own a vehicle then we expect that it will incur costs such as insurance, repair, fuel etc. which are proof of its existence.

The engine and chassis number should be checked to ensure that the vehicle described in the logbook is the same one we are looking at as clients can change the registration number plates from one vehicle to another.

Beneficial ownership

Ensure client's name is the one in the logbook.

Disposal of non-current assets

- The issue here is authorization for disposal
- Also the auditor tries to ensure that he value obtained was reasonable either by engaging an expert or by looking at the values obtained and related values for assets of that nature .

Verification of current assets

Cash in hand

The cash in hand will mainly be composed of the petty cash float and any unbanked receipts from customers. Most organizations refrain from maintaining substantial cash amounts in their premises due to the risk involved.

Audit objectives

The main audit objective is to ascertain the completeness and existence of the cash in hand.

Audit procedures

i. These audit objectives are fulfilled by carrying out the following procedures:
ii. Where appropriate the auditor should visit the client at the balance sheet date and count cash at hand and compare it with cashbook entries. He should count authorized IOU's, stamps and cheque drafts as well.
iii. If the company has different cash collection centers cash in all entries must be counted simultaneously to avoid a shortage in one centre being made up with balances from other centers.
iv. The counting should be in the presence of the cahier so that in case of a shortage the auditor can ask for a certificate of shortage from the cashier which should be mentioned in the management letter.

v. The auditor should obtain a certificate of cash in hand from all branches should he be unable to attend a cash count in those branches. He should mention this in his report i.e. he relied on certificate of balances from the branches.
vi. If there is cash held by third parties he should request for a certificate of balance from them.
vii. If the auditor cannot visit the client, he should obtain a certificate from the client's management confirming the amount of cash held as at the end of the financial period.
viii. A reconciliation of the actual cash in hand counted and the expected cash balance per the cashbook should be prepared. Any reported variances should be investigated and appropriate action taken.

Cash in bank

Audit objectives

The auditor will be concerned with ascertaining whether:

- The bank balance exists
- Completeness and accuracy

Audit procedures

The above objectives are tested by performing the following procedures:

1. The auditor should obtain the bank reconciliation statement as at the end of the period and perform the following procedures;
   i. Verify that the reconciliation is accurately prepared
   ii. Ensure that the correct balances as per the bank statement and the cash book have been picked in the reconciliation.
   iii. Verify that all un-presented cheques had been dispatched to the payees and that all un-credited deposits have cleared. This will assist the auditor in testing for window dressing. Window dressing in this context refers to attempts to overstate the liquidity of the company by keeping the cash book open such that money received after year end is credited to the cash book increasing the cash balance and reducing debtors. It could also take place by debiting cheques paid in the period under review but are not dispatched until after year-end.
   iv. This procedure of inspecting the bank reconciliation statement assists in verifying the completeness and accuracy of the bank balance.
2. The auditor should obtain a direct confirmation from the bank of the amount holding on behalf of the client. The auditor should obtain the clients consent to communicate directly with the bank. Where consent is granted a standard letter of request should be sent to the bank. Auditors use a standard letter of request because of the following:
   - Use of a standard letter by all auditors facilitates the quick preparation of the reply by the bank as they are well familiar with the contents and the required information in the letter.
   - Use of a standard letter ensures that no omission is made in the information required.
   - It is more efficient for the auditors because all that is needed is to amend the letter to reflect the specific details of the client.

The reply to this request is a good source of corroborative audit evidence to confirm the existence of the bank balance and other information such as the interest earned, any loans granted to the company or any restrictions placed on the operation of the account.

STUDY TEXT

Stocks and work in progress

Stock includes:

- Finished goods held for sales in the ordinary course of business
- Work in progress
- Raw materials

Stock comprises a significant portion of the company's assets and hence has a material effect on the presentation of the financial statements.

Problem encountered in the verification of stock

i. The amounts involved are invariably material.
ii. Stock has a one for one impact on the reported profits i.e. an increase in stock increase the reported profit. It is therefore open to distortion by management.
iii. Stock does not derive from the normal double entry system; it is arrived at by stock taking carried out at the year-end.
iv. Stocks are portable and valuable opening themselves to pilferage and deterioration either intentional or accidental.
v. The number of items involved is usually numerous creating verification problems as far as existence and condition is concerned.
vi. Although stocks are valued at the lower of cost and net realizable value, what constitutes cast 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.
vii. It is an area that is susceptible to manipulation by management provision for obsolescence, slow moving and damaged stocks is a question of judgment therefore it is easy for the auditor to disagree with management.
viii. stock is normally made up of different items e.g. work in progress, raw materials all these can be valued on a different basis and amalgamated and described as stocks.
ix. Stock may be overstated by inclusion of goods sold but not dispatched to customers.

Audit objectives

a. Ascertain the existence of stock.
b. Ascertain that stock is appropriately valued at lower of cost and net realizable value. Adequate provisions are created for dead and slow moving stock.
c. Verify the completeness and accuracy of the stock balance.
d. Verify that stock is appropriately presented and disclosed in the financial statements.

Audit of stock

Cost

This involves determining the method adopted by the organization in costing stocks. The auditor should then check the acceptability and appropriateness of the adopted policies.

The rest of the exercise is to test that the adopted exercise if correctly applied.

Valuation

Stock should be valued at lower of cost and net realizable value where net realizable value is defined as the amount that could be realized on the open market in the ordinary cause of business less the cost of putting them into a saleable condition and less the cost of sales.

It is up to the auditor to ensure that the net realizable value is properly calculated and is in accordance with the accounting standards.

Stocks should be reduced by a provision for obsolete or damaged and slow moving stock. This provision should not be excessive or inadequate. The auditor is guided by the factors such as age of stock, condition of stock, its turnover, technological advances in the industry, nature of stock (perishable or not), prevailing economic conditions etc. these guide him on judging the adequacy of provision for slow moving, obsolete or damaged stock.

Existence

The auditor must obtain adequate independent evidence that the stocks concerned are in existence. On several occasions auditors have certified accounts as giving a true and fair view when the stocks concerned were non-existent. The unfavorable decisions against the auditor have resulted in the profession making it obligatory that where stocks are of a significant figure in the accounts the auditor attending to observe the stock take.

It 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. The auditor should examine the internal control in order to determine the nature and extent of audit steps. Where stock 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.

When stock is based on records these must be substantiated by continuous or periodical physical stock takes. The records must be up to date.

Stock Taking exercise

It is the responsibility of management to ensure that the amount at which stocks are shown in the financial statements represents stocks physically in existence. The auditor should obtain evidence in order to enable him to draw conclusions about the validity of amounts attributable to stocks. Where stocks are material in the financial statements the auditor should attend the stock take. The auditor must be present during the stock take mot necessarily to count stock but to witness and observe the way stock taking is done to obtain assurance on the existence and value of stock in trade.

The procedures to be followed during the count vary according to the size and circumstances of the business, nature of its stock and its stock records. Define 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 instructions should contain:

i. Identification of the sock items and their ownership.
ii. Counting, weighing or measuring.
iii. Reporting of stocks which are damaged or defective.

The following issues should be addressed:

- Stock taking should be well planned and carried out systematically by persons who are fully informed of the duties involved.
- These persons should be familiar with the stock but supervisors should be from different departments. Counting should be done by at least two people, one to count and the other to check and record what has been counted.
- Stocks should be marked to facilitate counting. The whole stock taking area should be divided into sections for control purposes and avoids double counting.
- Ensure that properly qualified personnel are available where specialized knowledge is necessary to identify, quality and quantity of stock.

Cut off procedures should be performed i.e. dispatch documents for all goods belonging to customers and still held by client and those that have already passed to the customers. Exclude these from stock take.

Include al goods that have been purchased by client. This is in spite of them not being in the client's premises.

Goods held in safe custody for others should not be recorded as part of the client's stock.

Arrangements to confirm the goods held for the company by outside parties should be made.

There should be procedures to identify the slow moving and obsolete/damaged stock.

There should be procedures for identification of stage of completion of work in progress.

The following details should be available for the auditors during the stock take:

a. Details of stock movement during the count.
b. The last numbers of goods inwards and outward records for testing the cut off procedures.
c. The details of the numbering of stock sheets issued of those complete and those cancelled ad unused.

Auditors Duties

The procedures to be carried out by the auditor when attending stock taking are divided into:

- Duties before stock take.
- Duties during stock take.
- Duties after stock take.

Duties before stocktaking

The auditor should:

- Study of the clients stock taking instructions and recommend for changes or improvements if the auditor consider them inadequate.
- Familiarization with the location of the stocks and the opportunity to plan for the work to be undertaken.
- Familiarization with the nature and volume of stocks and especially with high value items.

Review of previous year's working papers and discussions with the managers of any significant changes from the previous year.

Consideration of the location of stocks and likely points of difficulty e.g. cut off.

Consideration of any involvement of the internal audit department and the extent of reliance to be placed upon their work.

Arranging to obtain from third parties confirmation of stocks held by them.

Establishing whether expert advice may be needed.

Duties during the stock take

- The main task id to ascertain whether the client's employees are carrying out their instructions properly so as to provide reasonable assurance that the stock take was accurate and not necessarily to count stock. He will do this by testing efficiency of the counting by counting selected items.
- He should make notes for follow up purposes of items counted in his presence, details of damaged, obsolete or slow moving items.
- Details of items for cut off purposes should be noted.

- He should find out the methods of identifying slow moving, obsolete or damaged stock.
- Record fully the work done and his impression on the stock take exercise.
- He must form a conclusion as to whether the stock take can be relied on.
- Get photocopied of rough stock sheets.
- Get details of the sequence of the stock sheets.
- Pay special attention to high value items.
- If the auditor is not satisfied about the way stock taking was conducted, he should inform management and may request a recount.

Note that

The auditor should conclude whether stock taking was properly carried out and can be relied upon for determining the existence of stock. He should also try to gain from his observations an overall impression of the levels and values of stocks held so as he may judge whether the value of stock appearing in the financial statements is reasonable.

Duties after the stock take

This is mainly a follow up exercise and it involves:

- Checking the cut off with the details of last numbers of stock movement forms and goods inwards and goods outward notes during the year and after the year end.
- Ensuring that the final stock checks have been properly prepared from the count records. He must particularly check that all the counts sheets issued were returned.
- Check the final stock sheets for pricing, extensions, casting, summarization and the necessary improvement.
- The auditor should ensure that the stock records have been adjusted to amounts physically counted and that all reported differences have been investigated.
- Follow up any notes made in the attendance. 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 either, because he has numerous clients with similar year ends or stock is located in remote locations, the auditor must still certify himself on the stock take. The auditor can in such cases:

i. Arrange for stock take to be done earlier.
ii. Appoint as agent.
iii. Examine perpetual inventory records more thoroughly.

Obtain representations from management on the existence, completeness and valuation of stock.

Ownership of stock

In January 1976 the case of Aluminium Industries Vasen BV v. Romalpa Aluminium Ltd, radically altered the law with regard to normal trading practices. Commercial law states that title to good passes to the buyer once they are delivered on a valid contract, therefore if the buying company went into liquidation then the seller company would probably lose the stock and money. This was accepted practice for centuries.

The Romalpa case rules that transactions can be made subject t reservation of title such a time as the buying company makes payment. The case further rules 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 not be included in the buying company's accounts until they are unpaid for.

Accounting treatment acknowledges substance over form and as a result the amounts are shown as sales if the selling 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. If the amount if stock is significant then it may be necessary to disclose in a note to the accounts that such creditors are secured by a specific stock.

Presentation

This as in all other assets should be in accord with the appropriate International Accounting Standards. The stock should be classified in a manner which is appropriated.

Disclosure

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 Act.

An example of a note to the accounts

The company purchases goods from certain suppliers subject to reservation of title. This gives the suppliers included in creditors in the balance sheet was Shs. X.

Accounting policies must be disclosed and changes therein as well.

Work in Progress

This item presents greater problems of ascertainment and valuation to the directors and to the auditor even though what applies to stocks applies to work in progress.

The auditor work will include:

- Enquiring into the costing system from which WIP is ascertained.
- Enquiry into checks that are made as part of the system on statistical data concerning inputs of materials and output of products and expectations
- Enquiry into the system of inspecting and reporting on work done so that allowance is made for scrapping and rectification work.
- Determine the basis on which overheads are included in costs.
- Making enquiry into the basis on which any profit elements are dealt with. Profit should be eliminated from work in progress.
- Where the organization constructs intentionally some of its own fixed assets, the auditor must make sure that such items as are under construction are not accounted for twice i.e. in fixed assets and in work in progress.

Debtors

For companies trading in credit debtors are significant balances.

Audit objectives

The auditor will be seeking to obtain sufficient appropriate audit evidence on the following assertions that:

- Debtors are complete
- Debtors exist
- Debtor's balances are accurately stated
- Debtors are appropriately valued.

Audit procedures

a) Carry out analytical review procedures by:

- Comparing the current year's debtors to the previous year and obtaining explanations for significant movements reported.
- Compute current year's debtors' days and compare this with that reported in the previous period and obtain explanations for the reported trend.
- Compare the ratio of bad debts provision in the current period and compare this with the previous period.

The purpose of these analytical procedures is to provide the auditor with indications as to whether the debtor's balances are complete and correctly valued.

b) The auditor should obtain a debtors listing and carry out the following procedures:

- Verify that the total debtors per listing agree to the ledger balance.
- Verify that the balances are not above the credit limit.

c) To test the completeness, existence and ownership carry out debtors' circularization. Obtain payments that have been received from the debtors subsequent to the end of the year. This will confirm the existence of the debtor and will provide evidence as to the valuation. Where the full amount is settled after the year-end, this indicates that the debt was fully recoverable as at year-end.

d) Basing of the cumulative information gathered ascertain whether the company has created an appropriate provision for doubtful debts and where appropriate discuss with management as to the recoverability of amounts not settled as at the balance sheet date.

e) Test that the company's cut off procedures for completeness of debtors.

Provision for bad and doubtful debts

Valuation of debtors is a consideration of whether the provision of bad and doubtful debts is adequate or not. The auditor must therefore consider the following matters:

i. The adequacy of the International Control System (ICS) for approval of credit and follow up of poor payers.

ii. The period of credit allowed and taken.

iii. Obtain the list of provision for bad and doubtful debts. Cast the list. Agree the total to the trial balance and the general ledger account. Compare the list to the aged debtors listing to ensure that no debtor has provision against them greater than the total amount due from those debtors.

Examine the evidence justifying the need for a provision. This include: debtors, payment record and correspondence with the debtor, legal action taken against the debtor and information from external sources such as liquidation on receiverships. Review also after date payments to confirm that the provisions are necessary and have not been set up against a debtor who has subsequently settled.

Review the debtors not provided for to assess whether they should be in fact provided for. This will involve reviewing the payment record of those debtors who have exceeded their limits or those debtors where other evidence indicates that they could be doubtful.

Debtors' circularization

This is a procedure by which the auditor obtains corroborative evidence regarding the existence, ownership and the value of debtors appearing in the financial statements. This is done by writing directly to the debtors and requesting written confirmation to be sent directly to the auditor.

Purpose for circularization

- To provide independent third party confirmation of the existence of the debt.
- To confirm the ownership rights to the amounts owned.
- To confirm the money amount.
- To provide support to compliance tests as to the functioning of the Internal Control over sales and debtors.
- To bring to light any disputed amounts which could point out irregularities or frauds in the area of debtors.
- To support other evidence with regard to the effectiveness of the cut-off procedures.

Types of circularization

Negative circularization

The debtor is expected to respond to the circular if they do not agree with the contents of the circular. The major drawbacks of this method of circularization is that should the debtor fail to receive the circular and therefore not reply, the auditor may wrongly assume that the debtor is in agreement with the contacts of the circular. Therefore unless the client has a very effective system of internal control or there exists other evidence to enable the auditor satisfies themselves with regard to the purposes of circularization the negative method should not be used.

Positive circularization

The debtor is required to respond to the circular whether they agree or do not agree with the contents of the circular. Accordingly the positive method if the preferred method of circularization.

The approach for circularization is as follows:

i. Obtain the client's consent to send the requests to the debtors.
ii. Select the date at which you desire to perform the circularization.
iii. Select the debtors you wish to circularize and confirm management's acceptance of those debtors.
iv. Draft a circular, which should be from the client to the debtor with the request that the debtor should reply direct to the auditors.
v. Send reminders to non-repliers.
vi. Evaluate the replies. This involves comparing the amount acknowledged in the reply with what appears in the clients' ledger and investigating any differences.
vii. Perform alternative test to non-repliers.
viii. Conclude on whether the objectives of the debtors' circularization have been achieved.

Selecting the debtors for circularization

A representative sample should be selected from the debtors listing. When selecting the sample the following classes of accounts should receive special attention:

i. All large debtors would be circularized i.e. debtors above the materially level set for debtors.
ii. Credit balances would also be selected to try to confirm that they are genuine credit balances. This is because debtors system should produce debit balances and not credit balances.
iii. Debtors who seem to have exceeded their credit limits in terms of amounts or time may also be selected.
iv. Small or nil balances on accounts that are normally very active during the year would be selected to confirm that there is no window dressing.

v. Newly opened accounts also tend to be circularized. The remaining accounts tend to be selected on a random basis.
vi. Long outstanding balances. This helps in assessing the need to create a provision for irrecoverable balances.
vii. Accounts in dispute.

Alternative

Where it proves difficult to get confirmations from individual debtors the following alternative procedures can be applied:

i. Review of the after-date payments: because if the debtors have subsequently paid then there is evidence that the debtor was in existence.
ii. Review of supporting evidence for the invoices that make up the balance. These include: customer orders and acknowledgement or receipting of the goods.
iii. Sometimes the correspondence with the customer is also reviewed.

Cut off procedures

Cut off procedures are tests performed to ascertain whether the company's transactions are recorded in the financial period to which they relate. If transactions are recorded in the wrong financial period account balances could be over/under stated. E.g. where there is a time lag between the dispatching of goods and the recording of these dispatches as sales, such sales may be recorded as sales in the wrong period.

Cut off test with regards to debtors should be performed to ensure that debtors are recorded in the correct period.

Illustration of testing the sales cut off procedures

The following tests can be performed:

i. Take note of the last serial number of the goods dispatch note for the period under review.
ii. Verify that the sale was recorded in the current period.
iii. Verify that such items sold were not included as part of closing stock.

Teeming and lading in debtors

This is a fraud that can occur in debtors if the person in charge of posting entries to the debtors account has access to cash receipts. This can also occur by colluding with the cashiers. This fraud involves the concealment of cash received from debtors by delaying to record the receipts. The cash received is then misappropriated. The debtor could then be written off as a bad debt or money received from another debtor could be credited to such an account concealing the fraud.

Verification of liabilities

The auditors' duties with regard to liabilities can be summarized as:

a. To verify the existence of liabilities shown in the balance sheet and that these are genuine obligations of the company.
b. To verify the correctness or accuracy of the money amount of such liabilities
c. To verify the appropriateness of the description given in the accounts and the adequacy of the disclosure.

d. To verify that all existing liabilities are actually included in the accounts i.e. completeness

Number (d) poses the most difficulty to the auditor.

Inclusion of all liabilities

It is not enough for the auditor to be satisfied that all liabilities recorded in the books are correct and are incorporated in the final accounts he must also be satisfied that no other liabilities exist but which are not for various reasons in the books and in the accounts.

Examples of such liabilities include:

- Contingent liabilities such as claims by ex-employees for unfair dismissal, pending law suits etc.
- Bonuses under profit sharing arrangements
- Tax liabilities
- Claims under warranties and guarantees
- Bills receivable discounted

The auditor must take steps to identify such liabilities. The procedure carried out would include:

- Enquiry of the directors and other officers
- Examination of post balance sheet events, which includes inspection of purchase invoices and the cashbook etc.
- Examination of minutes of meetings
- Review of previous years working papers
- Awareness of the possibilities at all times when conducting the audit e.g. discovering during the audit that the client deals in future will alert the auditor of the possibility of outstanding commitment.
- Obtain a letter of representation from the client.

General verification procedures for liabilities

- Obtain or prepare a schedule for each class of liability. This should show the make-up of the liability i.e. the opening and closing balance and the changes.
- The auditor should verify cut-off foe example a trade creditor should not be included unless the goods were acquired before the year end.
- Consider the reasonableness of the liability asking the question whether there may be circumstances which ought to excite suspicion.
- Where there exists a system of internal controls covering that liability, determine, evaluate and compliance test the internal control procedures.
- Consider the liabilities at the previous accounting date. Have they all been cleared
- Terms and liabilities. This applies principally to loans. The auditor should determine that all terms and conditions agreed when accepting a loan have been complied with.
- Authority: the authority for all liabilities should be sought. This will found in the company minutes on director’s minutes. Authority of the Articles of Association or Memorandum may be required.
- Description: He should see the description that the account for each liability is adequate.
- He should examine all the relevant documents.
- The auditor should find out if there is security and he should ensure that it has been registered. The company’s Act requires that the nature of security, the item covered and aggregate amount of debt be disclosed.
- The auditor must satisfy himself that appropriate accounting policies have been adopted and applied consistently.

- External verification: With many liabilities it is possible to verify the liability directly with the creditor.
- The auditor must always perform a post balance sheet review with regard to liabilities.

Current liabilities

Tax payable

Audit objectives

To verify that:

- All tax liabilities have been taken up in the books i.e. completeness
- Tax liabilities have been accurately computed.
- All tax liabilities are disclosed in the financial statements.

Audit procedures

- Obtain or prepare the tax computation.
- Review the correspondence between the clients and the tax authority in case any queries have been raised so that the auditor can determine the status of those year's returns.
- Vouch installment payments to the cashbook and the receipts from the Income Tax Department.
- Obtain or prepare a schedule showing the year of income, the balance brought forward, the amount paid in year under audit, charge to the P&L A/c and the balance carried down.
- Balance brought forward should be in agreement with the balance for the previous year.
- The amount paid in the year should be agreeing with the cash flow statement and the cashbook.
- Balance carried forward to the draft balance sheet.

The auditor should ensure that disclosure is adequate. Note to the accounts should explain the basis for driving at the provision for tax that year. On the face of the P&L account the corporation tax charge for that year should be separately disclosed.

Trade creditors

Audit objectives

The auditor seeks to ascertain:

- The completeness and accuracy of the creditors balances.
- That all creditors exist and are genuine liabilities of the entity.
- Creditors are properly presented and disclosed in the financial statements.

Audit procedures

i) Obtain a creditors listing and verify that the total per the listing agrees with the total per the ledger.

ii) From the listing select a sample of creditors and carry out the following procedures

- Obtain or prepare a reconciliation of the creditors balance per the ledger to the suppliers' statements.
- Obtain explanations for all the reconciling items and where appropriate ensure that the reconciling items have been adjusted in the books of account. The reconciling items will mainly include suppliers invoices not posted in the clients ledger or payments not reflected in the suppliers statements.

STUDY TEXT

iii) Obtain a sample of payments made to suppliers after year-end and verify that all the invoices that related to the period under review had been accrued for.
iv) Obtain all the pending invoices and verify that these had been accrued for.

Provisions and Reserves

Students tend to confuse these two words, which are in common use. The correct use of these two words is:

Provision

Any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

Thus a provision:

i. Is a debit on profit and loss account (reducing profit and therefore dividends and retained profits)
ii. Is for a likely or certain future payment.
iii. Is where the amount or the date of payment is uncertain.

Reserve

That part of shareholders funds not accounted for by the nominal value of issued share capital or by the share premium account.

The need for the creation of provision is an important consideration for directors who are responsible for accounts and consequently for the auditors. Post balance sheets events can often cast light on the amount of provision required. The auditor has a duty to see that any provisions set up are used for the purpose for which they were set up and that any provision s which are no longer needed are transferred back to profit and loss account.

The verification procedures are:

Verification of provisions and accruals:

a. Review of post balance sheet events often casts light on the amount of the provision required.
b. The creditor'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.
c. Consideration 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.
d. The auditor must ensure that last years accruals are written back.
e. Accruals do not alter mush 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 lesser would call for investigation.

Long-term liabilities

Long term liabilities mainly include term loans and debentures repayable within a period of more than one year. Such liabilities are usually evidenced by an agreement called a debenture. 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.

Audit objectives

To ascertain that:

i. All long-term liabilities are included in the financial statements i.e. completeness and accuracy.
ii. All long-term liabilities are genuine obligations of the entity.
iii. All long-term liabilities are properly presented and disclosed in the financial statement. All information that is relevant such as terms of the facilities should be disclosed.

Verification Procedures

- Obtain a schedule detailing the sums due at the beginning of the year, additions and redemption's and the sum due at the year-end.
- Obtain the terms and conditions of the loan as evidenced in the deed. This includes the amount lent, maturity date, repayment terms, interest payable etc.
- Agree the opening balances with last year's accounts and working papers.
- If any new loans have been received, verify that this was authorized by inspecting the minutes of the board meetings.
- Repayments made should be vouched through the cash book and the register of debenture holders and charges.
- Interest payments should be vouched through the cash book and any outstanding amounts should be correctly accounted for.
- If the loans are secured, confirm that the charge is registered at the registrar of companies.
- Agree total amounts outstanding with the register of debenture holders or the lender.
- Review restrictive terms of the contract and provisions relating to default in payment of interest and principal. If the company defaults in repayment determine the effect on the financial statements such as the need to provide for penalties. In extreme cases the company could be put under receivership.
- If the facility was acquired for a specific purpose, verify that it was actually applied for that intended purpose.
- Ensure disclosure is in accordance with Companies Act requirements, clearly stating the date of redemption of the debentures.

Verification of contingencies e.g. Pending Litigation

The auditor should carry out procedures to become aware of any material litigation or claims involving the entity. Such procedures would include:

- Review of the client system for recording claims and disputes and the procedures for bringing this to the attention of the board.
- Examination of the minutes of the board for reference to and indications of possible claims.
- Making appropriate enquires from management including obtaining representations about the existence and nature of litigation against the company. Inspection of bills rendered by the solicitors.
- Reviewing correspondence with solicitors with an estimate of the possible ultimate liability.
- 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 the auditor.

STUDY TEXT

Share Capital

This is a special sort of liability of a company. When share capital has been issued in a year its verification is as follows:

i. Ensure the issue is within the limits authorized by memorandum and articles of association.
ii. Ensure the issue was subject to a director's minute.
iii. Ascertain and evaluate the system for control of issue.
iv. Verify that the system has been properly operated. This will involve examining the prospectus (if there is one) applications, applicators, application and allotment sheets, the share register, cash received records, share certificate counterfoils and repayment to unsuccessful applicants.
v. When the issue was one which was contingent upon permission to deal being received from stock exchange then:
    - Ensure that permission has been obtained. If it has not been given, all money subscription must be returned.
    - Ensure all the money was kept in a separate bank account until all conditions were satisfied.
    - Ensure that the minimum subscription has been received. If there are not enough subscribers then the whole is returned.

When the issue is not for cash but for other consideration vouch the agreement and ensure that all entries are properly made.

Vouch the payment of underwriting and other fees. When no new issue of shares has been made the audit work will include:

a. Determine the total shares of each class as stated in the balance sheet and obtain a list of shareholdings which in total should agree with the balance sheet total.
b. Test the balances in the share register with the list and vice versa.
c. If this is not possible at the balance sheet it may be permissible to do it earlier provided that the auditor is satisfied with the system of control over transfers.
d. When the share register is maintained by an independent firm of registrars, the auditor should obtain a certificate that the above work (a & b) has been done.

Loans

Loans can be secured or unsecured. Secured by a fixed charge over a specific asset or secured by a floating charge on all the assets. Secured liabilities are at times called mortgage debentures.

The verification procedures are:

i. Obtain a schedule detailing the sums due at the beginning of the year, additions and redemption/repayments and the sum due at the year end.
ii. Note or photocopy, for the permanent file the terms and conditions of the loans as evidenced in the debenture.
iii. Agree opening balance with last year's papers.
iv. Vouch receipt of new loans with prospectus, board minutes, memorandum and articles of association, register of debenture holders etc.
v. Vouch repayments with debenture deeds. (Terms are correctly interpreted) cashbook, register of debenture holders.
vi. Vouch interest payments with debenture deed, cash book and see amount paid is correctly shown as a percentage of amounts outstanding.

vii. Agree total amount outstanding with register of debenture holders.
viii. If loans are secured, verify charge is registered at company's house.
ix. Verify disclosure is in accordance with Companies Act requirements. Note that long term loans which are repayable within 12 months of the accounting date must be shown as such.

Post balance sheet events considerations

Post balance sheet events are those events both favorable and unfavorable that occur between the balance sheet date and the day the accounts are approved by the Board of Directors.

Types of events

- Adjusting events - those that provide additional evidence about conditions existing at the balance sheet date.

Non- adjusting events - those that are indicative of conditions that arose after the balance sheet date.

Examples of adjusting events

An enterprise should adjust the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date. The following are adjusting events which require an enterprise to adjust the amounts recognized in its financial statements.

- The resolution after the balance sheet date a court case which, because it confirms that an enterprise already had a present obligation at the balance sheet date, requires the enterprise to adjust a provision already recognized or to recognize a provision instead or merely disclosing a contingent liability.
- The bankruptcy of a customer which occurs after the balance sheet date usually confirms that a loss already existed at the balance sheet date on a debtor and that the company needs to adjust the carrying amount of debtors by writing off the amount that is irrecoverable.
- The sale of stock after the balance sheet date may give evidence about the net realizable value at the balance sheet date. This can be used to revalue the stock to the lower of cost and net realizable value.
- The discovery of a fraud or errors that show that the financial statements were correct.

Examples of non-adjusting post balance sheet events

A company should not adjust the amounts recognized in its financial statements t reflect non-adjusting events after the balance sheet.

Decline in the market value of investments between the balance sheet date and the date when the financial statements are authorized for issue. The fall in the market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances that have arisen in the following period. Therefore the company should not adjust the carrying value of its investments.

Post Balance Sheet Events

Included under considerations of post balance sheet events are those events ordinarily referred to as window dressing. This involves transactions that are entered into before the balance sheet date with the sole purpose of altering the appearance of the balance sheet. They mature or reverse immediately after the balance sheet date.

The provisions of the standard are that,

- Changes should be made to the amounts in the financial statements when it is an adjusting event or it indicates that the going concern assumption is not appropriate to the whole or a significant portion of the entity.
- Material non-adjusting events should be disclosed in the financial statements if their non disclosure would affect the ability of the reader to reach a proper understanding of the financial position or they include transactions which reverse or mature immediately after the balance sheet date but were entered into before the balance sheet date with the primary purpose of altering the appearance of the balance sheet.

The information to be disclosed is:

The nature of the event.

A prudent estimate of the financial effect or a statement that it is not practicable to make such a statement.

Management's use of Post Balance Sheet events

Financial year ends artificially breakdown the line of companies into fixed periods of time. In reality, an entity's life is continuous. Invariably, there will always be transaction in progress at the balance sheet date i.e. started in the year under review and materializing/maturing in the following year. To determine the portion at the balance sheet date, reference will have to be made to the transactions concerned. Thus to value assets and liabilities for balance sheet purposes and to determine the charges or credits to the profit and loss account, management must consider post balance sheet events.

Audited financial statements become public knowledge well after the year end and even though they relate to past date, they are used for making decisions in the period after become public knowledge. Consequently, should an event take place between the balance sheet date the financial statements become public and such event is not brought to the attention of the readers of the financial statements, those financial statements may be considered not to be giving a true and fair view.

The Auditors interest in Post Balance Sheet Events

Therefore management have used post balance sheet events in preparing the financial statements, the auditor has an interest in ensuring that the post balance sheet events have been properly accounted for.

Timing considerations

a. Balance sheet date.
b. Date the directors approve the draft accounts.
c. Date the auditor signs his audit report.
d. The intervening period from the date of signing the audit report to the date of dispatching the audited financial statements to the shareholders.
e. An AGM at which the members either adopt or reject the financial statements.

At the AGM if the financial statements are adopted then the auditors' responsibility towards those financial statements ceases.

The Auditors' procedures with regard to Post Balance Sheet Events

i. Discuss with management whether they are of nay such events and if so obtain a full listing of those events.
ii. Review minutes of management's looking for such matters as losses of major contracts, acquisition of a major new business, approval of capital expenditure, the effect of man-made and natural disasters and management plans on discontinuance of sectors of the entity.
iii. Review major transactions documents and primary books such as material payments, material receipts, material sales and material purchases.
iv. Consider whether all material post balance sheet events have been identified and accounted for properly.

Contingencies

The standard describes a contingency as a condition existing at the balance sheet date whose ultimate outcome is dependent on the occurrence or non-occurrence of one or more uncertain future events. A contingent gain or loss is a gain or loss dependent on a contingency. The standard then identifies 3 possible conditions of a contingency:-

a. Probable
b. Possible
c. Remote

Where:-

PROBABLE means very likely to materialize

POSSIBLE means can materialize

REMOTE means unlikely to materialize

The standard then says:

Losses

If a loss is probable, and it can be estimated with reasonable accuracy it should be provided for in the financial statements.

If a loss is probable but it cannot be estimated with reasonable accuracy it should be disclosed.

If a loss possible it should be disclosed.

If the possibility of loss is remote, even disclosure is not necessary.

Gains

If a gain is probable, do not accrue in the financial statement only disclose.

If a gain is possible or remote, disclosure is not necessary.

The information to be disclosed is:-

- The nature of the contingency.
- The events likely to affect the ultimate outcome.
- A prudent estimate of the financial effect or a statement that it not practicable to make such a statement.

The Auditor's Procedures

i. Obtain a listing of contingencies identified by management with full management assessment as to whether the contingency is probable, possible or remote.
ii. Examine the evidence or documentation that management have used to identify and classify the contingencies.
iii. Search for any other contingencies that may have been recognized by management.
iv. Communicate with the relevant third parties for their assessment of the position.
v. Consider whether the requirements of the standard have been complied with.

The most common contingencies are:

- Guarantees
- Pending litigation or claims
- Discounted bills.

Guarantees

The auditors should refer to the minutes and send and obtain a reply to a bank letter.

Discounted Bills

Again a bank letter should be obtained.

Claims

Refer to earlier notes on pending litigation

EXAM QUESTIONS

QUESTION ONE

Tasty ice cream employs thirty salesmen each with defined geographical area coverage. Each salesperson is supplied with a car which is changed every three years. At end of each week, each salesperson is submits claim on a preprinted form for expenses with supporting vouchers. Expenditure is on petrol, repairs and servicing the car, hotels, lunches and entertainment. Each claim is scrutinized by Beatrice who is the deputy chief accountant. She verifies that the claims are supported by the vouchers. She clears any inconsistencies with the salesperson concerned and makes out cheques for signatures by two company directors. The total amount paid in year ended 31/12/2006 was Kshs. 25,000,000. The company made a profit of Kshs. 125,000,000.

Required:

a. Discuss the short comings of this system and suggest ways of improving the system.
b. List and describe the tests of control the auditor would undertake in this system.
c. During the audit, the auditor discovered that a salesperson in one area was submitting false claims for entertaining customers. What actions should the auditor take?

QUESTION TWO

"Action must be specifically taken to prevent the occurrence of frauds involving the assets of the company", Finance Director of Food All Limited addressing accounting staff of the company. Of particular interest to the directors are:

- The safety of unclaimed wages
- The receipt of cash from customers.
- The company's cheque books
- Issue of credit notes to debtors.

Required:

a. For each of the above, explain how a fraud can occur in the area.
b. What controls should be in place to prevent the occurrence of each of the frauds described in (a) above?

QUESTION THREE

You have been asked by the manager in charge of the audit of Timab agencies to consider and describe various aspects of carrying out a debtor's circularization at its year ending 31st December 2006. The company sells its products on credit and the draft accounts show annual turnover of twenty five million shillings. The accounts also show debtors of five million shillings. Your compliance test on the sales system has shown that there is only satisfactory division of duties in the sales system and only minor errors were found in compliance tests.

Required

a. Consider the reliability of a debtor's circularization in providing audit evidence and in verifying value of year end debtors.
b. Describe the work you will carry out in auditing the replies to debtors circularization where debtor does not reply to circularization

QUESTION FOUR

IAS 2 'Inventories' requires that inventories are measured at the lower of cost and net realizable value.

Required:

(a) Explain why the audit of inventory is important to auditors.
(b) Define 'cost' and 'net realizable value' according to IAS 2 'Inventories'.
(c) Describe the audit evidence that you would obtain for the cost and net realizable value of finished inventory in a company that manufactures household furniture.

QUESTION FIVE

(a) ISA 505, External Confirmations, states that 'the auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level'.

STUDY TEXT

Required:

i. List four examples of external confirmations.

ii. For each of the examples in (i) above explain one audit assertion that the external confirmation supports, and one audit assertion that the external confirmation does not support.

(b) Jayne Co has a significant number of cash transactions and recent non-current asset purchases have been financed by a bank loan. This loan is repayable in equal annual installments for the next five years.

Required:

i. Explain the procedures to obtain a bank report for audit purposes from Jayne Co's bank and the substantive procedures that should be carried out on that report.

ii. List the further substantive procedures that should be carried out on the bank balances in Jayne Co's financial statements.

CHAPTER NINE

COMPUTERIZED INFORMATION SYSTEMS

CHAPTER 9
COMPUTERIZED INFORMATION SYSTEMS

▶ CHAPTER OBJECTIVES

By the end of this chapter, the student is expected have covered the following areas;

i. Introduction to Computer Accountancy Systems.
ii. Introduction to Computers and the way they process data.
iii. Programs & operating Systems.
iv. Introduction to Computer Control.
v. Auditing in a Computerized Environment.
vi. The auditor's Approach
vii. Auditing around the computer
viii. Auditing through the computer
ix. real time and on-line Systems

▶ INDUSTRY CONTEXT

With the current trend in technological changes auditors need to be updated in system use to make their work easier. This means that the auditor has to device new means of carrying out an audit in a computerized environment. He also needs to understand how the controls work in such a system.

▶ KEY TERMS

Transaction Files: Are the equivalent of journals such as the sales journal or the purchases journal or the cashbook.

Programs are the instructions telling the computer how each type of transaction is to be processed.

Test data are designed to test the performance of the clients' programs.

▶ EXAM CONTEXT

As the world embraces the emerging technological changes, so does the audit profession. Bearing this in mind, questions bordering on the application of information technology will be common in the exam. The questions that are likely to appear are the ones that deal with the impact Information technology has had on audit.

▶ INTRODUCTION

In the business environment today and in today's world, there has been an irreversible push for companies to automate their systems and their way of doing business so a to be competitive. The push for companies to embrace the new technological changes has come with new challenges for the audit environment. Unlike before where most systems were manual and the procedures carried out by the auditor's were tailor made for them, most company systems today are automated. This means that the auditor has to device new means of carrying out an audit in a computerized environment. He also needs to understand how the controls work in such a system. In the chapter below, all this is covered so that the student can be able to understand and appreciate the challenges and the gains in auditing in a computerized environment.

A computer system requires procedures to;

- Convert data to machine readable form.
- Input data into the computer.
- Process data.
- Store data in machine readable form.
- Convert data into desired output form.

For these procedures to be undertaken, a mixture of hardware and software is needed. The hardware will consist of;

i. Input devices. These include keyboards, optical readers, and bar code scanners.
ii. Processing devices. These are the computers themselves. i.e. CPU
iii. Storages devices include hard disk, diskettes and magnetic tapes.
iv. Output devices. These include the visual display unit (VDU) and printers.

The computer software consists of programs and operating systems.

Programs are the instructions telling the computer how each type of transaction is to be processed. These instructions include routines of checking and controlling data, matching data with master files and performing mathematical operations on data. E.g. for sales transactions, matching routines will enable the computer to identify the right sales price from the sales master file and the right customer from debtors master file. Mathematical routines will include calculating the total debtor's amount and updating customer's balance in the debtors' master file.

Operating system relates to a series of related programs to provide instructions as to what files are required to be on-line, what output devices are required to be ready and what additional file need to be created for further processing. E.g. with a batch of sales transactions, the sales price file and debtor's file need to be on-line. The printer must be loaded with blank invoice forms and the totals must be retained for posting to the sales and debtors control accounts in the general ledger master file.

An operating system will provide details of further processing runs within the system. So, for example, in sales these will include updating the general ledger, processing cash receipts and credit notes to the debtor's file, printing out monthly statements and printing out analysis of due accounts for credit control purposes.

In a batch processing system, the operating system may consist of a set of instructions provided to the operator but increasingly the operating system is part of the computer software such that with real time system, the computer identifies source of an incoming signal and automatically processes that transaction using the appropriate programs and the right file.

Computer files.

These are equivalent of books and records in a manual system and are described as either transaction files or master files.

a) Transaction files.

These are equivalent of journal such as sales journal, the purchases journal or the cash book. They contain details of individual transactions, but unlike books, a transaction file is not a cumulative record. A separate file is set up for each batch. Thus in real time systems, a transaction file is not necessary, but good systems will always create a transaction file for control purposes to provide a security back up, incase of errors or computer malfunctions during processing data to master file.

b) Master files.

These contain what is referred as standing data. They may be the equivalent of ledgers but may also contain semi permanent data needed to process transactions. E.g. a debtor's master file the equivalent of debtor's ledger but will also include data that in a manual system may be kept separately such as invoicing address, discount terms and credit limits, even non accounting data as cumulative sales to specific customers.

When master files are updated by processing them against a transaction file, the entire contents of the file are usually re-written in a separate location so that after processing, the two files can be compared and the difference agreed to the total of the transaction file. Any errors in updating the master file will thus be detected and the process repeated. In practice, the old copy of the master file and transaction file will be retained until the master file is updated again. This is the grandfather-father-son approach. If the current master file is corrupted or lost due to machine or operator error, previous versions provide back up from which the master file can be re-created. Master files holding semi permanent data would in the case of debtor's system include current sales price list and in the case of personnel department, a personnel file giving details of wage rates, authorized deductions and cumulative record of amounts paid to date for purpose of providing tax certificates.

A special class of transactions includes those of amending standing data held in master files such as sales price or wage rate. These transactions require special consideration because an error in such data held in a master file will cause errors in all transactions processed against the master file. E.g. an item priced erroneously in sales price list will mean all sales will be charged to customers at the wrong price.

The audit approach in computerized information systems

The actual approach adopted by the auditor will depend on:

- The auditor's experience with the client.
- The control environment.
- The complexity of the computerized information system.
- The risk profile of the client.
- The risk of misstatements in the financial statements.

The approach taken by the auditor when examining computerized records takes either of the two main forms.

a. Auditing round the computer.
b. Auditing through the computer.

a. Auditing round the computer.

This means examining evidence for all items in the financial statements without getting immersed in the details of the computerized information system. The benefits of this approach are that it saves time and its justification is that computers are 100% accurate in processing transactions and therefore material processing errors simply do not occur.

The draw back of this approach is that once an application is programmed to process an item incorrectly, then it processes exactly as programmed indefinitely. However, major frauds and error or system failures should be picked up in the assets and liabilities verification e.g. if processing of sales is incorrect, verification of debtors can uncover the error. Also an analysis of gross profit margins will help discover any errors in sales. This approach is suitable for small businesses but largely unsuitable for large scale entities.

b. Auditing through the computer.

There are two basic techniques available to the auditor for auditing through the computer. These are use of test data and use of computer audit programs which are also called CAATs (computer assisted audit techniques).

i) Test data

These are designed to test the performance of client's programs. What it involves is for the auditor either using dummy data or live data for processing to manually work out the expected result using the logic of the program. This 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 program is used continuously throughout the year, then it will perform as required. This technique of test data falls under compliance testing.

Live data testing has the following disadvantages

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

Client's files and totals are corrupted although this may be immaterial.

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

Dummy testing has the following disadvantages

i. Difficulties will be encountered in simulating the whole system or part of it.
ii. A more detailed knowledge of the system is required than with 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 live testing.

ii) Computer programs or audit software

These consist of computer programs used by the auditor to read magnetic files and to extract specified information from the files. They are also used to carry out audit work on the contents of the files. These programs are sometimes called enquiry or interrogation programs. They can be written by an audit firm or they can be bought from software houses. They have the advantage that they can be used to train unskilled staff.

Real time and on-line systems

Traditional batch processing has the advantage 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 and other financial institutions. The auditor's duties do not change but his audit techniques must change.

The key features of these systems are that they are based on the use of a remote terminal which is just a VDU and a keyboard. These terminals will be scattered within the user department and 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 updated by the remote terminals without an adequate audit trail. Necessary precautions have to be made therefore to ensure that these terminals are used in a controlled way by authorized personnel only. The security techniques include;

- Hardware constraints e.g. necessitating the use of a key of magnetic strip badge or card to engage a terminal or placing the terminal in allocation to which access is carefully restricted and which is constantly monitored by closed circuit television surveillance systems.
- The allocation of identification numbers to authorized terminal operators. With or without the use of passwords, these are checked by the main frame computer against stored records of authorized numbers or passwords.
- Using operator characteristics such as voice, fingerprints and hand geometry (finger length ratios) as a means of identification by the mainframe computer.
- Restricting the access to particular programs or master files in the mainframe computer to designated terminals.
- In top security systems, the authority to allocate authorities such as determination of passwords and nominating selected terminals should be restricted to senior personnel other than intended users.
- A special file maybe maintained in the central processor which records every occasion on which access is made by particular terminals and operators to the central programs and files. This log will be printed out on regular basis or on request by personnel with appropriate authority.

What differentiate on-line system from 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 input from the remote terminals to be checked by a special scanning program before processing commences.

With real systems however, action at the terminal causes an immediate response in the central processor where the terminal is on-line. Security against unauthorized 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.

In planning the audit, the auditor should consider how the presence of computerized information systems may affect client's accounting and internal control system and the conduct of the audit. This is because computerized information systems have unique features compared to manual systems and require inbuilt adequate controls to ensure that the accounting system can be relied upon for complete and accurate accounting records. These features include;

- Consistency unlike manual systems. Computerized information systems will process transactions consistently. This implies that if the system is properly programmed, the all transactions will be processed consistently and accurately. On the other hand, if there are any programming errors, the transactions will be consistently processed inaccurately.
- Concentration of functions and controls. In a computerized information system, few people are involved in processing of financial information. This may compromise segregation of duties such that persons involved in writing of programs may also be involved in processing transactions. This increases risk of manipulation of operating programs and data. Programs ad data are held together increasing the potential for unauthorized access and alteration.
- Computerized information systems are designed to limit paperwork.. This result in less visible evidence to support transactions processed which ultimately leads to loss of the audit trail.
- Ease of access of data and computer programs. Where there are no proper controls over access to computers at remote terminals, there is increased danger of unauthorized access and alteration of data and programs.
- Use of programmed controls. In a computerized environment, controls are programmed together with data processing instructions e.g. protection of data against unauthorized access may be by way of using passwords and user profiles that grant different levels of access to the system. Use of programmed controls implies that the auditor must adopt an audit approach to test effectiveness of those controls.
- System generated transactions. Many systems are capable of generating transactions automatically without manual intervention e.g. calculation of interest from customer's accounts may be done and charged to income automatically. If the system set up is interfered with, this could affect the accuracy and integrity of transactions generated.
- Data and programs are stored in portable magnetic disks and tapes which are vulnerable to theft and intentional or accidental alteration.

Internal controls in a computerized information system

To mitigate the risks occasioned by the features of a computerized information system, the management should design internal controls over the system. These controls are mainly classified into general controls and application controls.

1. General controls.

These relate to the environment within which the computer based systems are developed, maintained and operated aimed at providing reasonable assurance that the overall objectives of internal controls are achieved e.g. completeness, accuracy and validity of financial information.

The objective of the general controls is to ensure the proper development and implementation of applications and the integrity of program files and information. These controls could either be manual or programmed and are classified into;

- System development controls
- Access controls.
- Computer operations and other controls.

a. System development controls.

These relate to controls that must be exercised by the client when developing new systems or modifying existing systems. The controls that can be exercised during systems development can be discussed in the following groupings.

Appropriate review testing and approval of new systems.

The organization should set up a steering committee composed of senior management and high level representatives of system users who should the development and implementation of the new system.

Management should approve specifications of the new system after the steering committee has assessed the user needs. Before the new system is commissioned for use, appropriate testing should be carried out to ensure that both the hardware and the application programs are operating effectively. The testing will provide assurance that the new system is reliable.

The information technology manager, user department and the appropriate management level should give appropriate approval of new system before being placed under operation and after reviewing completeness of system documentation and results of its testing.

Controls over program changes.

Program changes refer to modifications made to existing programs. Changes in the computer system should be subject to strict controls e.g. a written request for an application program changes should be met by user department and authorized by designated manager or committee. Once changes have been made, appropriate testing should be carried out to ensure that the modified system is reliable.

The system documentation should then be amended to reflect the changes and appropriate approval obtained for the modified system to start running.

User training should also be carried out as appropriate.

System documentation.

This involves putting together information that supports and explains computer applications. The documentation provides details of capability of the system and how it is operated.

System documentation is important in conducting user training and also enables the management to effectively review the system by considering whether appropriate controls have been put in place during system development.

Parallel running.

Before switching to the new system, the whole system should be tested by running it alongside the old system for a specified period. This is important because it provides user with the opportunity to familiarize themselves with the new system before it is fully implemented and ensures that the new system is reliable and data is correctly carried forward from the old to the new system.

b. Access controls.

The success of computerized information systems is largely dependent on the accuracy, validity and credibility of the data processed by the system. Access controls to computer hardware, software and data files is therefore vital.

Access controls provide assurance that only authorized individuals use the system and that the usage is for authorized purposes only.

Access may be restricted to specified persons, files, functions or computer devices. This can be achieved using both physical and programmed controls. Examples of access controls include;

- Physical restriction of access to computer facilities to specified persons only e.g. file servers should be maintained in a secure location where access is granted to only specified persons.
- Controls over computers stored in the user department could be improved by making sure that vital data on programs are not left running when the computer is left unattended.
- Passwords should be used by all staff when accessing computer facilities.
- Passwords should be changed regularly and access to password data held in a computer system should be subject to stringent controls. This will ensure that some users do not gain access to other people's passwords.
- In granting user rights within the system, there should be appropriate segregation of duties to ensure that rights granted are not excessive. E.g. a user should not have right to post data and also make amendments on the same data.
- When designing the user rights, sensitive data and programs should only be accessible to few individuals. In other cases, some files should be designed as 'read only' to avoid unauthorized amendments.
- Programs and data that do not need to be online should be stored in secure locations.
- A system's access log to record all attempts to log in the system should be maintained. This would record name of user, data accessed or entered, time of log in and mode of access.
- When transmitting data over communication lines, it should be encrypted to make it difficult for persons with access to communication lines from being able to modify the contents.
- There should be automatic log off i.e. the disconnection of active data terminal to prevent viewing of sensitive data on unattended terminals.

c. Computer operations and other controls.

The organization should have a reconstruction or disaster recovery plan that will allow it to regenerate impor6ant programs and data files incase of disasters or accidental destructions.

The recovery plan should create back up or duplicate copies of important data files and programs which should be stored off site.

The recovery plan should also be tested on regular basis to ensure that it indeed works. Other issues that should be addressed include:

- Undertaking protection measures against natural disasters such as setting up computer rooms in areas protected from floods and fitted with smoke or fire detectors.
- There should be standby equipment to revert to incase of computer breakdown.

- There should be adequate virus detection. Procedures for dealing with virus infection are.
  - Establishing a formal security policy which requires only clean and certified copies of software are installed and checking data introduced from external sources for viruses.
  - The company can also install antivirus software.
  - Clean back up should be maintained and there should be adequate segregation of duties such that people with powers and knowledge in making amendments to the application programs should not have the responsibility for initiation and processing transactions and even making amendments to existing data.

2. Application controls

The objective of application controls which may be manual or programmed is to ensure completeness and accuracy of accounting records and the validity of transactions processed.

Application controls are therefore important in providing assurance that all transaction are recorded on timely basis and that only valid transactions are captured by the system. Application controls are divided into;

1. Input controls.
2. Processing controls.
3. Output controls
4. Controls over master files and standby data

However, some of the controls management implement would cut across the four categories mentioned above. E.g. some edit checks could provide comfort over the completeness and accuracy of the input data by the way the data is processed and output information obtained and also provide protection over standby data.

Input controls.

Most errors in data processed by computerized information systems can be traced to errors made when the data was being input into the system. Controls over input fulfill the following objectives.

Completeness of input. This ensures that all transactions that took place have been processed.

Accuracy. This ensures that the recorded transactions have been captured accurately.

Validity. This ensures that only valid or genuine transactions appropriately authorized have been recorded. It also ensures credibility and reliability of recorded transactions.

To achieve the above objectives the most common types of input controls that management can implement are called edit controls and examples include:

Field checks. These controls check that all data fields required to process the transactions have been filled with correct information. The controls also ensure accuracy of processed data and its completeness because transactions cannot be properly processed if necessary data is missing.

Valid character checks. These check that data fields are filled with data of the correct type. E.g. that amounts column is filled with numerical variables. This also ensures correctness of input data.

Reasonableness or limit checks. These verify that data falls within predetermined reasonable limits. E.g. if the authorized discount is 10%, the system would seek to verify that no customer is awarded discounts beyond this limit without approved authorization. These controls ensure accuracy and validity of the input data.

Master file checks. These verify that the codes used in processing transactions match with those from master files. E.g. that customer identification code keyed in matches with what is on sales master file. These controls ensure that data is processed against correct master file.

Document count. This agrees number of input records if what is expected as per batch control. This control ensures that all transactions are processed.

Sign checks. These ensure that data has been keyed in with correct arithmetic sign. E.g. a positive sign for debit entry and a negative sign for credit entry. The objective is to check validity and accuracy of the processed data.

Zero balance checks. These verify that for every transaction process, debit entries equal credit entries and any mismatches found are reported through an exception report. This control ensures accuracy of input data.

Other input controls include;

Generation of exception reports to capture transactions that have been rejected for failing various control checks.

Measures to ensure that the reasons behind rejected transactions are investigated and corrective action taken.

There may be need for manual controls to for instance, a check to reveal that all purchase orders have been appropriately authorized before a transaction is submitted for processing.

Processing controls.

These controls seek to ensure that transactions are processed by the right programs and against the correct master files. They also seek to ensure that data is not lost, duplicated or altered during processing and that errors are identified ad corrected.

Some of the controls in input could help in meeting the above objectives of processing controls. In addition to those, processing controls include;

Physical file identification procedures. This is in form of labels which are physically attached to files or diskettes to ensure right files are used during processing of transactions.

Sequence tests over pre-numbered documents. This ensures that all transactions are being processed.

Comparing the contents in files before and after processing a transaction to ensure that the expected processing results have been achieved.

Zero balance checks that add up debits and credits of the transactions posted to ensure that the result is zero as an indication that double entry has been completed.

An audit trail should be created through use of input and output control logs and maintenance of transaction listing. This trail will facilitate an attempt to trace a transaction as a way of verifying that it has been correctly processed.

Output controls.

These are necessary to ensure that:

- Expected reports are received from input data processed.
- Results of processing are accurate.
- Output is distributed to appropriate users promptly.

Controls over output include;

- Matching and agreeing output information to the input data e.g. for input data related to journal processed to create an additional provision for bad and doubtful debts, one may want to compare or match the balance appearing in the ledger after the transaction is processed as a way of verifying that output matches the input.
- Noting distribution of all output information to verify that this information is accessible to and is distributed to the list of authorized users only.
- Error listing or exception reports should be generated on a daily basis and reviewed by an independent person to ensure that the transactions summarized in these reports are investigated and where appropriate resubmitted for processing.

Controls over master files and standby data.

Standing data refers to the data that is required during processing of the transactions but which does not vary or change with every transaction. E.g. customer details such as name and address do not change with every transaction although they are required in processing every transaction with the customer.

Controls over master files and standing data are aimed at ensuring completeness, accuracy and credibility of the information maintained. These controls include;

- Restrictive access to standing data and ensuring that only few individuals have the user rights within the system to make adjustments to the standing data.
- Before any changes are made to the standing data, appropriate authorization should be obtained. E.g. before any changes are made on selling prices in the master file, appropriate authorization should be obtained from the responsible officials.
- Once amendments have been made on standing data, a print out should be obtained from the system such that an independent person can verify that the correct amendments have been made.
- Where necessary, the organization should print out all the standing data and an independent check be carried out to verify that this data is accurate and complete.
- An exception report should be generated on a regular basis providing details of any unauthorized amendments made on standing data.

Testing the internal controls in a computerized environment

The auditor tests the internal controls when he wishes to place reliance on the controls to determine whether the accounting records are reliable.

A computerized information system may differ from a manual system by having both manual and programmed controls. The manual controls are tested in exactly the same way as in a manual system. The programmed controlled in the following ways:

- By examination of exception reports and rejection reports. But there is no assurance that the items on the exception reports were the only exceptions or that they actually met the parameters set by the management. The auditor must seek for ways to test the performance of the programs by auditing.
- Use of CAATs (computer assisted audit techniques). Test data is mainly applied in testing computerized information systems.

Substantive tests in computerized environment

Substantive testing of computer records is possible and necessary. The extent depends on the degree of reliance the auditor has placed on the internal controls. Substantive testing includes two basic approaches both of which would be used.

Manual testing techniques.

- Review of exception reports. The auditor attempts to confirm these with other data. e.g. comparison of an outstanding dispatch note listing with the actual dispatch notes.
- Totaling. Relevant totals for example for debtors and creditors can be manually verified.
- Re-performance. The auditor may re-perform a sample of computer generated calculations. E.g. for depreciation and interest expense.
- Reconciliations. These will include reconciliations for computer listings with creditor's statements, bank statements, actual stock and personnel records.
- Comparison with other evidence such as results of debtor's circularization, attendance at stock take and physical inspection of fixed asset.

Computer audit programs sometimes generalized audit software. These programs are also called inquiry or interrogation programs. Computer audit programs are computer programs used by the auditor to;

- Read magnetic files and to extract specified information from the files.
- To carry out audit work on the contents of the files.

Uses of computer audit programs.

- In the selection of representative or randomly chosen transactions or items for audit tests.
- The scrutiny of files and selection of exceptional items for testing. E.g. On wages payments over Shs.1000 or all stock items worth more than Shs.100,000 in total.
- Comparison of two files and printing out the difference. E.g. payrolls at two selected dates.
- Preparing exception reports. E.g. overdue debts.
- Stratification of data such as stock items or debtors with a view to examine only the material items.
- Carrying out detailed tests and calculations.
- Verifying data such as stock or fixed assets at the interim stage and then comparing the examined file with the end file so that only changed items need to be examined at the final audit.

The Control file

When auditing computerized information 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 computers own capability and all users are competitors for its time. It is therefore important that an audit control file be built as part of working papers and the auditor must that he is on the distribution list for notifications of all new procedures, documents and system changes in general.

The following should be included in the control file;

- Copies of all the forms which source documents might take and details of the checks that have been carried out to ensure their accuracy.
- Details of physical controls over source documents as well as of the nature of any control totals of numbers, quantities or values including the names of persons keeping these controls.
- Full description of how the source documents are to be converted into input media and the checking of control procedures.
- A detailed account of the clerical, procedural and systems development controls contained in the system. E.g. separation of programs from operators and separation of controls over assets from records relating to the assets.
- 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 event of error or mishap.
- A detailed flow diagram of what takes place during each routine processing run.
- Details of all tapes and discs in use including their layout, labeling, storage and retention arrangements.
- Copies of all the forms which output documents might take and details of their sorting and checking.
- The auditor's comments on the effectiveness of the controls.

CHAPTER SUMMARY

- Internal controls over computer processing include both manual procedures and procedures built into the computer programs.
- The use of computers does not affect the auditor's primary responsibility of reporting on the accounts but the way in which the auditor carries out his substantive and compliance procedures to arrive, at his opinion will be considerably different.
- The objectives of application controls which may be manual or programmed are to ensure the completeness and accuracy of the accounting records and the validity of the entries made therein resulting from both manual and programmed processing.
- There are basically two techniques available to the auditor for auditing through the computer. These are a use of test data and the use of computer audit programs.
- Substantive testing of computer records is possible and necessary. The extent depends on the degree of reliance the auditor has placed on the internal controls

QUIZ

1. List the different types of application Controls.
2. What are computer audit programs?

ANSWERS TO THE QUIZ

1. Processing controls.
   - Output controls
   - Input controls
   - Controls over master files and standing data.

2. These consist of computer programs used by an auditor to read magnetic files and to extract specified information from the files.

EXAM QUESTIONS

QUESTION ONE

A medium size firm which has been your client for several years has changed from manual accounting system to a computerized one. State and explain the factors which you will take into account when planning the first audit under the new system.

QUESTION TWO

Computer security is of vital importance not only to the accountant in industry but also to the accountant in practice who may be advising his client as to suitable security controls or who may be auditing a computer system. Security is the means by which losses are controlled and therefore involves the identification of risks and the institution of measures to either prevent such risks entirely or to reduce their impact.

a. State four areas of risk which may arise in relation to a computer system and in each case explain one factor which could lead to the system being exposed to such risk.
b. Describe the different forms of control which should be instituted to safeguard against computer security risks.

QUESTION THREE

(a) Computer-Assisted Audit Techniques (CAATs) are used to assist an auditor in the collection of audit evidence from computerized systems.

Required:

List and briefly explain four advantages of CAATs.

(b) Nagaya a limited liability company is a reseller of sports equipment, specializing in racquet sports such as tennis, squash and badminton. The company purchases equipment from a variety of different suppliers and then resells this using the Internet as the only selling media. The company has over 150 different types of racquets available in inventory, each identified via a unique product code.

Customers place their orders directly on the Internet site. Most orders are for one or two racquets only. The ordering/sales software automatically verifies the order details, customer address and credit card information prior to orders being verified and goods being dispatched. The integrity of the ordering system is checked regularly by Archer Web, an independent Internet service company.

You are the audit manager working for the external auditors of Nagaya, and you have just started planning the audit of the sales system of the company. You have decided to use test data to check the input of details into the sales system. This will involve entering dummy orders into the Nagaya's system from an online terminal.

Required:

List the test data you will use in your audit of the financial statements of Nagaya to confirm the completeness and accuracy of input into the sales system, clearly explaining the reason for each item of data.

(c) You are also considering using audit software as part of your substantive testing of the data files in the sales and inventory systems of Nagaya.

List and briefly explain some of the difficulties of using audit software.

QUESTION FOUR

Walsh Co sells motor vehicle fuel, accessories and spares to retail customers. The company owns 25 shops. The company has recently implemented a new computerized wages system. Employees work a standard eight hour day. Hours are recorded using a magnetic card system; when each employee arrives for work, they hold their card close to the card reader; the reader recognizes the magnetic information on the card identifying the employee as being 'at work'. When the employee leaves work at the end of the day the process is reversed showing that the employee has left work.

Hours worked are calculated each week by the computer system using the magnetic card information. Overtime is calculated as any excess over the standard hours worked. Any overtime over 10% of standard hours is sent on a computer generated report by e-mail to the financial accountant. If necessary, the accountant overrides overtime payments if the hours worked are incorrect.

Statutory deductions and net pay are also computer calculated with payments being made directly into the employee's bank account. The only other manual check is the financial accountant authorizing the net pay from Walsh's bank account, having reviewed the list of wages to be paid.

Required:

a. Using examples from Walsh Co, explain the benefits of using Computer-Assisted Audit Techniques to help the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
b. List SIX examples of audit tests on Walsh Co's wages system using audit software.
c. Explain how using test data should help in the audit of Walsh Co's wages system, noting any problems with this audit technique.

STUDY TEXT

CHAPTER TEN

AUDITORS' REPORT (ISA 700)

CHAPTER 10
AUDITORS' REPORT (ISA 700)

▶ CHAPTER OBJECTIVES

By the end of this the reader should have covered.

i. Auditors report to shareholders .
ii. Audit opinions.

▶ INTRODUCTION

Once the auditor has gathered sufficient appropriate audit evidence on which to base his opinion, he is expected to put his findings on the true and fairness of the financial statements in a report. This report is referred to as the auditors report. The report is primarily meant for the Shareholders but can be of benefit to other users of the financial statements as well for example the banks. The wording and the format of the report is guided by law.

The Companies Act cap 486 requires that the auditor of a limited liability company to report to the members whether the financial statements laid before the AGM show true and fair view of the state of affairs of the company and comply with the requirements of the companies act. The audit report is therefore the means by which the auditor reports his opinions as to whether the financial statements show a true and fair view of the state of affairs. The report is addressed to shareholders.

▶DEFINITION OF KEY TERMS

Qualified audit reports-When the auditor has reservation on any matter that is considered material to the financial statements, he may introduce qualifying remarks in the audit report.

Going Concern- this concept states that the transactions and the financial statements have to be recognized and prepared in such a way that the entity shall continue with operations for the foreseeable future period and shall not cease to be in existence, stop or curtail is present production either currently or in the near future.

▶EXAM CONTEXT

This is a common question in the exam. Students are expected to be aware of the contents of the audit report as they may be required to state the contents or write an audit report in the exam. The students are also expected to know the different types of reports issued by the auditor.

▶INDUSTRY CONTEXT

The main purpose of any audit is to form an opinion on the financial statements, this opinion is expressed in a report. This area is therefore important in any auditors work.

The requirements of Companies Act regarding auditors report

Section 162(1) of the Companies Act stipulates the statements that should be expressly stated in the auditor's report. These are;

- Whether the auditor has obtained all the information and explanation which to the best of his knowledge and belief were necessary for audit proposes.
- Whether in his opinion, proper books of accounts have been kept by the company, so far as it appears from the examination of those books and proper returns adequate for the purposes of the audit from branches not visited by him.
- Whether the company's balanced sheet and profit and loss accounts dealt by the report are in agreement with the books of the accounts and returns.
- Whether in his opinion and to the best of his information and according to the explanations given to him, the financial statements give the information required by the Companies Act in the manner so required and give at rue and fair view.
- In the case of the balance sheet, of the state of affairs of the company as at the end of the accounting period.
- In the case of the profit and loss account, of the state of profit or loss of the company in the financial year.
- In the case of a holding company submitting group financial statements whether in his opinion, the group financial statements have been prepared in accordance with the provisions of the Companies Act so as to give a true and fair view of the state of affairs and profit or loss of the company.

Basic elements of auditors report

The Companies Act does not stipulate the form the auditor's report should take. The auditing standards seek to ensure that the auditor's report is clear and unambiguous. To this end, it seeks to standardize the form of the auditor's report. It does this by giving the basic elements of the auditor's report.

i. Appropriate report title

Auditing standards require that the report be titled and that the title includes the word 'independent' e.g. independent auditors report'. The requirement that the title includes the word independent is intended to convey to users that the audit was unbiased in all aspects.

ii. Address

The report is usually addressed to the company, its stockholders or the board of directors. For practical reasons, it limits the users of auditor's report.

iii. Introductory paragraph

The first paragraph has three purposes, fist, it makes a statement that the practice did an audit. Secondly, it lists all the financial statements that were audited including the balance sheet dates and accounting periods for the income statement and cash flow statement. The wording of the financial statements in the report should be identical to those used by management on the financial statements. Thirdly, the introductory paragraph states that the statements are the responsibility of management and that the auditor's responsibility is to express an opinion on the statements based on the audit.

iv. Scope paragraph

This paragraph is a factual statement about what the auditor did in the audit. This paragraph states how the audit was planned and performed in accordance with ISAs and states that the audit is designed to obtain reasonable assurance whether the financial statements are free of material misstatements.

v. Opinion paragraph

This final paragraph states the auditors conclusions based on the results of the audit. This part of the report is so important that often the audit report is simply called the auditor's opinion. The opinion paragraph is stated as an opinion rather than a statement of absolute fact or a guarantee.

vi. Audit report date

The appropriate date for the report is the one on which the auditor has completed the most important audit procedures in the field. This date is important to users of financial statements as it indicates the last day of auditor's responsibility for review of significant events that have occurred after date of financial statements.

vii. Name of audit firm

The firm's name is used because the entire firm has the legal responsibility to ensure that the quality of audit meets professional standards.

Types of audit opinions

a. Unqualified opinion.
b. Disclaimer opinion
c. Qualified opinion
d. Adverse opinion

a) Unqualified opinion.

This is issued when the auditor is satisfied in all material aspects that enable him express the required opinion on financial statements without any reservation. This is sometimes called a clean opinion. It is expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the relevant financial reporting standards.

Emphasis on matter report

There are occasions when the auditor has no reservation as to the financial statements but where they exists unusual events, conditions or accounting policies and he feels that unless the reader may not reach a proper understanding of the financial position and results. In such circumstances, the auditor should express an unqualified opinion including an extra paragraph called 'emphasis of the matter paragraph' to draw attention of the reader to the unusual matter.

The addition of such an emphasis of matter paragraph does not lead to a qualification of the audit

STUDY TEXT

opinion but is intended to enable the reader obtain a better understanding. To avoid this being understood as a qualification, the emphasis of the matter paragraph should contain the phrase 'without qualifying our opinion'.

Practical circumstances requiring emphasis of matter paragraph are:

i. Unusual condition would include destruction of assets after balance sheet date but the company remains a going concern.
ii. The company being insolvent on the face of its own balance sheet but the auditor has letters of support which he is satisfied can be fulfilled by the other party thus he will accept appropriateness of the going concern assumption. Unusual events could also include changes in the legislation that could have a material impact on the entity's business operations subsequent to the balance sheet date. Unusual accounting policies that may lead to emphasis of matter paragraph would involve those matters not covered by any accounting standard.
ii. Inherent uncertainties that may call for emphasis of matter paragraph would include contingencies at the balance sheet date which have not been resolved at the date of signing the auditor's report.
iv. Negotiations for financing which have not been financed by date of signing of the auditor's report.

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, 20x1, 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, 20x1 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

STUDY TEXT

Qualifications of audit reports

When the auditor has reservation on any matter that is considered material to the financial statements, he may introduce qualifying remarks in the audit report. The auditor's reservation could arise out of the following;

- Limitation on the scope of his work.
- Disagreement with management.
- Significant uncertainty affecting financial statements, the resolution of which is dependent upon future events.

b) Qualified audit opinion or except for opinion.

This is expressed when auditor concludes that unqualified opinion cannot be expressed but that the effect of any disagreement with management or limitation in scope is not so material and pervasive as to require an adverse opinion or disclaimed opinion. A qualified opinion implies that all aspects of the financial statements are okay expect for the effects of the matters which the qualifications relate.

c) Disclaimer of opinion.

This is issued when the possible effect of a limitation in scope or uncertainty is so material or pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence, as a result he is unable to express an opinion on financial statements. A disclaimer of opinion implies that the auditor is unable to form an opinion because sufficient audit evidence could not be obtained.

d) Adverse opinion.

This is expressed when the effects 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 and incomplete nature of the financial statements. The auditor states that due to the nature of the disagreement in his opinion, the financial statements do not show true and fair view.

Limitation of scope

If for any reason the auditor is unable to receive all the information and explanations he deems necessary for the purposes of his audit, then there is a limitation in scope of his work. It means that the auditor to conclude his work objectively. This could arise due to the following reasons;

- Refusals by management to allow the auditor examine certain documents or records.
- If the auditor is denied the opportunity to carry out an auditing procedure he considers important and he cannot conclude through alternative procedures, then there is limitation of scope in auditor's work.
- Destruction of accounting records or documents through fire of other disaster meaning that such documents or records are not available for examination by the auditor.
- Being appointed auditor after the year end with the result that certain evidence will not be collected.

Effects of limitation in scope on the auditor's opinion

If the possible effect of limitation in scope of an audit is material but not fundamental to the financial statements, the auditor issues a qualified opinion. (Except for opinion.)

If the possible effect of limitation in scope of an audit is of fundamental importance that the auditor is unable to express an opinion on the financial statements, the auditor issues a disclaimer of opinion as mentioned above.

When there is a limitation in scope of auditor's work that requires the expression of a qualified opinion or a disclaimer of opinion, the auditor should describe the nature of the limitation in his report and indicate the possible adjustments to the financial statements that might have been determined to be necessary, had the limitation not existed.

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, 20x1, 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 20x1 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.

Inherent uncertainties

Inherent uncertainties result from circumstances in which it is impossible for the auditor to reach any objective conclusion as to the outcome of a situation due to the circumstances themselves rather than a limitation of scope of the audit. Such uncertainties are only resolved through the passage of time e.g. to wait for the outcome of a litigation. However, time is a great constraint and financial statements must be prepared within the required time. The auditor should form an opinion on the adequacy of the accounting treatment of such uncertainties. This will involve consideration of:

- The appropriateness of any accounting policies adopted by the management in treating the effect of such uncertainties.
- The reasonableness of the estimates included in the financial statements.
- The adequacy of disclosure of the uncertainties.

Some inherent uncertainties are fundamental. These are uncertainties where the degree of uncertainty and its potential impact on the view given by the financial statements may very great. In determining whether an uncertainty is fundamental, the auditor considers the following:

- The risk of the estimate included in the balance sheet being subject to change.
- The range of possible outcomes.
- The consequences of those outcomes on the view given by the financial statements.

Inherent uncertainties are considered fundamental when they involve a significant level of concern about the validity of the going concern assumption or other matters whose potential effect on the financial statements is usually great.

Disagreement

Under disagreement, the auditor is able to conclude objectively that he has received all the information and explanations he considers necessary for the purpose of the audit. But his conclusion is at variance with the position adopted by the management or the view given by the financial statements. Circumstances giving rise to disagreements include;

- Application of inappropriate records by the management.
- Some facts or amounts included in the financial statements e.g. the auditor may feel that the amount provided for as a contingent loss arising from a lawsuit against the company is too low.
- Interpretation of accounting policies or legislation.
- Manner, mode or extent of disclosure of facts or amounts in the financial statements.

Whether the auditor agrees with the accounting treatment or disclosure of a matter in the financial statements and in the auditor's opinion, the effect of that disagreement is material to the financial statements, the auditor should;

- Include in his report a description of all the factors giving rise to the disagreement.
- The implications of such factors on the financial statements.
- A quantification of the effect on the financial statements.

Examples

(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, 20x1 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, 2OO7, 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, 20x1. 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, 20x1, 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).

Effects of disagreements on auditor's opinion

When the auditor concludes that the effect of the matter giving rise to disagreement is so fundamental that the financial statements are misleading, the auditor should issue an adverse opinion.

If the nature of the disagreement is material but not fundamental, the auditor should issue a qualified opinion indicating that all other aspects of the financial statements are okay except for the matter giving rise to the disagreement.

Material but not pervasive

The auditor may not include qualifying remarks in his audit report unless the matter is material. Material but not pervasive means that the reservation the auditor has is material in the context of a segment of the financial statements but not to the financial statements taken as a whole.

Material and pervasive

A matter becomes material and pervasive when it is material in the context of the financial statements taken as a whole. A limitation of scope becomes pervasive when it makes the financial statements misleading for decision making purposes or of little value for decision making purposes. A disagreement becomes pervasive when it makes the financial statements taken as a whole to be totally misleading.

Qualification matrix

Nature of circumstance	Material but not significant	Fundamental
Limitation of scope or uncertainty	Qualified opinion (except for opinion)	Disclaimer of opinion
Disagreement	Qualified opinion (except for opinion)	Adverse opinion

Going Concern (ISA 570)

The going concern concept is a fundamental concept of IAS 1 (disclosure of accounting policies) which governs the preparation and presentation of financial statements. This concept states that the transactions and the financial statements have to be recognized and prepared in such a way that the entity shall continue with operations for the foreseeable future period and shall not cease to be in existence, stop or curtail is present production either currently or in the near future.

The auditor when reporting on the financial statements is categorically concerned of the going concern concept because;

- It affects true and fair view of the financial statements
- It facilitates qualification of audit reports.
- It confirms compliance of financial statements with the generally accepted accounting principles and policies.
- The auditor's main interest will be that all material matters affecting the financial statements have been disclosed.

If fundamental accounting principles governing the financial statements have been properly observed in all material aspects, the financial statements presented show a true and fair view.

Appropriateness of going concern assumption

The auditor should consider the risk that the going concern assumption may no longer be appropriate. Indications of the risk that the continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications are as follows:

a. Financial indicators.

- Changes of the financial position of the company drastically within a short period of time especially from bad to worse.
- Financial difficulties affecting the company's production process and sales.
- Changes of credit policies especially from credit to cash on delivery.
- Difficulties in paying salaries and wages of employees.
- Increased financial borrowing.

b. Non financial indicators.

- High staff turnover in key accounting and managerial officials and finance personnel especially without replacement.
- Unfriendly environment between management and management and employees
- Unusual pressure within the entity for no apparent reason.
- Circumstances of labour disputes e.g. strikes by employees leading to demonstrations ad protests.
- Where the entity relies heavily on a customer for sale of its products or for marketing its output.
- Pending legal proceedings against the entity that may, if successful, result in judgements that could not be met.
- Non compliance with capital and other statutory requirements.

The significance of such indications can often be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced y 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 .

STUDY TEXT

CHAPTER SUMMARY

a) Unqualified opinion

When the auditor is satisfied in all material respects that enables him to express the required opinion on the financial statements without any reservations. This is sometimes called a clean opinion. This is expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the relevant financial reporting framework.

b) Qualified audit opinion (except for opinion)

This is 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 disclaimer of opinion. A qualified report implies that all other aspects of the financial statements are okay except for the effects of the matter to which the qualification relates.

c) Disclaimer of opinion

This is issued when the possible effect of a limitation on scope or uncertainty is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and as a result he is unable to express an opinion on the financial statements. A disclaimer of opinion implies that the auditor is unable to form an opinion because sufficient audit evidence could not be obtained.

d) Adverse opinion

This is expressed when the effects 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. The auditor states that due to the nature of the disagreement in his opinion the financial statements do not show a true and fair view.

e) Limitation of scope

If for any reason the auditor is unable to receive all the information and explanation he deems necessary for the purposes of his audit then there has been a limitation in the scope of his work. It means that the auditor is unable to conclude objectively.

QUIZ

1. List the different types of Audit opinions.
2. List the basic elements of the audit report.
3. List the factors that lead to the qualification of an audit Report.

ANSWERS TO THE QUIZ

1. a) Unqualified opinion
   b) Qualified opinion
   c) Disclaimer of opinion
   d) Adverse opinion
2. a. An Appropriate title
   b. The auditor's report should be appropriately addressed
   c. The Introductory paragraph
   d. A Paragraph on the scope of the audit
   e. An Opinion Paragraph
   f. Dating the audit report
   g, The Auditors address
   h. A Signature in the name of the audit firm and location of the auditor i.e office
3. This occurs when;
   a) There is a limitation on the scope of his work;
   b) There is a disagreement with management
   c) There is a significant uncertainty affecting the financial statements, the resolution of which is dependent upon future events.

EXAM QUESTIONS

QUESTION ONE

Going concern concept is a fundamental assumption underlying the preparation of the financial statements. What are the procedures you would perform to ensure that the going concern is appropriate for you audit client.

QUESTION TWO

a) In respect of the going concern concept:
   i. Define 'going concern' and state two situations in which it should NOT be applied in the preparation of financial statements.
   ii. Explain the directors' responsibilities and the auditors' responsibilities regarding financial statements prepared on the going concern principle.
b) List the audit procedures that should be carried out to determine whether or not the going concern basis is appropriate for Green Co.

QUESTION THREE

The Companies Act (Cap.486) sets out the duties of the auditors for a company in respect of his report and other matters.

Required:

a. State four situations under which the Act requires auditors to qualify their report.
b. State two circumstances in which the auditors may qualify their report owing to inherent uncertainty.
c. State four types of circumstances in which the auditors may qualify their report as a result of disagreement with the directors

QUESTION FOUR

An extract from the draft audit report produced by an audit junior is given below:

Basis of Opinion

'We conducted our audit in accordance with Auditing Standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of all the estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

'We planned and performed our audit so as to obtain as much information and explanation as possible given the time available for the audit. We confirm that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the company's annual report.'

Required:

Identify and explain the errors in the above extract.

SUGGESTED SOLUTIONS

SUGGESTED SOLUTIONS

CHAPTER 1: THE GENERAL AUDIT ENVIRONMENT

QUESTION ONE

a. The need for an audit. These are the requirements of the Companies Act Cap 486.
   - To prove the true and fair view of the companies state of affairs as at a given date.
   - To find out whether the company has kept proper books of account.
   - To write a report to be used by stakeholders.
   - To provide advice to management on areas of internal weaknesses.
   - Detection of errors and frauds.

b. Procedures for the appointment of an auditor
   - Upon registration of a company (30 days after) the Board of Directors or the Registrar of Companies appoints an auditor.
   - He can also be appointed at the AGM. If this approach is used the outgoing auditor must be given a 28 days notice.
   - Automatic reappointment. This occurs if there is no resolution to remove the existing auditor, if the existing auditor has not given in writing a notice to resign and if he has not committed an act to disqualify automatic re-appointment.
   - Casual vacancies may arise and should be filled by the directors of the company except if he resigned in which case it is filled by shareholders Casual vacancies arise if the auditor dies becomes incapacitated or he resigns.

c. Director's duties with regard to accounting function:
   - Safeguarding the company assets an preventing fraud and error
   - Selecting suitable accounting policies and applying them consistently
   - Ensuring that the company keeps proper accounting records as per the Companies Act.
   - Delivering to the government agency, court or stock exchange a copy of the company's auditor financial statements within the specified period after year-end.
   - Stating whether applicable accounting standards have been followed subject to any material departure disclosed and explained in the financial statements.
   - Prepare the financial statements on a going concern basis unless it is appropriate to presume that the company will continue operations.
   - Setting up an internal control system to enable all the above responsibilities to be carried out as required.

d. The auditor should make a report to members on accounts examined by them and laid before company in AGM. It must contain statements as to matters mentioned in the 7th schedule. They include:
   - Whether or not they have obtained all information and explanations which to the best of their knowledge and belief were necessary for the audit.
   - Whether in their opinion proper books of account have been kept and proper returns adequate for the purpose of the audit have been received from branches not visited.
   - Whether the profit and loss account and balance sheet are in agreement with the books of account and returns.

STUDY TEXT

- Whether in their opinion and to the best of their knowledge and according to explanations given to them financial statements give information required by companies act in the manner so required and give the true and fair view.
- In the balance sheet, the stare of affairs at the end of its financial year. In the profit and loss account, the profit or loss for the year.

QUESTION TWO

(a) Reliance on work of internal auditors

As requested, the external auditors will seek to rely on the work of internal audit to the maximum extent possible. This might cover planning, risk assessment, tests of controls and substantive testing.

In all cases, the external auditor should be aware that the purpose of internal audit's work will not be primarily directed towards the financial statements.

In relation to the cyclical audit of internal controls, it may be possible to rely on the work of internal audit in relation to all of the areas noted, but only if the internal controls audited affect the financial statements. It may be that internal audit's work on operations and customer support is less relevant than its work in other areas.

In relation to the four-year review of internal controls – the extent of reliance will depend on how long ago the last review was conducted. If it was conducted recently, it will provide help in relation to the external auditor's assessment of the accounting and internal control systems.

In relation to risk management – the relevance of internal audit work depends on the extent to which risks in relation to reporting in general and the financial statements in particular, have been addressed separately by management. This work will be relevant to the external auditor's risk assessment and planning.

(b) Information required

(i) The information required to determine the extent of external audit reliance on internal audit's cyclical audit will be:

Internal audit's systems documentation (the work on information systems and finance may include documentation of the company's accounting and internal control systems);

Internal audit's planning documentation which may cover a risk analysis, tests of controls and substantive procedures;

The results of tests of control and substantive procedures;

Documentation on the four-year review of internal controls, particularly in relation to the finance and information services functions.

(ii) The external auditors should ask to see all documentation relating to the work performed by internal audit on information services restructuring during the year because the external auditor's assessment and testing of systems will be split into two parts, pre- and post-restructuring.

(iii) Other documentation requested will include internal audit's operating procedures manuals and documentation relating to the recruitment, training and development of internal audit staff, and management responses to internal audit recommendations. This information is required to enable the external auditor to form an opinion on the competence and effectiveness of the internal audit function.

(c) Circumstances in which it would not be possible to rely on the work of internal audit

(i) It may not be possible to rely on the work of internal auditors if they:

- Are not competent (this relates to experience as well as qualifications).

- Lack integrity;
- Do not properly plan or document their work, or if management does not act on (or at least respond to) recommendations made;
- Do not perform work relevant to the external auditor.

(ii) It will also not be possible to rely on internal audit if internal audit is insufficiently independent within the organization, i.e. where internal auditors have insufficient operational freedom, where they are reporting to those who control the functions that they work on, or where they are reporting on their own work.

(d) External auditor work

External auditors will wish to perform work independently, regardless of internal audit work, in all areas that are material to the financial statements. For immaterial areas in which internal audit work can be shown by testing and review to be adequate, it may be possible to rely on the work of internal audit without performing any other work.

Areas material to the financial statements are likely to be long and short-term leasing receivables and inventory. Leases may be complex and the auditors will wish to ensure that accounting policies are appropriate and that they have been properly applied. The valuation of inventory will have a direct effect on the profit for the period. This is an area that is easy to manipulate and external auditors will wish to ensure that this has not happened.

External auditors will also wish to perform their own risk analysis and final review of financial statements in order to ensure that no high risk areas have been overlooked.

QUESTION THREE

(a) Six financial statement assertions

i. Existence: an asset, liability or equity interest exists;
ii. Cut off: transactions and events have been recorded in the correct accounting period;
iii. Occurrence: a transaction or event that has been recorded took place and pertains to the entity during the period;
iv. Accuracy and valuation: financial and other information is disclosed fairly and at appropriate amounts;
v. Rights and obligations: the entity holds or controls the rights to assets, and liabilities or obligations of the entity; and
vi. Classification: transactions and events have been recorded in the proper accounts.

QUESTION FOUR

- Training material: purpose of external audit and its role
- The external audit has a long history that derives largely from the separation of the ownership and management of assets. Those who own assets wish to ensure that those to whom they have entrusted control are using those assets wisely. This is known as the 'stewardship' function.
- The requirement for an independent audit helps to ensure that financial statements are free of bias and manipulation for the benefit of users of financial information.
- Companies are owned by shareholders but they are managed by directors (in very small companies, owners and managers are the same, but many such companies are not subject to statutory audit requirements).

- The requirement for a statutory audit is a public interest issue: the public is invited to invest in enterprises, it is in the interests of the capital markets (and society as a whole) that those investing do so in the knowledge that they will be provided with 'true and fair' information about the enterprise. This should result in the efficient allocation of capital as investors are able to make rational decisions on the basis of transparent financial information.
- The requirement for an audit can help prevent investors from being defrauded, although there is no guarantee of this because the external audit has inherent limitations. Reducing the possibility of false information being provided by managers to owners is achieved by the requirement for external auditors to be independent of the managers upon whose financial statements they are reporting.
- The purpose of the external audit under International Standards on Auditing is for the auditor to obtain sufficient appropriate audit evidence on which to base the audit opinion. This opinion is to the effect that the financial statements give a 'true and fair view' (or 'present fairly in all material respects') of the position, performance (and cash flows) of the entity. This opinion is prepared for the benefit of shareholders.

CHAPTER 2: THE AUDITOR AND THE COMPANIES ACT

QUESTION ONE

a. Why the letter of engagement is sent before any new audit appointment is accepted.
It is the purpose of a letter of engagement to dearly define the extent of the auditor's responsibilities and so minimize the possibility of any misunderstanding between the auditor and the client.
It provides a written confirmation of the auditor's acceptance-of the appointment, the scope of the audit, form of his report and scope of non audit services. If a letter of engagement is not sent to clients both new and existing, there is scope for argument about the precise extent of the respective obligations of the clients and its auditors and directors.

b. Contents of a letter of engagement.
Definition and scope of audit: it should be made dear that an audit involves the examination of and expression of opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in the case of a statutory audit, that the matters to be reported upon are laid down in Companies Act 1962 or any relevant legislation.
Fraud and irregularities: the responsibility of the prevention and detection of errors and frauds rests with the management and this responsibility is fulfilled mainly through the implementation and continued operation of an adequate internal control system.
Accounting, Taxation and other services:-the letter should delineate clearly the accountant's and the client a responsibilities in relation to these services and the day to day book-keeping, the maintenance of all accounting records and the preparation of financial statements.
Fees: mention should be made of fees and the general basis on which fees are computed and rendered.

c. The auditor should ensure that;
Proper accounting records and returns have been kept.
The accounts kept are in agreement with the accounting records and returns. If they are not in agreement the directors should readily provide the auditor with all the explanations and information he requires.

d. When it might be necessary to re-draft an engagement letter and have it re-affirmed by the client's management:
When there are new clients who have appointed the auditor
When there is an existing client who has not received **it** previously in particular statutory audits.
Where there is a change in circumstances which will lead to change in duties of the auditor e.g. an extra assignment.

QUESTION TWO

External auditor objectivity

(a) Why external auditor objectivity may be, or appear to be, threatened

STUDY TEXT

Undue dependence

If the auditor depends, or relies on a particular client or group of connected clients because the firm takes a large part of its fee income from the client, the auditor may be less likely to challenge accounting policies or disclosures proposed by the client, for fear of upsetting them. This typically happens when the firm is small, but the client is large.

Where the firm feels that an audit qualification may be necessary, it may be reluctant to issue it for fear of losing the client and the fee income. This applies regardless of whether the fee income is audit fee income or income for other work. The issue is important because if the auditor does not issue a qualified audit report where appropriate, the firm may be sued for negligence. Where a large client is involved, the firm's professional indemnity insurance may not cover the claim.

Financial interest

Where a partner or member of staff in a firm (or the firm itself) holds shares in a client, they have an interest in the client's performance. If the client performs well, the value of the shares may rise. A qualified audit report is not usually associated with good performance and the firm may therefore be reluctant to issue one where appropriate. This is important for the reasons noted above.

Even if there is no question of a qualified audit report, there may be a temptation to help the client present the results in the best possible light, instead of presenting a balanced view.

There is also a financial interest where partners, staff or the firm make loans to, or guarantee the borrowings of the client or vice versa. Significantly overdue fees of amounts that are significant to either auditor or client are akin to loans.

Family or other close personal or business relationships

Where there is family or other close personal or business relationships between client and audit firm, the individuals concerned may try to influence the firm in its dealings with the client in order to protect the family or personal relationship, or the mutual business interest.

If, for example, an audit partner is married to the finance director of a client, it is less likely that the client will receive a qualified audit report than it would be if the relationship did not exist. This is important in any case but more so where the effect of a qualified (or modified) audit report is likely to result in, say, withdrawal or non-renewal of banking facilities which might result in the business ceasing to be a going concern. If the firm does not issue a modified audit report in such circumstances, the firm may be exposed to claims of negligence by the bank.

If there are close business relationships between client and auditor, both parties have an interest in each other's performance and there is therefore a double pressure to present the results in the best possible light and not to issue a qualified audit report.

Other services

Many audit firms provide their audit clients with services other than audit services. It is very common for auditors to provide their very small audit clients with accountancy services, for example.

Other services that can be provided include tax, management consulting, IT and human resources advice. Some firms not only provide consulting advice, but also perform IT and other functions for some of their clients.

There are two threats to objectivity where other services are provided. Firstly, the firm may find that it is reporting on a system that the firm itself has set up or advised on, or reporting on information that the firm itself has prepared. This means that it is reporting on its own work and it may be difficult to be objective in such circumstances. Secondly, the fee income from other services may well exceed the fee income from the audit and the client may pressure the firm to give an unqualified audit report by threatening to take the other services to another firm if a qualified report is given.

(b) Requirements

Most of the following are requirements of rules of professional conduct.

(i) Undue dependence

A firm should put in place additional safeguards where the recurring fee income from one client or group exceeds 15% of the gross practice income (10% for clients listed on a stock exchange or where the public interest is involved). Additional safeguards include supplementary reviews and the rotation of the engagement partner and senior staff.

There are exceptions where a practice is being set up or run down. The rules are also applied to members practicing part-time.

A review mechanism should be triggered within the firm where the gross fee income exceeds 10% (5%) of gross practice income.

More generally, there is a requirement for firms to carry professional indemnity insurance to cover professional negligence claims and ACCA monitors practicing firms to ensure that they are complying with, amongst other things, the independence requirements. Firms are also required to keep up with changes in independence requirements as a condition of being permitted to practice.

(ii) Financial interest

No partner in a firm, or any member of staff working on a particular audit, or any person closely connected with them, should hold any shares in an audit client.

There are exceptions where collective investments are held by third parties, where the individual concerned has no control over the composition of investments.

Where such shares or interests are acquired through marriage or inheritance, for example, the shares should be disposed of at the earliest possible opportunity, provided that the disposal does not involve insider trading. Where shares are held by the auditor because the company's constitution requires it, the minimum level should be held and the votes attaching to the shares should not be exercised.

There are some exceptions for transactions on normal commercial terms with money lending institutions – a normal mortgage from a bank, for example.

Firms, their partners and staff should not make loans to, or guarantee the borrowings of, any audit client, or vice versa.

(iii) Family or other close personal or business relationships

An officer (such as a director) or employee of an audit client, or a partner or employee of such a person, is prohibited from accepting appointment as auditor of that client. Problems can also arise if an officer or senior employee of an audit client is closely connected with a partner or senior staff member responsible for the conduct of the audit (or anyone closely connected with them).

Closely connected persons generally include minor children and spouses. In this case, adult children and their spouses, siblings, and any other relative to whom regular financial assistance is given (or who is otherwise indebted to the partner or employee) are also included.

STUDY TEXT

A member should not personally take part in the audit where he or she has been an officer or employee of a company within the two years prior to the commencement of the first day of the period reported on.

(iv) Other services

A firm should not participate in the preparation of the accounting records of a company listed on a stock exchange or a public interest company except in relation to the finalization of the statutory accounts (assistance of a mechanical nature) or in an emergency situation.

Where a firm does provide such assistance to a smaller firm, care should be taken not to take on management functions, to ensure that the client accepts responsibility for the accounting records, and to ensure that adequate audit tests are performed and properly recorded.

A firm may advertise for and interview prospective staff for a client and produce a short list and recommendations, but the client must make the final decision.

A firm should not audit a client's financial statements which include the product of specialist valuations performed by the firm (such as the valuation of intangible assets or pension funds).

Where a firm provides other services to audit clients, it is important that the audit team should be entirely independent of the team providing the other service. One method of achieving this is by setting up internal structures whereby the two teams do not communicate with one another.

QUESTION THREE

(a) Internal matters and other procedures before appointment

Before accepting appointment the firm should ensure that:

- It has the necessary staff with appropriate competencies to complete the audit (this seems likely given that the firm has other clients in this sector)
- The staff are available at what is a busy time of year for the firm (it may be possible that all of the staff with the necessary competencies are otherwise occupied)
- The firm is independent of client. It is unlikely that there will be any issues concerning shareholdings in the client (because it is owned and run by two entrepreneurs) however, there may be staff or partners who are related to the client or are otherwise connected with it.
- There are no conflicts of interest that cannot be properly managed. Conflicts of interest may exist because the firm has other clients in this sector.

Other procedures

The firm should:

- Seek the directors' permission to communicate with the company accountant about the nature of the 'disagreement' and the directors should authorize the accountant to co-operate with the firm.
- Seek the directors' permission to communicate with the incumbent auditors. If permission is refused, the appointment should not be accepted.
- Ask the client to write to the incumbent auditors notifying them of the change and giving them permission to communicate with the firm (if client refuses to give permission to the incumbent auditors the appointment should not be accepted)

- Communicate with the incumbent auditors (preferably in writing) requesting all the information which ought to be made available to enable the firm to decide whether or not to accept the appointment (if there are no such matters, the incumbent auditors should inform the firm of this)
- Seek appropriate transfer information (such as a copy of the last set of accounts and a detailed trial balance reconciled to the accounts).
- Indicate a likely fee (or the basis on which fees are calculated) to client, ensure that this is acceptable and that the client is able to pay.
- Ensure that the incumbent auditor has properly resigned, been dismissed or has not sought re-appointment in accordance with legal requirements.

(b) Starting the audit

It is inappropriate to start the audit before the procedures referred to above have been completed because:

Without the staff with appropriate competencies, the firm will be in breach of the rules (and may be found negligent if things were to go wrong).

Without complying with the requirements relating to independence and conflicts of interest, the firm will not only be in breach of the rules, but will lack objectivity and may find that the client (or other party) objects to the appointment to another client in the same sector.

Without performing appropriate procedures the firm will be unable to form an opinion on the integrity of the client. It may find itself associated with an entity engaging in doubtful or even illegal activities (taking account of the disagreement over disclosures).

Without agreeing a fee it is almost inevitable that misunderstandings or disagreements will arise.

Without communicating with the accountant and the incumbent auditor, it is quite possible that disagreements over disclosures will arise, similar to those that have arisen in the past

Without ensuring that the incumbent auditor is no longer in place, it will be inappropriate for the firm to seek appointment.

(c) Engagement letter

The engagement letter is of benefit to both the client and auditor and helps prevent misunderstandings. It:

(i) Confirms the auditor's acceptance of appointment and constitutes a contract between the auditor and the client.

(ii) Summarizes the respective responsibilities of directors and auditors.

(iii) Contains details on:
- The responsibilities of the directors (for accounting records, the financial statements and the accounting policies on which they are based).
- The responsibilities of auditors and the scope of the audit (their duty to conduct an audit in accordance with auditing standards, to review accounting policies and disclosures, to perform tests and to form an opinion on the financial statements).
- The form of report to be issued.
- Other services to be provided.
- The basis of calculation of fees.
- Applicable legislation.

QUESTION FOUR

Memo

From: Chief Internal Auditor

To: Board of ZX

Subject: Role of Audit Committee

Date: June 2005

(a) Areas where the internal audit department can assist the directors with the implementation of good corporate governance in an organization include:

Board reports

Reviewing reports to the board and reports produced by the board to ensure that they do present a balanced and understandable assessment of the company's position and prospects. The internal audit department will have good knowledge of the operations of the company as well as access to accounting information. The department can effectively 'audit' board reports to ensure they are accurate and understandable.

Internal controls

The board needs to maintain a sound system of internal control. The internal audit department will be able to review existing controls and recommend improvements to ensure this objective is met.

Application of ISAs and IASs.

The board needs to have a policy for applying appropriate International Statements on Auditing (ISA) and International Accounting Standards (IAS) to the organization. Internal audit will certainly be aware of new auditing standards and will have the technical expertise (especially where internal auditors are professionally qualified) to identify changes required by accounting standards. Amendments to control systems for new auditing standards and financial accounting systems for new accounting standards can therefore be recommended.

Communication with external auditors

Under corporate governance regulations, communications with external auditors will normally be via the audit committee, although the board must maintain an appropriate relationship with the external auditors. However, internal and external auditors can also work together to ensure that the internal control system is sufficient; possibly by external audit delegating work to internal audit, and each auditor reviewing the work of the other auditor. The board will therefore receive reports from both sets of auditors which will be accurate because they have been properly checked.

Communication to the board

The internal auditor can also check that appropriate information is provided to the board from the external auditor. ISA 260 provides a list of matters which should be communicated to the board and the internal auditor can work with the external auditor to ensure that this information is provided.

(b) The advantages of an audit committee include:

Public confidence

It provides increasing public confidence in the credibility and objectivity of published financial information. This will be particularly important for ZX if listing arrangements go ahead. While an internal audit department is not normally necessary for incorporated companies, the provision of that department will provide additional confidence in the accuracy of the financial statements and hopefully make ZX an attractive investment.

Financial reporting

It supports the directors in fulfilling their financial reporting obligations. The directors have to prepare financial statements for ZX. The committee can assist by checking the financial statements to ensure that they comply with appropriate reporting requirements. This is especially important where the board do not have detailed knowledge of accounting requirements.

Communication

It enhances the role of ZX's external auditors by providing an appropriate channel of communication. Use of the audit committee will enable the external auditor to discuss issues with the financial statements with the internal auditor, prior to providing a final summary of key points to the board.

'Friend' of the Board

The audit committee may also act as a 'critical friend' to the board by monitoring the work of the board and providing helpful guidance, where corporate governance requirements do not appear to be being met. The audit committee should have detailed knowledge of corporate governance as part of its monitoring function of the company and can share this with the board who may not have the time to obtain detailed information.

c) The disadvantages of an audit committee include:

Lack of understanding of function

As the directors in ZX do not have much knowledge of corporate governance, they may see the additional involvement of the audit committee as a threat to their authority or taking away some of their responsibilities. This memo has hopefully outlined the advantages of an audit committee in supporting the work of the directors, removing this as a problem.

Role of non-executive directors

As the audit committee will be made up mainly from non-executive directors, the board may see this as a means of decreasing their power and possibly letting other people run the company. Again, the audit committee must be seen as fulfilling a supporting role for the main board. It will utilize the special knowledge of account production and internal controls from the external auditor and business non-executives to provide appropriate review of information being given to the board.

Cost

The audit committee will increase the expenditure of the company as the non-executive directors will require some remuneration due to their additional responsibilities. While this cannot be avoided, the benefits of the committee in terms of providing assistance to the board and raising the profile of ZX ready for possible listing must not be forgotten.

QUESTION FIVE

(a) Confidential information

Information obtained during an audit is normally held to be confidential; that is it will not be disclosed to a third party.

However, client information may be disclosed where:

– Consent has been obtained from the client
– There is a public duty to disclose or
– There is a legal or professional right or duty to disclose.

(b) Independence risks

Audit partner – time in office

Mr. Grace has been the audit partner of Ancients for eight years. His objectivity for the audit may be threatened by the ongoing close relationship with the client. In other words, he may be too friendly with the directors of Ancients. This means he may not be willing or able to take difficult decisions such as issuing a modified audit report for fear of prejudicing his friendship with the directors. Rotating the audit partner would remove this threat.

Unpaid taxation fees

Ancients has not paid the taxation fees for work that took place nearly six months ago. The non-payment of fees can be a threat to objectivity similar to that of an unpaid loan. In effect, McKay is providing Ancients with an interest free loan. The audit partner in McKay may not wish to issue a modified report for fear that the client leaves and the 'loan' is not repaid. The unpaid fee must be discussed with the directors in Ancients and reasons for non-payment obtained. McKay may wish to delay starting the audit work for this year until the fee is paid to remove the potential independence problem. If the fee is not paid at all then McKay may decline to carry out the audit.

Fee income

No details are provided regarding fee income obtained from Ancients. However, the company is growing rapidly and McKay does provide other services besides audit. As a limited liability company, McKay should ensure that no more than 10% of its recurring practice income (including auditing, accountancy and other work combined) is derived from this client. Obtaining more than 10% could indicate undue financial reliance on one client, and impair objectivity regarding the audit report (again fear of issuing a modified report and losing the fee income from the audit client). If the 10% limit is close, McKay may have to limit other services provided so that independence is not impaired. An annual review will be required on clients where the fee is between 5 and 10% to ensure that the fee income rules will not be breached.

Allyson Grace

Allyson Grace is not deemed to be connected to Mr. Grace because she is presumably over the age of 18. If she was still a minor, then there would be a connection and it would be inappropriate for Mr. Grace to be the audit partner as he could in theory influence Allyson's decisions. However, there may still appear to be an independence problem as Mr. Grace may not be objective in making audit decisions. He may not wish to annoy his daughter by having to qualify the financial statements.

Appointing another audit partner would remove the perceived independence problem.

Meal

The offer of a meal by Allyson may appear to be a threat to independence; having received an expensive meal, the audit staff may be favorably disposed towards Ancients and be less inclined to investigate potential errors. Audit staff are allowed to receive modest benefits on commercial terms; whether there is a benefit depends on how expensive the meal is. To ensure no independence issues it would appear that the invitation should be declined. One possible option would be for Mr. Grace and Allyson to pay personally as a purely social event even though this may be unlikely. However, this does not remove the implied independence issue.

CHAPTER 3: IT PLANNING, CONTROL & RECORDING (ISA 300)

QUESTION ONE

a) Planning for an audit of a new client

In planning the audit of a new client the auditor should carry out the following procedures:

- Carry out a preliminary review of the client. This will involve seeking to obtain a good understanding of the nature of die clients and the client's business.
- Hold discussion with management to obtain an understanding of the management structure and a general feel of the current trading circumstances of the client and any factors that affect the client accounting and internal control system.
- Communicate with the previous auditor of the client and obtain all the information that is relevant to the audit of this new client. This would include any issues that arose from the previous audits that could have a continuing effect on the audit of this client.
- Seek to obtain a preliminary understanding of the nature of the clients accounting and internal control system. This will assist in determining whether the auditor could rely on the internal control system.
- Consider any accounting standards and legislation that could have an impact on the audit of this new client.
- The audit senior should check the nature and timing of reports and other communications with the client so that the audit plan accommodates such timings e.g. he should consider the dates of the animal general meeting, stock taking, dates when management reports are available.
- The audit senior should also determine the number of audit staff required, experience and special skills required and the timing of the audit visits.
- Prepare an audit planning memorandum that summarizes the scope of the work under the engagement and the strategy to be followed to meet the client's needs.

b) How audit planning assists in the conduct of an audit

- It establishes the intended means of achieving the objectives of the audit. The plan lays out the strategy to be followed to ensure that the audit objectives as set out in the letter of engagement arc met.
- It assists in the direction and control of the work. A good plan assists in the proper utilization of assistants and in the coordination of work done by other auditors and specialists.
- It helps to ensure that attention is devoted to important areas of the audit. The planning process identifies potential problematic areas. E.g. areas with weak internal controls where more detailed substantive testing should be carried out.
- It helps to ensure that audit work is completed especially through more efficient use of time and proper allocation of work to audit staff.
- Ensures proper division of work between interim and final audit to avoid repetition of work already done.

- The audit plan takes into consideration times when information needed for audit purposes is available and when the client is not very busy. This encourages co-operation by ensuring less disruption of client's work.

c. i. Direction and supervision

Direction involves giving audit assistants to whom work is delegated appropriate instructions/ directions. This involves informing assistants of their responsibilities and the objectives of the procedures then are to perform. This also involves informing them of matters such as the nature of the entity's business and possible accounting and auditing problems that may affect the nature, liming and extent of audit procedures to be performed. Supervision involves;

Monitoring the progress of the audit to consider whether assistants have the necessary skills and competence to carry out the assigned work.

Establish whether assistants understand audit instructions.

Ensure work is being carried out in accordance with the overall audit plan and program.

To identify and address any significant accounting and auditing questions raised during the audit.

Resolve any differences of professional judgment between personnel.

ii. Review and coordination of work.

This involves a review of audit work performed by each staff member by a person of equal or higher competence to consider whether

The audit work has been performed in accordance with the audit program.

The work performed and results obtained have been adequately documented.

All significant audit matters have been resolved or reflected in audit conclusions.

The objectives of the audit have been achieved.

The conclusions expressed are consistent with the results of the work performed and support the audit opinion.

iii. Quality controls

Quality controls refer to the various policies and procedures put in place by the auditor to ensure that all audits conducted by the firm meet the quality standards set by the accounting profession and firm's own quality standards.

STUDY TEXT

QUESTION TWO

(a) Information and procedures: understanding the entity and its environment and risk assessment for Rock

(i) Understanding the entity and risk assessment is likely to involve a review of prior year risk assessments as a starting point and the identification of changes during the year from the information gathered that may alter that assessment.

(ii) Risk assessment procedures involve enquiries of management and others, analytical procedures and observation and inspection. Members of the engagements team should discuss the susceptibility of the financial statements to material misstatements.

(iii) Risk assessment also involves obtaining an understanding of the relevant industry, regulatory and other matters including the financial reporting framework, the nature of the entity, the application of accounting policies, the entity's objectives and related business risks, and its financial performance. This may involve:

A review of prior year working papers noting any particular issues that arose warranting attention in the current year.

Discussions with the audit senior or manager working on Rock in prior years to establish any particular problem areas.

Discussions with Rock (and their other advisors such as banks and lawyers) to establish any particular problem areas.
A review of any third party information on the client such as press reports.
A review of management accounts, any financial information provided to the stock exchange or draft financial statements that may be available to establish trends in the business.
A review of any changes in stock exchange requirements.
A review of systems documentation (either generated by Rock or held by the firm) to see if it needs updating.

(iv) Auditors should obtain an understanding of the control environment, the entity's process for identifying and dealing with business risk, information systems, control activities and monitoring of controls.

(v) Risks should be assessed at the financial statements level, and at the assertion level, and identify significant risks that require special audit consideration, and risks for which substantive procedures alone do not provide sufficient, appropriate audit evidence.

(vi) Analytical procedures are often used to highlight areas warranting particular audit attention. In the case of Rock, they are likely to focus on inventory which is likely to have a significant effect on profit (there may be slow moving or obsolete inventory that needs to be written down) and on property, plant and equipment which (as a manufacturer and distributor) is likely to be a significant item on the balance sheet.

(vii) Risk assessment will facilitate the determination of materiality and tolerable error (calculations are normally based on sales, profit and assets) that will be used in determining the sample sizes and in the evaluation of errors.

(b) Types and features of audit working papers

Features of audit working papers:

- All working papers (without exception) should show by whom they were prepared and when, and when they were reviewed and/or updated, and by whom, by means of signatures and dates – these may be electronic in the case of electronic working papers.
- Audit planning documentation should include the risk assessment which should be cross referenced to the audit program, and the audit program should be cross referenced to the audit working papers and vice versa.
- Working papers showing the work performed should be cross referenced to the audit program and the lead schedule on that particular section of the audit file, and should describe the nature of the work performed, the evidence obtained, and the conclusions reached.
- Each section of the audit file should have a lead schedule which should be cross referenced back to the relevant working papers.
- Trial balances should be cross referenced back to the relevant section of the audit file, and cross referenced forward to the financial statements.
- The financial statements should be cross referenced to the trial balance.
- Schedules of unadjusted differences should be cross referenced to the sections of the file to which they relate.
- Schedules of review points should all be 'cleared' to show that all outstanding matters have been dealt with.

QUESTION THREE

(a) The purposes of audit working papers include:
- To assist with the planning and performance of the audit.
- To assist in the supervision and review of audit work, and
- To record the audit evidence resulting from the audit work performed to support the auditor's opinion.

(b) The audit working paper does not meet the standards normally expected in a working paper because:
- The page reference is unclear making it very difficult to either file the working paper in the audit file or locate the working paper should there be queries on it.
- It is not clear what the client year end date is – the year is missing. The working paper could easily be filed in the wrong year's audit file.
- There is no signature of the person who prepared the working paper. This means it is unclear who to address queries to regarding the preparation or contents of the working paper.
- There is evidence of a reviewer's signature. However, given that the reviewer did not query the lack of preparer's signature or other omissions noted below, the effectiveness of the review must be put in question.
- The test 'objective' is vague – it is not clear what 'correct' means for example, it would be better to state the objective in terms of assertions such as completeness or accuracy.
- The test objective is also stated as an audit assertion. This is not the case as no audit assertions are actually listed here.
- It is not clear how the number for testing was determined. This means it will be very difficult to determine whether sufficient audit evidence was obtained for this test.
- Stating that details of testing can be found on another working paper is insufficient – time will be wasted finding the working paper, if it has, in fact, been included in the audit working paper file.
- Information on the results of the test is unclear – the working paper should clearly state the results of the test without bias. The preparer appears to have used personal judgment which is not appropriate as the opinion should be based on the facts available, not speculation.
- The conclusion provided does not appear to be consistent with the results of the test. Five errors were found therefore it is likely that there are some systems weaknesses.

QUESTION FOUR

Importance of audit planning
- According to International Standard on Auditing 300 (Revised), the auditor should plan the audit work so that the engagement will be performed in an effective manner. Specifically, planning is required for the following reasons:
- To develop a general strategy and detailed approach for the specific nature, timing and extent of the audit work. This will help to ensure that the audit is carried out in an efficient and timely manner.
- So that attention is devoted to the important areas of the audit. Planning will also help to identify problem areas so they can be addressed in a timely fashion.

- To determine the amount of work to be carried out and therefore assist in determining the number of staff required to perform the audit work.
- To provide a document as a reference for an initial discussion of the approach to the audit with the company's audit committee. The plan will also help ensure that audit work is coordinated with client staff: e.g. for production of specific documentation to assist the auditor.
- To act as a basis for the production of the audit program.

CHAPTER 4 :THE ACCOUNTING AND INTERNAL CONTROL SYSTEMS (ISA 400)

QUESTION ONE

Internal control procedures for purchasing system

- The company should have clear division of duties between the various departments i.e. the manufacturing department, stores department and factory department.
- A responsible official should be charged with the duty of overseeing purchase of raw materials in the company and should report to the managing director or other appropriate senior level of management.
- The company should establish the re-order levels for purchase of all materials used in production. When the re-order level is reached a purchase requisition should be raised and must be authorized by the factory managers. This should then be sent to the purchasing department.
- Upon receipt of the purchase requisition, it should be checked to confirm that the transaction is authorized. Another person should prepare a purchase order and submit this together with the purchase requisition for the authorization by purchasing manager.
- Upon delivery an official from stores department must inspect the goods for quality and quantity. All units received should be recorded in a suitable documentation e.g. a goods received note (GRN) which store's staff and supplier's staff should counter sign.
- The goods received note and the suppliers invoice should be taken to the accounts department where an independent person should post the entries to the purchases ledger.
- Before payments are made to the suppliers, supplier's statement should be reconciled to the ledger balance.

QUESTION TWO

Report to audit committee

Inventory control and Sales System

Seed division

12 June 2007

The internal audit of the inventory and sales system identified the following weaknesses:

Weakness	Potential effect of weakness	Recommendation
Recording of orders. Orders placed on the internet site are transferred manually to the inventory and sales system. Manual transfer of order details may result in information being transferred incompletely or incorrectly. E.g. order quantities may be incorrect or the wrong product code recorded.	Customers will be sent incorrect goods resulting in increased customer complaints.	The computer systems should be amended so that order details are transferred directly between the two systems. This will remove manual transfer of details limiting the possibility of human error.
Control over orders and packing lists. Each order/packing list is given a random alphabetical code. While this is useful, using this type of code makes it difficult to check completeness of orders at any stage in the dispatch and invoicing process.	Packing lists can be lost resulting either in goods not being dispatched to the customer or the customer's credit card not being charged.	Orders/packing lists are controlled with a numeric sequence. At end of each day, gaps in the sequence of packing lists are investigated.
Obtaining payment The customer's credit card is charged after dispatch of goods to the customer, meaning that goods are already sent to the customer before payment is authorized.	Rhapsody Co will not be paid for the goods dispatched where the credit card company rejects the payment request. Given that customers are unlikely to return seeds, Rhapsody will automatically incur bad debts.	Authorization to charge the customer's credit card is obtained prior to dispatch of goods to ensure Rhapsody Co is paid for all goods dispatched.
Completeness of orders. The computer system correctly ensures that order details are available for all charges to customer credit cards. However, there is no overall check that all orders recorded on the inventory and sales system have actually been invoiced.	Entire orders may be overlooked and consequently sales and profit understated.	The computer is programmed to review the order file and orders where there is no corresponding invoice for an order; these should be flagged for subsequent investigation.

Summary

We look forward to arranging a meeting to discuss these weaknesses with you in more detail.

(b) Advantages of having an audit committee to Rhapsody include:
It provides the internal audit department with an independent reporting mechanism compared to reporting to the directors who may wish to hide or amend unfavorable internal audit reports.
The audit committee will assist the internal auditor by ensuring that recommendations in internal audit reports are actioned.
Shareholder and public confidence in published financial information is enhanced because it has been reviewed by an independent committee.
The committee helps the directors fulfill any obligations under corporate governance to implement and maintain an appropriate system of internal control within Rhapsody.
The committee should assist in providing better communication between the directors, external auditors and management by arranging meetings with the external auditor.
Strengthens the independence of Rhapsody's external auditor by providing a clear reporting structure and separate appointment mechanism from the board of Rhapsody.

QUESTION THREE

(a) (i) Internal control objectives

- Control objectives include policies and procedures designed by management to:
- Achieve the orderly and efficient running of the business including adherence to internal policies – this would include the regular, accurate processing and recording of payroll payments.
- Safeguard assets – this would include the physical safeguarding of cash and safeguarding money held in bank accounts by means of other controls.
- Prevent and detect fraud and error – fraud and error would include incorrect payments or deductions from the payroll and payments of incorrect amounts for tax and social insurance, payments for work not performed and payments to dummy employees, for example.
- Achieve accuracy and completeness of the accounting records and timely preparation of reliable financial information; this would include making correct payments and deductions from the payroll, correct payments for tax and social insurance, and making payments for work performed only (not to dummy employees, for example), in order that quarterly or half-yearly accounts can be prepared (possibly), but in any case in order that annual accounts can be prepared within the time limits for small companies.

(ii) Internal control environment and control procedures
The control environment relates to:
Management's overall style in encouraging awareness of the need for good controls, for example.
The existence of organizational controls such as review of the payroll by an independent person such as the managing director, and the rotation of payroll duties amongst staff responsible for processing it – this helps achieve all of the objectives set out above.
Segregation of duties and supervisory controls to avoid the misappropriation of cash (or allegations thereof) and to avoid fraudulent collusion to create, for example, dummy employees or to make inflated payments – this prevents the loss of assets and/or inaccurate records.

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Internal control procedures include:

- Limiting direct physical access to the cash, such as the use of a security firm to deliver cash, locking doors to areas where cash is held, keeping cash in a fire-proof safe and the protection of the computer by password controls – this will help safeguard assets and ensure the completeness and accuracy of the records and financial statements.
- Controls over computerized applications, checking the arithmetical accuracy of documents and the maintenance of control accounts – this can be achieved by, for example, the use of timesheets or clock cards, the use of reliable software with programmed controls for the calculation of deductions, and the use of batch and hash totals for information that is input into the computer system – this helps achieve the orderly and efficient running of the business and the accuracy and completeness of records and financial statements.
- Approval and control of documents, such as the authorization of the payroll itself, and authorization for the bank to make transfers and to deliver cash.

(b) Audit objectives, tests of control and substantive procedures

Objectives Tests of control and substantive procedures.

Objectives	Tests of control and substantive procedures
Existence: of assets and liabilities such as cash on hand and in the bank, and of the liability to pay staff and the associated tax and social insurance liabilities.	Testing controls over the security of cash to ensure that they are operating effectively throughout the relevant period. Performing cash counts, with reconciliations to the records and observing cash payments to staff, ensuring that appropriate signatures are obtained and that unclaimed cash is immediately re-banked.
Occurrence: payroll transactions occurred during the relevant accounting period.	Performing cut off tests to ensure that payroll costs incurred during the period have been recorded during the period by examining entries in the payroll just before and after the period end and checking back to source documents, such as time sheets and clock cards.
Completeness: there are no unrecorded assets or liabilities such as those noted under 'existence' above or undisclosed items such as payroll liabilities.	Performing starters and leavers tests to ensure that staff are not paid before they join the company or after they leave. This involves checking the payroll for two separate periods and examining entries relating to starters and leavers in the intervening period. Manually checking the accuracy of payroll calculations to ensure that correct payments and deductions are being made in accordance with approved pay rates and approved deduction rates. Reviewing evidence of authorization controls to ensure that the payroll has already been checked.
Measurement: transactions such as payroll payments are recorded at the correct amounts and are recorded in the correct period.	As fro completeness, above, and checking to ensure that the payroll has been properly authorized and reviewed. Checking entries relating to hours or time worked in the payroll to source documentation.
Presentation and disclosure: an item is disclosed in accordance with accounting standards and legislation.	Reviewing the financial statements with the aid of disclosure check list to ensure that disclosure requirements have been met. Reviewing the overall presentation of payroll transactions and balances.

QUESTION FOUR

(a) Risks and implications for audit risk

Inherent and control risks

Charities can be viewed as inherently risky because they are often managed by non-professionals and are susceptible to fraud, although many charities and the volunteers that run them are people of the highest integrity who take a great deal of care over their work. The assessment of this aspect of inherent risk depends on each individual charity and the areas in which it operates.

Charities are also at risk of being in violation of their constitutions which is important where funds are raised from public or private donors who may well object strongly if funds are not applied in the manner expected. Other charities and regulatory bodies supervising charities may also object. Again, the auditors will assess the level of risk. The involvement of a recently retired Chartered Certified Accountant in the preparation of accounts in the past may lower the auditor's assessed inherent risk to an extent.

Most small charities have a high level of control risk because formal internal controls are expensive and are not often in place. This means that donations are susceptible to misappropriation. Charities rely on the trustworthiness of volunteers. The auditors will assess the level of risk.

Detection risk

Detection risk comprises sampling risk and non-sampling risk. It is possible in this case that all transactions will be tested and therefore sampling risk (the risk that samples are unrepresentative of the populations from which they are drawn) is not present.

Non-sampling risk is the risk that auditors will draw incorrect conclusions because, for example, mistakes are made, or errors of judgment are made in interpreting results, or because the auditors are unfamiliar with the client, as is the case here.

Audit risk Audit risk is the product of inherent risk, control risk and detection risk and is the risk that the auditors will issue an inappropriate audit opinion. This risk can be managed by decreasing detection risk by altering the nature, timing and extent of audit procedures applied. Where inherent risk is high and controls are weak (as may be the case here) more audit work will be performed in appropriate areas in order to reduce audit risk to an acceptable level.

(b) Audit tests– fund raising events

Attend fund raising events and observe the procedures employed in collecting, counting, banking and recording the cash.

This will help provide audit evidence that funds have not been misappropriated and that all income from such events has been recorded. Sealed boxes or tins that are opened in the presence of two volunteers are often used for these purposes.

Perform cash counts at the events to provide evidence that cash has been counted correctly and that there is no collusion between volunteers to misappropriate funds.

Examine bank paying in slips, bank statements and bank reconciliations and ensure that these agree with records made at events. This also provides evidence as to the completeness of income.

Examine the records of expenditure for fund raising events (hire of equipment, entertainers, purchase of refreshments. etc.) and ensure that these have been properly authorized (where appropriate) and that receipts have been obtained for all expenditure. This provides evidence as to the completeness and accuracy of expenditure.

Review the income and expenditure of fund raising events against any budgets that have been prepared and investigate any significant discrepancies.

Ensure that all necessary licences (such as public entertainment licences) have been obtained by the trustees for such events in order to ensure that no action is likely to be taken against the charity or volunteers.

Obtain representations from the trustees to the effect that there are no outstanding unrecorded liabilities for such events– again for completeness of expenditure and liabilities.

QUESTION FIVE

Audit risks

Over-trading

The turnover of Parker is growing quite rapidly, although this growth is not matched in net profits. The company has been expanding into the Internet, and plans to introduce other product lines for sale in this division. There is the risk that the business will exhaust any cash reserves as it continues to expand but does not generate sufficient additional cash to pay for that expansion. In this situation suppliers may go unpaid and at the extreme the business will be forced into liquidation. Therefore the financial statements may not adequately disclose doubts about going concern.

Internet trading

The decision to expand the Internet business may cause other problems for Parker. Selling of books and CDs appear to be related as they are both forms of entertainment and the customer knows what the product is like. Selling toys may fall into a similar category, but garden furniture and clothes are different. Garden furniture is bulky and will certainly cost more to deliver while clothes are sold more on taste and a high level of returns can be expected. Specific risks with this decision therefore relate to:

The overall ability of management to run the business given their apparent lack of knowledge of Internet trading.

The need to setup and manage systems for the sales of many new products.

The need to allow for a much larger volume of returns.

The possibility of inventory obsolescence if Parker overstocks on clothes which go ‘out of fashion’.

Control environment.

The whole environment in which the control systems should be operating appears weak. There are errors in the systems, the extent of which is not known, and the directors and the accountant do not appear to be inclined to attempt to remedy the situation. The skills of the accountant may also be questioned because he appears to have been appointed not on merit, but from some personal relationship with the directors. Other errors may also have occurred which have not been detected. The risk is that the financial statements may have material errors in them.

Bank loan

The directors require additional finance to expand the business. To provide this finance it is likely that the bank will require sight of the audited financial statements; the directors of Parker expect the audit to be completed prior to meeting the bank. The auditor may need to write to the bank to disclaim reliance on the audit report for the purposes of making a bank loan. There is a risk to the audit firm of being sued if the bank relies on the report and sustains financial loss.

There is also a risk to Parker that the loan is not obtained and the company goes into liquidation. The financial statements may need to be prepared on a breakup basis.

First year of audit

The audit is also risky for the audit firm because it is the first year of an audit and the client has expectations about the type of auditor's report to be produced. The accounting systems also appear to be unreliable, again increasing the risk of material error. The audit firm must ensure that sufficient time and resources are allocated to the audit to ensure that the audit opinion can be supported. Pressure from the directors to complete the audit quickly will have to be resisted.

CHAPTER 5: FRAUD & ERROR (ISA 240)

QUESTION ONE

(a) Internal audit function: risk of fraud and error

The internal audit function in any entity is part of the overall corporate governance function of an entity. Corporate governance objectives include the management of the risks to which the entity is subject that would prevent it achieving its overall objectives such as profitability. Corporate governance objectives also include the overarching need for the management of an entity to exercise a stewardship function over the entity's assets.

A large part of the management of risks, and the proper exercise of stewardship, involves the maintenance of proper controls over the business. Controls over the business as a whole, and in relation to specific areas, include the effective operation of an internal audit function.

Internal audit can help management manage risks in relation to fraud and error, and exercise proper stewardship by:

Commenting on the process used by management to identify and classify the specific fraud and error risks to which the entity is subject (and in some cases helping management develop and implement that process);

Commenting on the appropriateness and effectiveness of actions taken by management to manage the risks identified (and in some cases helping management develop appropriate actions by making recommendations);

Periodically auditing or reviewing systems or operations to determine whether the risks of fraud and error are being effectively managed;

Monitoring the incidence of fraud and error, investigating serious cases and making recommendations for appropriate management responses.

iv. In practice, the work of internal audit often focuses on the adequacy and effectiveness of internal control procedures for the prevention, detection and reporting of fraud and error. Routine internal controls (such as the controls over computer systems and the production of routine financial information) and non-routine controls (such as controls over year-end adjustments to the financial statements) are relevant.

v. It should be recognized however that many significant frauds bypass normal internal control systems and that in the case of management fraud in particular, much higher level controls (those relating to the high level governance of the entity) need to be reviewed by internal audit in order to establish the nature of the risks, and to manage them effectively.

(b) Nature of risks arising from fraud and error: Stone Holidays

Stone Holidays is subject to all of the risks of error arising from the use of computer systems. If programmed controls do not operate properly, for example, the information produced may be incomplete or incorrect. Inadequate controls also give rise to the risk of fraud by those who understand the system and are able to manipulate it in order to hide the misappropriation of assets such as receipts from customers.

All networked systems are also subject to the risk of error because of the possibility of the loss or corruption of data in transit. They are also subject to the risk of fraud where the transmission of data is not securely encrypted.
All entities that employ staff who handle company assets (such as receipts from customers) are subject to the risk that staff may make mistakes (error) or that they may misappropriate those assets (fraud) and then seek to hide the error or fraud by falsifying the records.
Stone Holidays is subject to problems arising from the risk of fraud perpetrated by customers using stolen credit or debit cards or even cash. Whilst credit card companies may be liable for such frauds, attempts to use stolen cards can cause considerable inconvenience.
There is a risk of fraud perpetrated by senior management who might seek to lower the amount of money payable to the central fund (and the company's tax liability) by falsifying the company's sales figures, particularly if a large proportion of holidays are paid for in cash.
There is a risk that staff may seek to maximize the commission they are paid by entering false transactions into the computer system that are then reversed after the commission has been paid.

QUESTION TWO

External auditors: fraud and error in an audit of financial statements
External auditors are required by ISA 240 to consider the risks of material misstatements in the financial statements due to fraud. Their audit procedures will then be based on a risk assessment. Regardless of the risk assessment, auditors are required to be alert to the possibility of fraud throughout the audit and maintain an attitude of professional skepticism, notwithstanding the auditors' past experience of the honesty and integrity of management and those charged with governance. Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements due to fraud.
Auditors should make enquiries of management regarding management's assessment of fraud risk, its process for dealing with risk, and its communications with those charged with governance and employees. They should enquire of those charged with governance about the oversight process.
Auditors should also enquire of management and those charged with governance about any suspected or actual instance of fraud.
Auditors should consider fraud risk factors, unusual or unexpected relationships, and assess the risk of misstatements due to fraud, identifying any significant risks. Auditors should evaluate the design of relevant internal controls, and determine whether they have been implemented.
Auditors should determine an overall response to the assessed risk of material misstatements due to fraud and develop appropriate audit procedures, including testing certain journal entries, reviewing estimates for bias, and obtaining an understanding of the business rationale of significant transactions outside the normal course of business. Appropriate management representations should be obtained.
Auditors are only concerned with risks that might cause material error in the financial statements. External auditors might therefore pay less attention than internal auditors to small frauds (and errors), although they must always consider whether evidence of single instances of fraud (or error) are indicative of more systematic problems.
It is accepted that because of the hidden nature of fraud, an audit properly conducted in accordance with ISAs might not detect a material misstatement in the financial statements arising from fraud. In practice, routine errors are much easier to detect than frauds

Where auditors encounter suspicions or actual instances of fraud (or error), they must consider the effect on the financial statements, which will usually involve further investigations. They should also consider the need to report to management and those charged with governance.
Where serious frauds (or errors) are encountered, auditors need also to consider the effect on the going concern status of the entity, and the possible need to report externally to third parties, either in the public interest, for national security reasons, or for regulatory reasons. Many entities in the financial services sector are subject to this type of regulatory reporting and many countries have legislation relating to the reporting of money laundering activities, for example.

QUESTION THREE

Materiality. A matter is material if its inclusion or omission will affect the decision reached by the user of the account and if they affect the view of the account. Whether an item is material may depend on the degree of approximation of item of which it is a part. There may be critical points 'when materiality can be important, for example in turning a small profit into a small loss or just making a company's assets exceed its liabilities or reversing a trend.
Duty of confidentiality. The guide to professional ethics states that information acquired in the course of professional work should not be disclosed except consent has been acquired from client or where there is public duty to disclose or where there is a legal or professional duty or right to disclose. A member acquiring information in the course of professional work should neither use nor appear to use that information for his personal advantage or for the advantage of a third party.
Professional indemnity insurance. There is a tendency to sue the auditor knowing that he will hot have to pay but his insurer will. The auditor seeks to pay some premiums to an insurance firm so that in case of any suit flied against him the insurer can pay. The effect of this is that the insurer will insist on reasonable skill and care on the part of the insured.
Peer review may be described as an independent review of a firm's accounting and auditing practices. It is intended that the review be done by practitioners upon fellow practitioners hence the term "peer review". The work of the review is limited to:-

- Professional aspects of the practice.
- Overall total quality control policies.

Quality control;. Audits should be extremely well done and yet be completed expeditiously and economically. The auditor should ensure that audits are carried out.
In accordance with international accounting standards.
In conformity with statutory and contractual requirements.
In accordance with ethical standards.
In agreement with any professional standards set out by the firm and by other professional bodies.
Economically and to time schedules with minimum risk.

QUESTION FOUR

Preparation of financial statements

The directors are normally required to prepare the financial statements of the company using the appropriate law of their country and in accordance with the International Accounting Standards (IASs). The auditors are normally required to check or audit those financial statements, again in accordance with the legislation of their country and the International Statements on Auditing.

Fraud and error

The directors are responsible for preventing and detecting fraud and error in the financial statements, no matter how immaterial this may be. Auditors are responsible for ensuring that the financial statements show a true and fair view; in other words that the financial statements are materially correct. Auditors are not required to detect immaterial fraud or error.

Disclosure

The directors must ensure that there is adequate disclosure of all matters required by statute or IASs in the financial statements. The auditor will check that disclosure provisions have been complied with, and where certain disclosures have not been made (e.g. ISA 550 regarding related party transactions) provide this information in the audit report.

Going concern.

The directors are responsible for ensuring that the company will continue in operational existence for the foreseeable future, and report to the members in the published financial statements if this is unlikely to be the case. The auditor will check the accuracy of the directors' workings and assumptions and if these are considered incorrect or inappropriate, then the audit report may be modified or qualified to bring the situation to the attention of the members of the company.

CHAPTER 6: AUDIT EVIDENCE (ISA 500)

QUESTION ONE

a) Audit evidence consists of any information used by the auditor to enable him to arrive at conclusion necessary for his opinion. Auditing is concerned with the verification of accounting data and with determining the accuracy and reliability of accounting statements and reports.

b)

Relevant audit evidence

It depends on whether it assists the auditor to form an opinion on some aspect of the financial statements. For example evidence that indicates that a recorded asset exists is relevant to audit objectives.

Reliable audit evidence

Reliability of audit evidence can be assessed to some extent on the following presumptions:

- Documentary evidence is more reliable than oral evidence.
- Evidence from outside the enterprise is more reliable than that secured solely from within the enterprise.
- Evidence originated by auditor by such means as analyzing and physical inspection is more reliable than evidence obtained from others.
- Evidence for a figure in accounts is usually obtained from several sources. The cumulative effect of several evidential sources which give a consistent view is greater than that from a single source.
- Original documents are more reliable than photocopies or facsimiles.

c.

Written confirmation of a trade debtor circularize at the year end. Evidence from the enterprise is more reliable than that secured solely from within the enterprise. Though debtor circularization may not be sufficient evidence depending on the circumstances.

Work in progress stocks identified during annual physical stock count. If the auditor was present during the stock take, then as the evidence has originated as a means of analysis and physical inspection by the auditor it is more reliable than if obtained from others. The auditor however needs to refer to other materials and statements so as to collect sufficient evidence.

Solicitors letter confirming pending legal action. It is more reliable evidence than evidence from management. However, it will be sufficient on its own because the solicitor is the one who solely deals with cases.

QUESTION TWO

Main audit procedures and processes: interim and final audit
The interim audit generally involves risk assessment, the testing of internal controls, and certain analytical and other substantive procedures. Many of these procedures are often performed concurrently.
Risk assessment involves gathering information about the business, inquiries, analytical procedures and determining the response to assessed risk. In practice it also involves the determination of materiality and tolerable error.
Risk assessment also involves evaluating the design of internal controls and determining whether they have been implemented
Final audit procedures also involve a review of the financial statements as a whole to ensure that they are internally consistent, and in accordance with the relevant financial reporting framework and the auditor's knowledge of the business.
Substantive procedures, which include analytical procedures, are designed to provide evidence that the figures and disclosures in the financial statements are complete, relevant, and accurate. Arriving at the final conclusions often involves the performance of further analytical procedures on the financial statements as a whole.
It is common for auditors to provide management with lists of control weaknesses (both structural and operational) together with recommendations for improvement both after the interim and final audits.
Auditors are also required to communicate with those charged with governance. Mention could also be made of management representations, third party confirmations, the review of working papers, and a number of other matters.

QUESTION THREE

(a) Headings: accounts payable and accrued expenditure
Whilst there are a great number of possible headings for accounts payable and accrued expenditure, the seven headings below seem likely:
Food and beverages;
Payroll;
Cleaning;
Maintenance of properties;
Waste disposal;
Light, heat, water and other utilities;
Business and other local taxes.

(b) Audit tests and reasons: accounts payable and accrued expenditure
General
The firm would first obtain an understanding of the business, including reviewing management and financial accounts, in order to enable the firm to make some predictions as to the likely relationships between items of financial and non financial data. There are likely to be direct relationships that do not vary such as gross margins, and income and expenditure. These relationships may be applied to each restaurant and to the company as a whole. Understanding the business is important because it is the firm's first year as auditor and because it enables the auditor to properly plan tests, and evaluate the results thereof.
Tests of controls would be performed on expenditure under each heading to enable the firm to determine the level of substantive procedures required at the year-end.

Analytical procedures would be applied to each heading, both for the company as a whole, for regions and for individual restaurants if necessary. This would establish the level of expenditure, and the level of accounts payable and accruals in the prior year and for each period within the current year for which figures were available. Any unusual items would be investigated and explanations sought and substantiated. Analytical procedures are useful in the planning of audit tests to establish areas to which greater audit resources need to be devoted.

Food, payroll, cleaning, maintenance of properties

In all cases, substantive procedures would involve tracing source documentation created by the company (such as purchase orders for food, contracts with the cleaning and maintenance agencies and clock cards or timesheets) through the system (via goods received notes, signed documentation indicating that services had been performed, etc.) to daybooks, ledgers and control accounts and finally to schedules supporting the financial statements. This type of test helps provide audit comfort that accounts payable and accruals are complete, correctly calculated, properly authorized and recorded in the correct accounting period.

Substantive procedures tracing entries in the financial statements back to supporting schedules, entries in the ledgers, control accounts and daybooks through to source documentation help provide audit comfort that accounts payable and accruals exist are properly authorized and recorded in the correct accounting period.

Substantive procedures may also involve direct confirmation of accounts payable, although if suppliers send regular statements this may not be necessary. Such confirmations and statements provide the auditor with valuable third party, written evidence that is generated outside the company, showing the existence, accuracy and proper recording of accounts payable.

After-date payment of both accounts payable and accruals also provides evidence of the existence and accuracy of accounts payable and accrued expenditure.

Cut-off tests (checking samples of invoices for food received just before and just after the year-end to goods received notes, purchase invoices and records of inventory counts, for example) help ensure that expenditure and the related accounts payable and accruals are recorded in the correct accounting period.

For many such items, there may be accrued expenditure. Tests for accrued expenditure will be similar to those noted under the following heading.

Waste disposal, light, heat, water and other utilities and business and other local taxes

These items are less likely to have source documentation created by the company than those noted above. They are also more likely to be billed or invoiced less frequently than those noted above and there are likely to be more accruals for such items.

Accrued expenditure is an accounting estimate based on previous experience. Analytical procedures such as those noted above form a large part of the checking of accrued expenditure.

The firm should establish the basis on which accrued expenditure is calculated to ensure that it appears reasonable and consistent with prior periods, and check the actual calculation of the expenditure (possibly on a sample basis).

Checking accrued expenditure to invoices or bills received after the year-end and to payments after the year-end provides evidence as to the correct calculation of accruals.

(c) Difficulties and decisions: direct confirmation of accounts payable

Many of the difficulties faced by auditors conducting direct confirmations of accounts payable are the same as those relating to direct confirmations of accounts receivable. Clients are sometimes resistant to conducting such confirmations.

Auditors have to consider whether the resources required to conduct a confirmation are likely to be warranted in terms of the audit evidence likely to be obtained, particularly where alternative third party evidence is available in the form of supplier statements. The level of response is often low, responses may be delayed and responses may be inaccurate (particularly if the error is in the favour of the creditor).

Auditors have to decide whether to send a positive or negative confirmation. Positive confirmations ask for a reply in any case (and may have a low response rate), negative confirmations only require a reply when the creditor disagrees with the amounts stated, although the auditor can never be absolutely sure whether a non-reply indicates agreement of the amount or whether the request has simply been ignored. The auditor is generally most concerned to ensure that liabilities are not understated and requests for confirmation are therefore usually positive.

Auditors also have to decide whether to state the balance in the request (which enables the supplier to provide a reconciliation if there is a disagreement), or not to (in which case the auditor has to perform a reconciliation although strictly speaking, this is the responsibility of the client).

In practice, reconciling accounts can be time consuming and inefficient, and often requires the assistance of the client's staff.

QUESTION FOUR

(a) Advantages and disadvantages

Analytical procedures

Advantages

The main advantage of analytical procedures is that they can be used at all stages of the audit to enquire into the absolute amounts to be included in the financial statements, and into the relationships between those amounts.

Analytical procedures are a good test for the overall reasonableness of an amount. They can be used on a global basis, and they can be split down into their constituent elements.

Analytical procedures enable the auditor to make comparisons on a continuous basis, taking prior years into account, and providing the auditor with a better understanding of both the business as a whole, and of individual account areas.

Disadvantages

Analytical procedures often have to be performed on management accounts, or draft or incomplete accounts before the final financial statements have been prepared. This means that significant adjustments, which are often made at a late stage, are not taken into account.

Without a prior and proper understanding of the business, the auditor may be tempted to accept the results of analytical procedures that show no unusual variations as evidence that there is nothing wrong, which may not be the case if there have been significant changes in the business of which the auditor is unaware (and which management may wish to hide from the auditors).

Auditors may also be tempted to accept 'plausible' explanations for changes and variations without much further substantiation, where further investigation may actually be warranted.

2. Audit sampling

Advantages

Audit sampling enables the auditor to draw conclusions about a population without testing all of the transactions or balances in the population as a whole.

Audit sampling also enables the auditor to concentrate on high risk or high value items, and

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to differentiate between elements of a population which may be subject to differing internal controls.

Disadvantages

There is always a risk that the auditor's sample is not representative of the population as a whole (known as 'sampling risk'). Auditors calculate and accept this risk, and perform other procedures to compensate for it, but it always remains a risk.

Sampling relies on the use of judgment in relation to materiality, exceptions, and in drawing conclusions, for example. Judgment can be abused, or simply fail, particularly where staff are inexperienced.

3. Tests of controls

   Advantages

   Tests of controls enable the auditor to establish whether a control system in operation is effective. If properly designed controls are operating as prescribed, auditors can reduce the level of substantive testing required at the period-end.

   Tests of controls mean that auditors do not have to concentrate all of their efforts on substantive procedures at the period-end which would in many cases be impractical, inefficient and not cost-effective.

   Disadvantages

   Tests of controls are often performed on a sample basis (disadvantages noted above).

   Tests of controls are often performed on routine transactions for which there are high quality automated controls. The very high risk areas in financial statements are often outside this area and relate to non-routine transactions and more intangible environmental or general controls which are not easy to test.

4. Detailed testing of transactions and balances

   Advantages

   Detailed testing enables the auditors to form a view as to whether the figures on which he is reporting are fairly stated and often involves third party, written confirmation which is a good source of audit evidence.

   In detailed testing of transactions and balances, auditors are directly examining the figures and assertions that appear in the financial statements.

   Disadvantages

   Detailed testing of transactions and balances is often performed on a sample basis (disadvantages noted above).

   The level of testing of transactions and balances is determined by the level of comfort obtained by the auditor from tests of controls. If too much comfort has been obtained from tests of controls, it is likely that any error will be compounded by an inadequate level of testing of transactions and balances.

5. Computer assisted audit techniques (CAATs)

   Advantages

   CAATs reduce the level of human error in testing and enable a very high level of audit evidence to be derived.

   The use of CAATs frees up expensive human resources that would otherwise be engaged in routine, mechanical work to concentrate on judgmental areas.

   CAATs enable the auditors to test a large volume of data, or the operation of the controls in a system, accurately and quickly. They are therefore very-cost efficient when operated properly.

   Disadvantages

   CAATs are expensive to set up and require the co-operation of the client. It is usually necessary for a continuing audit relationship to be present before it is worth committing the audit resources.

Major changes in client systems often require major changes in CAATs which is expensive. If the audit fee is based on the assumption that the prior year's CAATs can be used, and a change is made without warning, the client may have unrealistic expectations about the level of service that can be provided for the fee.

(b) Relationship between the methods of evidence gathering

Analytical procedures are often first used during the planning stage of the audit. Materiality levels and levels of tolerable error are often derived (at least in part) from analytical procedures. These are in turn used in audit sampling procedures.

Analytical procedures help the auditor determine the audit approach (the levels and areas for tests of controls and detailed testing).

The results of tests of controls determine the level of detailed testing of transactions and balances. Analytical procedures provide indirect evidence as to the effective operation of internal controls (if controls are working, analytical procedures may help prove that the population as a whole is fairly stated).

Detailed tests of transactions and balances are often performed towards the end of the audit in conjunction with analytical procedures – analytical procedures compensate to an extent for the weaknesses in sampling procedures both for tests of controls and detailed testing of transactions and balances (and vice versa).

Sampling is used for both tests of controls and detailed testing of transactions and balances. Where CAATs are used, sampling may not be necessary because CAATs can often be used to test the whole population, either for tests of controls, or for detailed testing of transactions and balances.

QUESTION FIVE

a) Management representations are a form of audit evidence. They are contained in a letter, written by the company's directors and sent to the auditor, just prior to the completion of audit work and before the audit report is signed.

Representations are required for two reasons:

Firstly, so the directors can acknowledge their collective responsibility for the preparation of the financial statements and to confirm that they have approved those statements.

Secondly, to confirm any matters, which are material to the financial statements where representations are crucial to obtaining sufficient and appropriate audit evidence.

In the latter situation, other forms of audit evidence are normally unavailable because knowledge of the facts is confined to management and the matter is one of judgment or opinion.

Obtaining representations does not mean that other evidence does not have to be obtained. Audit evidence will still be collected and the representation will support that evidence. Any contradiction between sources of evidence should, as always, be investigated.

(b) Lack of representation letter

The auditor may take the following actions:

Discuss the situation with the directors to try and resolve the issue that the directors have raised. The auditor will need to explain the need for the representation letter again (and note that the signing of the letter was mentioned in the engagement letter).

Ascertain exact reasons why the directors will not sign the letter. Consider whether amendments can be made to the letter to incorporate the directors' concerns that will still provide the auditor with appropriate and sufficient audit evidence.

The discussion must clearly explain the fact that if the auditor does not receive sufficient and appropriate audit evidence, then the audit report will have to be modified.

The reason for the audit qualification will be uncertainty regarding the amounts and disclosures in the financial statements.

An 'except for' qualification for the material uncertainty is likely, although a disclaimer may be required, especially if the legal claim is thought to require a provision.

Even if the letter is subsequently signed, the auditor must still evaluate the reliability of the evidence. If, in the auditor's opinion, the letter no longer provides sufficient or reliable evidence, then a qualification may still be required.

CHAPTER 7: AUDIT SAMPLING ISA 530

QUESTION ONE

a. Audit sampling involves the application of substantive or compliance procedures to less than 100% of items within an account balance or class of transactions to be enable the auditor obtain and evaluate some characteristics of the balance and form a conclusion concerning that characteristic.

b. Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.
Inherent risk is the susceptibility of an account balance or class of transactions to misstatements that could be material assuming that there were no related internal controls
Control risk is the risk that a material misstatement that occurs in an account balance or class of transactions and that could be material will not be prevented or detected and corrected on timely basis by the accounting and internal control system.
Detection risk is the risk that auditor's substantive tests will not detect a misstatement that exists in an account balance that could be material.
On the other hand, sampling risk arises from the possibility that the auditor's conclusion based on the tests performed on the selected sample may be different from the conclusion that could be reached if the entire population was subjected to the same procedure.

c. Conditions necessary to carry out sampling.
   - The population must consist of items of the same nature and subject to the same level of risk i.e. it must be homogeneous.
   - The population should cover the whole of the period under review and not just a few months.
   - The population must be large enough to allow statistical methods to be used to select and evaluate a sample.
   - The estimated rate of error must be low. If many errors are expected, compliance testing should be abandoned and the auditor should extent the level of substantive testing.

d. Management representations
Representations by management are a source of audit evidence normally sought from the directors at the concluding stages of an audit to confirm various matters stated in the accounts particularly those which concern questions of facts or judgment which difficult for the auditor to prove objectively. There is no need to obtain a letter of representation on bank balance as this can be approved objectively but there is need to obtain representations that all contingent liabilities have been properly stated as this is difficult to prove.
Management makes various oral representations throughout the audit process in response to specific enquiries. The auditor should not rely on unsupported oral representations of management as being sufficient and reliable evidence when they relate to matters material to the financial statements. The auditor should obtain written representations from management on mattes material to the financial information when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

e. Factor to consider before relying on work of an expert
   - The skills and competence of the expert. This is done by considering the expert's professional qualifications, membership to appropriate professional bodies, experience and reputation in the field the auditor is seeking evidence.
   - Objectivity and independence of the expert. The risk of impairment increases when the expert is employed by the client or where he is related financially with the client.
   - The sources of data used by the expert in arriving at his opinion. If the sources can be regarded as reliable, the auditor can reasonably use the work of the expert as audit evidence.
   - The assumptions and methods used by the expert. These should be reasonable and appropriate to the circumstances.

QUESTION TWO

(a) Sampling risk is the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion reached if the entire population were subjected to the audit procedure.
The auditor may conclude from the results of testing that either material misstatements exist, when they do not, or that material misstatements do not exist when in fact they do.
Sampling risk is controlled by the audit firm ensuring that it is using a valid method of selecting items from a population and/or increasing the sample size.

Non-sampling risk arises from any factor that causes an auditor to reach an incorrect conclusion that is not related to the size of the sample.
Examples of non-sampling risk include the use of inappropriate procedures, misinterpretation of evidence or the auditor simply 'missing' an error.
Non-sampling risk is controlled by providing appropriate training for staff so they know which audit techniques to use and will recognize an error when one occurs.

(b) The audit manager suggests checking all invoices, effectively ignoring any statistical sampling; in other words this is not statistical sampling. Audit tests will be applied to all of the sales invoices. This approach may be appropriate for the audit of Tam because:
   - The population is relatively small and it is likely to be quicker to test all the items than spend time constructing a sample.
   - All the transactions are not large but could be considered material in their own right, e.g. compared to project. As all the transactions are material, then they all need to be tested.

The audit senior suggests using statistical sampling. This will mean selecting a limited number of sales invoices from the population using probability theory ensuring a random selection of the sample and then applying audit tests to those invoices only. This approach may be appropriate because:
   - The population consists of similar items (i.e. it is homogeneous) and there are no indications of the control system failing or changing during the year. There is the query about how long it will take to determine and produce a sample, which may make statistical sampling inappropriate in this situation.

The audit junior suggests using 'random' sampling, which the junior auditor appears to understand as manually choosing which invoices to look at. The approach therefore involves an element of bias and is not statistical or true 'random' sampling. While this approach appears to save time, it is not appropriate because:

- The sample selected will not be chosen 'randomly' but on the whim of the auditor. Human nature will tend to avoid difficult items for testing.
- Also, as invoices will not have been chosen using statistical sampling, no valid conclusion can be drawn from the results of the test. If an error is found it will be difficult extrapolating that error on to the population.

QUESTION THREE

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

It is important that the auditors of Tam ensure that the financial statements are free from material error for the following reasons:

- There is a legal requirement to audit financial statements and present an opinion on those financial statements. If the auditors do not detect a material error then their opinion on the financial statements could be incorrect
- There are only two owner/directors who will be the initial users of the financial statements. While the owners/directors maintain the accounting records, the directors will want to know if there are material errors resulting from any mistakes they may have made; the auditor has a responsibility to the members to ensure that the financial statements are materially correct.
- There are also other users of the financial statements who will include the taxation authorities and the bank who have made a loan to the company. They will want to see 'true and fair' accounts. The auditors must therefore ensure that the financial statements are free from material misstatement to avoid any legal liability to third parties if they audit the financial statements negligently.

QUESTION FOUR

Description

a. Judgment and statistical sampling
   Judgment sampling uses the auditor's judgment to select the number of items to be tested, which items to be tested, and to interpret the results. Statistical sampling uses probability theory to do the same. Some judgment is always used in statistical sampling in the assessment of materiality and in the determination of what constitutes tolerable error, for example.

b. Representative sample
   A representative sample is one whose characteristics are the same as, or similar to, the characteristics of the population as a whole. All sample selection methods attempt to select samples that are representative.
   For example, a sample of invoices that have not been properly authorized in 5% of cases will be representative of all invoices if the population as a whole also has around 5% of invoices not authorized.

c. Tolerable error

Tolerable error is the maximum error that the auditor is prepared to accept and still conclude that the audit objective has been achieved.

For example, in relation to receivables, the auditor may be prepared to form the conclusion that receivables are not materially misstated if sampling shows that the receivables population has a value that is within plus or minus, say, 5% of the figure in the financial statements.

d. Different methods of sample selection

- Random selection requires the use of random number tables in order to select a representative sample.
- Haphazard selection may be deemed to approximate to random selection provided that no bias is displayed.
- Interval (or systematic) selection involves taking every nth item, starting at random. Monetary unit sampling is also a form of systematic selection.
- Block selection methods (taking one full part of the population) will probably not result in a representative selection.
- Block selection might involve obtaining confirmation of receivables from one region of the country only, for example.

e. Extrapolation of errors

Errors found in a sample are extrapolated across the population as a whole, in order to enable the auditor to form a conclusion on whether the population is materially misstated. It is important to remember that there is not necessarily a direct, linear relationship between errors in samples and errors in the populations from which they are drawn.

CHAPTER 8: AUDITORS REPORT ISA 700

QUESTION ONE

The procedures to ensure that the Going concern is still appropriate to your clients include:

- Assess the adequacy of the means by which the directors have satisfied themselves that the adoption of the going concern basis is appropriate.
- Examine all appropriate evidence.
- Assess the adequacy of the length of time into the future that the directors have looked.
- Assess the systems or other means by which the directors have identified warnings of future risks and uncertainties.
- Examine budgets and other future plans and assess the reliability of such budgets by reference to past performance.
- Examine management accounts and other reports of recent activities
- Consider the sensitivity of budgets and cash flow forecasts variable factors both within the control of the directors (e.g. capital expenditure) and outside their control (e.g. interest or debt collection)
- Review any obligations, undertakings or guarantees arranged with other entities for the giving or receiving of support. Other entities may mean lenders, suppliers, customers or other companies in the same group. A Kenyan company may be viable in itself but may have given guarantees to other members of the group and when, say the holding company in Uganda fails, the company goes down with it.
- Survey the existence, adequacy and terms of borrowing facilities and supplier credit.
- Appraise the key assumptions underlying the budgets, forecasts and other information used by the directors.
- Assess the director's plans for resolving any matters giving rise to concern (if any) about the appropriateness of the going concern basis. Such plans should be realistic, capable of resolving the doubts and the directors should have firm intentions to put them into effect.

Finally the auditor should review all the information they have and all the audit evidence available and consider whether they can accept the going concern basis. They should always have all their evidence documented and their reasoning explained fully in the working papers.

QUESTION TWO

a) (i) Going concern

IAS 1 *Presentation of Financial Statements* defines the going concern concept as the assumption that the enterprise will continue in operational existence for the foreseeable future.

An entity will normally use the going concern basis unless:

– It is being liquidated or has ceased trading, or

S T U D Y T E X T

– The directors have no realistic alternative than to liquidate the company or to cease trading.

(ii) Responsibilities

The directors' responsibilities regarding going concern is to prepare the financial statements of an entity ensuring that the going concern basis is reasonable. They may also prepare cash and/or profit forecasts for at least 12 months into the future to demonstrate that the entity is likely to continue to trade during this time.

The auditors' responsibility regarding going concern is to form an opinion on the appropriateness of management's assessment of the going concern status of the entity and the adequacy of disclosures, if any. The auditor will collect sufficient and appropriate audit evidence to ensure use of the going concern assumption is valid. To be clear, the auditors are not responsible for ensuring that the company is a going concern; this is a responsibility of the directors.

b) Audit procedures

Audit procedures on going concern will include:

- Obtaining cash and profit forecasts from the directors. Ensure that these have been properly prepared (for example, are arithmetically correct) and show that the firm will continue trading.
- Review the order books for the firm to determine the level of future sales.
- Contacting firm's lawyers to determine the progress, if there are court cases pending.
- Review the financial status of firm during the audit to identify other indicators of a going concern problem such as failure to repay loans or decrease in sales.
- Contacting firm's bank to ascertain whether any loan or overdraft agreements are due for renewal and whether these will be renewed.
- Obtaining written representation from the directors confirming that they are not aware of any circumstances other than those evaluated by the auditor, so they expect the firm to continue as a going concern.

QUESTION THREE

a) Four situations under which the Act requires auditors to qualify their report.

1. If the auditors are unable to obtain all the information and explanations they consider necessary for the purpose of their audit, for example, if they are unable to obtain satisfactory evidence:
   - Of the existence of ownership of material assets or of the amounts at which they have been stated on the basis adopted.
   - Of the validity of payments
   - 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.
2. If in the opinion of the auditors:
   - Proper books of accounts have not been kept in accordance with the Companies Act.
   - Proper returns adequate for their audit have not been received from branches nor visited by them.
   - The balance sheet and the profit and loss account are not in agreement with the accounting books and returns.
3. 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.

4. 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.

Because in the auditor's opinion the underlying accounting policies do no conform to accounting principles appropriate to the circumstances and nature of the business;

- Because they are prepared on principles inconsistent with those previously adopted and without adequate explanation and disclosure of the effects of the change
- Because the auditors are unable to agree with the amounts at which an asset or a liability is stated
- Because the auditors are unable to agree with the amount at which income or expenditure or profit is stated
- 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
- Because the additional information given in a note or in the director's report materially alters the view otherwise given by the accounts.

b. Circumstances in which the auditors may qualify their report owing to inherent uncertainty. Uncertainty is of two levels material and not fundamental and material and fundamental.

Material and not Fundamental

If the auditor has reservations on only a particular aspect of the accounts and not on the accounts as a whole he is able to form an opinion on the accounts as a whole with particular reservation on a specific matter. He therefore disclaims opinion on only an aspect of the accounts and not the accounts taken as a whole.

Material and Fundamental

This is when the 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 he is unable to form an opinion as to when the financial statements give a true and fair view.

QUESTION FOUR

The basis of opinion paragraph may not meet the requirements of ISA 700 for the following reasons:

- The use of the term Auditing Standards is not clear, because the report does not state which auditing standards have been used. This provides uncertainty regarding the actual standard of work performed.
- The assessment of estimates and judgments made by the directors normally relates to significant amounts only, rather than all of those estimates and judgments. The use of the word all implies that the audit was more thorough than it probably was. Replacing the word all with the word significant will show that there was some limit to the audit testing and that this was probably focused on material amounts only.
- Stating that time was a factor in obtaining information and explanations for the audit is not correct as this implies some factor which could have been avoided and that the audit may therefore be incomplete. The auditor has to plan the audit carefully and ensure that all the information and explanations considered necessary are obtained to form an opinion, not simply stop work when time runs out.

- The auditor does not confirm that the financial statements are free from material misstatement as this implies a degree of accuracy that the auditor simply cannot provide. Making the statement could also leave the auditor liable to claims from members or third parties should errors be found in the financial statements later. Rather than make such a categorical statement, the auditor provides reasonable assurance that the financial statements are free from material misstatement, which clearly implies that audit techniques are limited.
- The disclaimer regarding errors appears to be useful in that it limits the auditor's liability. However, it does not belong in the basis of opinion paragraph as it appears to severely limit the basis of the auditor's opinion to stating that the directors are responsible for all errors. Directors' responsibilities are also clearly outlined in another section of the report, and this statement also appears to extend those responsibilities making the audit report overall less clear. This could also imply that the auditor has done little or no work.
- As the auditor is not required to audit the whole of the annual report of a company, it is inappropriate to refer to disclosure in that report when checking overall adequacy of presentation. Adequacy of presentation can only be confirmed regarding items actually audited, which is basically the financial statements.

CHAPTER 9: COMPUTERISED INFORMATION SYSTEMS

QUESTION ONE

When planning the audit in a computerized environment the following factors should be considered:

- Auditors need to be involved in computerized systems at a planning, development and implementation stages. Knowledge of the systems gained at these stages will enable the auditor to plan the audit with an understanding of the system.
- Timing is more important in computerized environments than in manual environment because of the need of the auditor to be present when data and the files are available, more frequent visits to the client are usually required.
- Recording methods may be different. Recent developments including the use of portable micro computers to make audit working papers in diskettes and not in paper or coupling a client's mainframe computer to a micro computer in the auditor's office enabling auditors to download data files onto their own personal computers.
- The allocation of suitably skilled staff to the audit. Thus audit firms now use the computer audit department on some parts of the audit and allowing general audit staff to have some computer experience.
- The extent to which computer assisted audit techniques can be used. These techniques often require considerable planning in advance.

QUESTION TWO

a) Four areas of risk concerning a computer system are as follows.
- Hardware. The computer hardware may be stolen or damaged, especially the modern 'desk-top' type peripherals. A system which does not incorporate physical controls will be subject to such risk.
- Unauthorized access. If terminals are not secure it might be possible for unauthorized users to obtain or corrupt information held on file.
- System breakdown. If the system does not incorporate retrieval procedures there might be a loss of data if the system breaks down for any reason such as power failure.
- Corrupt files. If stringent checks are not carried out on data, input files may be corrupted, with the consequent fall in the quality of output

b) Forms of control which may be instituted to safeguard against these risks are as follows.
- Physical controls. All hardware and files should be kept in secure locations with access only available to authorized personnel. The use of special rooms, storage cupboards and strict control over keys will assist in establishing secure locations. To protect the hardware and files from damage they should be located away from possible hazards such as fire and flood which might arise near a canteen or washroom facilities. The installation of smoke/heat alarms and other detectors of environmental hazards should also be carried out.

- Access controls. This will be partly helped by physical controls such as locked EDP rooms. In addition to this, terminal keys should be issued to authorized personnel. These ensure that the terminal will only become live for a valid user. The use of unique passwords will further improve control because, in the event of a key being stolen, the system will still be inaccessible without a valid password

QUESTION THREE

(a) The advantages of Computer-Assisted Audit Techniques (CAATs) are that they:

- Enable the auditor to test program controls – if CAATs were not used then those controls would not be testable.
- Enable the auditor to test a greater number of items quickly and accurately. This will also increase the overall confidence for the audit opinion.
- Allow the auditor to test the actual accounting system and records rather than printouts which are only a copy of those records and could be incorrect.
- Are cost effective after they have been setup as long as the company does not change its systems.
- Allow the results from using CAATs to be compared with 'traditional' testing – if the two sources of evidence agree then this will increase overall audit confidence.

(b) Test Data	Reason for test
Input of an order for a negative number of tennis racquets	Ensures that only positive quantities are accepted although the company cannot dispatch negative quantities anyway
Input of an order for ten tennis racquets	There are reasonableness checks in the system to identify possible input errors. A warning message should appear on screen asking the customer to confirm any order for more than say two racquets
Input of an order without payment details	Input of invalid inventory code Ensures that the computer detects the invalid code and presents an error message rather than taking the nearest code and accepting that
Input of invalid customer credit card details	Online checking of credit card details to the credit card company ensures that goods cannot be dispatched without payment. This will also limit the number of bad debts.
Input of invalid addresses	Ensures that the address and valid zip code is valid, possibly by accessing a database of valid codes. If the code is not valid an error message should be displayed. This ensures that goods are only dispatched to valid addresses

(c) Audit software

Difficulties of using audit software

- Substantial setup costs because the client's procedures and files must be understood in detail before the audit software can be used to access and interrogate those files.
- Audit software may not be available for the specific systems setup by the client, especially if those systems are bespoke. The cost of writing audit software to test those systems may be difficult to justify against the possible benefits on the audit.
- The software may produce too much output either due to poor design of the software or using inappropriate parameters on a test. The auditor may waste considerable time checking what appear to be transactions with errors in them when the fault is actually in the audit software.
- Checking the client's files in a live situation. There is the danger that the client's systems are disrupted by the audit program. The data files can be used offline, but this will mean ensuring that the files are true copies of the live files.

QUESTION FOUR

(a) Use of Computer-Assisted Audit Techniques (CAATs)

Testing programmed controls

Reliance on CAATs will force the auditor to rely on programmed controls during an audit; in fact using CAATs may be the only way to test controls within a computer system. Use of the CAAT enables the auditor to meet the auditing standard requirement of obtaining appropriate audit evidence. For example, in Walsh Co, an overtime report is generated by the computer, although this can also be overridden by the accountant. Test data can be used to check that the overtime report is being created correctly and audit software can monitor that only the accountant's password can be used to override the overtime payment.

Test larger number of items

Using CAATs enables the auditor to test a larger number of items quickly and accurately, meeting the auditing standard requirement of obtaining sufficient audit evidence.

Using audit software, the auditor can check the deduction and net pay calculations of a significant proportion of wages calculations – or all of them if necessary. Checking each calculation manually would take a long time.

Test actual accounting records

Using CAATs enables the auditor to test the actual accounting records (the electronic version) rather then relying on printouts or other copies of the data. It is always appropriate for the auditor to test original documentation where possible. In the case of Walsh, the actual wages will be tested rather than any paper copies.

Cost

After initial set-up costs, using CAATs is likely to be cost effective; the same audit software programs can be run each year as long as the client does not change the accounting systems.

In Walsh Co, the system has just been implemented. Hopefully the wages system will be used for a number of years, making the use of CAATs cost-effective for the audit firm.

(b) Examples of the use of audit software

- Calculation checks: For example, re-calculation of net pay for a number of employees to ensure the mathematical calculation is correct.

- Reviewing the list of employees paid each week/month and printing a list of employees, who have not be been paid, for further investigation.
- Detecting unreasonable items: Reviewing the list of net wages for large or negative payments.
- Detecting violation of system rules: For example, where other people besides the accountant have been overriding overtime payments or employees amending their own gross wages.
- Conducting new analysis as part of the analytical review of wages. For example, calculating total wages for the year from the number of employees and average wages paid.
- Completeness checks – ensuring there is an electronic record of all employees who ‘clocked in’ for a day’s work and ‘clocked out’ again.

(c) Audit test data consists of data submitted by the auditor for processing on the client’s computer-based accounting systems.

The data can be processed during a normal processing run (a ‘live’ testing situation) or in a special run outside of the normal processing cycle (a ‘dead’ testing situation).

In Walsh, the auditor can create a ‘dummy employee’ record on the wages master file, and then use a magnetic card to mimic that employee working a certain number of hours in the company over the course of, for example, one week.

Knowing how many hours has been input into the wages system; the auditor can calculate the expected net pay and then compare this to the actual net pay produced by the computer system.

If the amounts agree then this provides appropriate audit evidence of the accuracy of recording and processing of the wages software.

The problems of using this audit technique include:

- The possibility that the client’s computer system will be damaged by the testing being undertaken by the auditor. For example, by errors being caused by entering data that the client’s software cannot process.
- The need to reverse or remove any transactions input by the auditor. The transactions may be incorrectly or incompletely removed leaving dummy data in the client’s live computer system.
- Use of test data can be expensive – the auditor needs to ensure that the benefit gained from the test outweighs the expense. In this situation, it will take a long time to input employee details and there may be more efficient audit tests available.

CHAPTER 10: AUDIT TESTS

QUESTION ONE

a) Shortcomings
- There is no check that expenses claimed by salesmen claimed by salespersons were actually expended. Invoices just need to be presented for payment to be made without a third party confirmation. This is appropriate because invoices can be falsified.
- There is no check that the expenses were properly incurred by salespersons in carrying out their duties.
- The deputy chief accountant could easily perpetrate fraud alone or with collusion with the salespersons as no one verifies her work.

Improvements

- Each salesperson should complete a weekly log showing, mileage covered and calls made. The logs and expense claims should be submitted to sales manager who should check and sign the log before passing it to the deputy chief accountant.
- At intervals, a member of the accounts staff should verify that claimed mileage is consistent with mileage shown on the car's odometer.
- The directors should verify that complete and signed documentation is attached to and is consistent with the cheques presented to the. They should then cancel the presented documents to prevent a second presentation.

b). Tests of control are those tests which seek to provide audit evidence that internal control procedures are being properly applied throughout the period under review. Tests of control that could be performed are;
- Select a sample of the payments and obtain the related documentation. Verify that each claim is fully supported by vouchers and the additions are correct.
- Examine the cheques made to the salespersons and verify that they are made out properly and are properly signed. This may form part of the audit of the bank transactions.

c)

- Inform management verbally immediately and in writing in the management letter.
- Consider whether the discovery casts doubt on the effectiveness of the system hence whether further audit tests may be required.
- Consider whether the discovery casts doubt on the company records in general and hence whether further audit procedures may be necessary in selected areas.

QUESTION TWO

a)

1. Safety of unclaimed wages.
   - Misappropriation of unclaimed wages.
   - The money being used to write off debtors accounts.
   - Use of the cash as petty cash and buying office items not authorized.
   - Double payments to already paid workers through collusion with clerk.

2. Receipt of cash from customers
   - Teeming and lading.
   - Misappropriation of cash received.
   - Writing off bad debts for customers who have paid.
   - Crediting other debtor's accounts with the cash after colluding.
3. Company's cheque books
   - Writing cheques for personal purposes.
   - Paying for expenses that are non-existent to suppliers after colluding.
   - Duplication of cheques such that the clerk has a cheque book for his own purposes that is identical to the company's businesses.
4. Issue of credit notes to debtors
   - Issue of credit notes when no goods are returned or when there is no justification.
   - Overstated credit notes.
   - Understated credit notes

QUESTION THREE

The most common type of circularization is where auditor writes a letter to the debtor or clients audited paper asking them to reply directly to the auditor whether he agrees, disagrees or can not confirm the balance on client's sales ledger. The client is asked to reply under all circumstances i.e. Positive circularization.

With negative circularization, a similar procedure is carried out but the debtor is asked to reply only if he disagrees with the balance.

Frequently with circularization of debtors, the percentage of debtors who reply is low. With negative circularization, the percentage is even lower. However, negative circularization leads to an invalid conclusion as many debtors never reply to any circularization and some of them will disagree with the balances. Negative circularization provides weak evidence of the reliability of debtors figure in the sales ledger as many debtors who do not agree with the balance will not reply.

Where client and debtor are independent of each other, replies to circularization are quite good evidence. However, there are some limitations in reliability

- Some debtors reply agreeing balance for any circularization even when there is a difference. In some cases they sign the reply that they agree with the balance without checking the purchases ledger. If the reply is from junior members of debtor staff, it is less reliable from senior's e.g. chief accountant.
- Sometimes the debtor will disagree with the balance on clients sales ledger is correct. Usually this arises through cash and goods in transit. In most businesses, the ledger is more reliable than the purchases ledger, as sales invoice is posted to sales ledger at the same time as the goods are dispatched to customer and cash is posted to sales ledger when it is received usually within a day. However with purchases ledger, there will be a considerable delay between receiving the goods and posting the invoice to the purchase ledger because there may be delay in receiving purchase invoice and delays in checking invoice to goods received note and purchase order. This creates inaccuracies in customers purchase ledger.
- Some debtors reply saying that they cannot confirm the balance because of accounting records they keep. In this case, only the existence of debtor is confirmed.

- Agreement of balance by debtor does not confirm that it is recoverable e.g. the debtor may confirm the balance but because of cash flow problems, he is unable to pay it and becomes a bad debt. Also, debtors who are experiencing cash flow problems may not reply to the circularization. Nevertheless, this is a serious weakness of debtor's circularization. Checking cash received at the year end is best way of verifying the recoverability of a debt.
- Although the great advantage over debtor's circularization is to confirm existence of debtor, it is time consuming to carry out and because of limitations above. It is a less efficient way of verifying debtors than other techniques such as looking at aged debtors at the year end and checking cash received after year end.
- It is carried out only on a small sample of debtors which could be a very small percentage of the total valuation of debtors. Therefore there is a problem of sampling risk.

b. Where a debtor does not reply to circularization, a number of techniques are used to confirm the existence of such a debtor.
   - Check sales invoices, dispatch notes and order confirmations generated by the company. This evidence is weak in reliability because it is generated by the company.
   - The best evidence of the existence of the debtor which is available within the company is correspondence from the debtor such as orders from the debtor which can be found in sales department and in the credit control.
   - Cheques received are further evidence of existence of debtors. Only the most recent cheques will be available for auditor to inspect but there should be remittance advices from customers showing invoices each cheque pays.
   - Other evidence can be obtained from trade directories and telephone directories. This confirms existence of the business on client's sales ledger but does not confirm that the business is a debtor of the client i.e. the debtor balance on the sales ledger could either be made of fictitious sales invoices or invoices posted to wrong accounts.
   - A further letter could be sent to the debtor to confirm that he received goods from the client but in the same way the debtor did not reply to the circularization, he could also not reply to the letter.
   - The debtor could be telephoned and asked if he purchased goods from the client. In using the telephone, one must be careful that the call is not intercepted by the client.

   To check the recoverability of a debt at the year end, the auditor should check its aging. The auditor should also check cash received between year end and the time of audit visit after year end. Any year end invoices cleared by cash received since year end can be considered good as it is unusual for a debtor to request repayment. If some paid since year end is large, one should check that the cheque has cleared particularly for debtors who have been outstanding for a long period. The auditor will discuss all old outstanding amounts because there is likely to be a dispute between the debtor and the client over the amount.

QUESTION FOUR

Inventories

(a) Importance of inventory
   - Inventories are important to the financial statements because the inventory figure, particularly for manufacturing companies, may be material to the balance sheet and income statement, both in the current year and as a comparative figure.

- Inventories may be high risk if they are valuable, and/or easily portable. The valuation of inventories is a matter requiring the exercise of judgment, which means that inventories are sometimes used to manipulate the appearance of both the income statement and the balance sheet.
- In the income statement, there is a direct relationship between the inventory figure and the profit for the period. If closing inventories are overstated, profits will be overstated.
- Many key accounting and performance ratios are calculated using the inventory figure. These include inventory turnover, inventory days, the current ratio and working capital ratios. Many companies use these ratios for internal purposes and many third parties, such as investment analysts, also use these figures to assess performance.
- Poor inventory control will be reflected in inventory figures at the period-end. For many companies, excess inventory is a sign of serious problems.
- Some significant cases of litigation against auditors have involved the alleged overstatement of inventories in financial statements of companies where the auditors have issued an unqualified audit report before the company has been taken over.
- There is sometimes relatively little audit evidence for the inventory figure, particularly for small companies and it is therefore important for auditors to scrutinize the evidence available carefully and consider the scope for misstatement or deliberate manipulation of the inventory figure.

(b) Cost and net realizable value

- IAS 2 requires that cost comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
- Costs of purchase include the purchase price, import duties and other taxes, transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and similar items are deducted.
- Costs of conversion include costs directly related to units of production such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials to finished goods.
- Fixed production overheads are indirect costs of production that remain relatively constant regardless of the volume of production such as depreciation, the maintenance of factory buildings and equipment and the cost of factory management and administration. The allocation of fixed overheads is based on a normal level of production.
- Variable production overheads vary directly, or nearly directly, with the volume of production and include indirect materials and labour. The allocation of variable overheads is based on actual levels of production.
- Other costs might include the costs of designing products for specific customers and borrowing costs, which may be included in certain circumstances.
- Costs not included are storage costs, unless these are necessary to the production process prior to completion, general administrative overheads and selling costs.
- 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, such as advertising costs.

(c) Audit evidence

- The costs of purchase for a furniture manufacturing company will include purchase costs such as the cost of timber, metals, fabrics, fillings and adhesives.
- These costs can be checked on a sample basis from the inventory records through to the daybooks, ledgers and purchase invoices, ensuring that the correct amounts have been recorded in the correct period.

- The variable production overheads will include direct labour costs (including tax and social insurance costs), the cost of power for factory machinery, the cost of small tools and similar items that are directly related to the level of production.
- Direct labour costs can be checked to payroll records, production records, timesheets or clock cards, and payment records, including entries in the bank statements. It is likely that the cost of power for machinery will have to be allocated, but if this is not possible it may be necessary to include such costs in fixed overheads. In either case, the cost can be traced to utility invoices and accruals. The costs of small tools can be checked in the same way as purchase invoices, ensuring that capital items are not included in the revenue accounts and vice versa.
- Fixed production overheads will include depreciation of machinery, the cost of heat and light in the factory, factory administration overheads and storage space for work in progress. It is important to establish that the factory is operating at a normal level of activity. If it is not, it is not appropriate to include overheads on the basis of an abnormal level of activity.
- Depreciation can be checked to asset registers. It is important that auditors examine both the accuracy of calculations, and the reasonableness of the depreciation rates applied as costs may be inappropriately included as assets, otherwise.
- Factory administration may include the wages and salaries of those administering the factory payroll for example, and the costs of the offices in which such staff work. It may be necessary to split such costs out from general administration overheads that should not be included. The attributable payroll and overhead costs can be checked in the same way as for direct factory costs.
- Analytical procedures can also be performed on all of the costs noted above and compared with prior periods and budgets, as well as production levels, profits and factory capacity where they vary directly with production or sales.
- Analytical procedures on gross margins will also provide audit comfort on costs.
- Cut-off tests may include checks between inventory records, the inventory itself, and purchase and sales records for a period just before and just after the period-end. It may also be necessary to examine provisions for goods dispatched or received but not invoiced before the period-end.
- The net realizable value of finished goods will only be relevant if it is likely to be lower than cost, i.e. if furniture is to be sold at a loss. Auditors should review inventory counting results and inventory records for old or slow-moving inventory and form an opinion, in discussion with directors, as to whether any such inventories need to be reduced to net realizable value.
- Evidence from post year-end sales or contracts is a good source of evidence in relation to net realisable value. If these are not available, it is important to review the entity's previous experience of having to sell furniture below cost. Current market conditions are relevant as is the existence of a high level of inventories, which may indicate problems.

QUESTION FIVE

(a) (i) Four examples of external confirmations are:
- Accounts receivable letter
- Solicitor letter
- Bank report letter
- Inventory held by third parties.

(ii)

Accounts receivable letter

- This letter provides evidence of the existence of the receivable when a reply is returned from that receivable direct to the auditor.
- The letter provides evidence on cut-off because sales or cash receipts recorded in the incorrect accounting period will have to be reconciled to the balance provided by the receivable.
- The letter does not provide evidence of completeness of the receivables balance because receivables may not query balances which are understated.
- The letter does not provide evidence of the valuation of the receivables balance because the receivable cannot be expected to list all outstanding balances and confirmation of the debt does not mean it will be paid.

Solicitor letter

A solicitor letter provides evidence as to the existence of claims at the period end as the solicitor will confirm specific claims.

However, the letter does not necessarily confirm the valuation of claims due to uncertainty about the future or the completeness of any legal claims as solicitors do not normally provide a list of all claims but they prefer to comment only on claims they are actually asked about.

Bank report letter

A bank confirmation letter provides good evidence on the existence of the company's bank accounts as the bank has confirmed this information in writing.

A bank letter cannot necessarily be relied on to provide complete or accurate information. Most banks place a disclaimer on the letter of 'errors and omissions exempted' indicating that the auditor must review this evidence against other cash and bank evidence obtained.

Inventory held by third parties

A letter from the third party holding the inventory will provide evidence of the existence of that inventory because the third party has confirmed this in writing.

However, the letter does not provide evidence regarding the valuation of the inventory; confirming something exists does not necessarily mean it is in good condition.

(b) (i) Procedure for obtaining a bank letter

- The auditor should consider if a bank letter is required. For the audit of Jayne Co the letter is required as the company has significant cash transactions and a loan from the bank.
- The auditor will produce a confirmation letter in accordance with local audit regulations and practices.
- The letter will be sent to the client to sign and authorize disclosure and then it will be forwarded on to Jayne's bank.
- Alternatively, the client may already have provided a standard authority for the bank to respond to a bank letter each year. In this case separate authority would not be required.
- Ideally the letter should be sent before the end of the accounting period to enable the bank to complete it on a timely basis e.g. at the year-end.
- The bank will complete the letter and send it back directly to the auditor.
- Audit procedures on the bank letter include:
- Agree the balances for each bank account to the relevant bank reconciliation and the year end balance in the financial statements.
- Agree total interest charges on the letter to the interest expense account in the general ledger.

- For any details of loans, ensure repayment terms are correctly disclosed in the financial statements between current and non-current liabilities.

(ii) Substantive procedures for the audit of bank balances.

(1) Obtain a copy of the year end trial balance.
Agree the bank balance on the trial balance to the year end bank balance on the computer system and the balance on the financial statements.

(2) Obtain a copy of Jayne Co's bank reconciliation.
- Cast the reconciliation
- Agree the bank balance to the trial balance.
- Agree the bank statement balance to the year end bank statement.
- Agree any unpresented lodgements to the bank statement after the end of the year
- Agree any unpresented cheques or similar expenses to the cash book before the end of the year and the bank statements after the end of the year.

GLOSSARY OF TERMS

GLOSSARY OF TERMS

Acceptance sampling is sampling to determine whether internal control compliance is greater than or less than the tolerable deviation rate.

Accounting data includes journals, ledgers and other records, such as spreadsheets, that support financial statements. It may be in computer readable form or on paper.

Accounting estimate An approximation of a financial statement element. Estimates are included in historical financial statements because some amounts are uncertain pending outcome of future events and relevant data about events that have occurred cannot be accumulated on a timely, cost-effective basis.

Accounting principles are alternative ways of reporting and disclosing information in financial statements and related footnotes.

Accounts receivable Debts due from customers from sales of products and services. Normally a current asset. adjusting entries are accounting entries made at the end of an accounting period to allocate items between accounting periods.

Adverse An audit opinion that the financial statements as a whole are not in conformity with. GAAPs.

Allocation. Distribution according to a plan. Depreciation, amortization, and depletion are methods to allocate costs to periods benefited.

Allowance for doubtful accounts A contra asset account with a credit balance used to reduce the carrying amount of accounts receivable to net realizable value. The allowance balance is the estimated total of uncollectible accounts included in accounts receivable.

Allowance for sampling risk The difference between a sample estimate and the projected population characteristic at a specified sampling risk. This allowance is also the difference between the expected error rate and the tolerable deviation rate.

Analytical procedure A comparison of financial statement amounts with an auditor's expectation. An example is to compare actual interest expense for the year (a financial statement amount) with an estimate of what that interest expense should be. The estimate can be found by multiplying a reasonable interest rate times the average balance of interest bearing debt outstanding during the year (the auditor's expectation). If actual interest expense differs significantly from the expectation, the auditor explains the difference in audit documentation.

Application control Programmed procedure in application software designed to ensure completeness and accuracy of information.

Approve To authorize. A manager authorizes a cash payment by signing a voucher providing approval for the disbursement.

Arm's length transactions are transactions between people who have no relationship other than that of buyer and seller. The price is the true fair market value of the goods or services sold. If you buy or sell something to a close relative, you might give better terms than to an unrelated party, so the price might not represent the true market value of the goods or services.

Ascertain An audit procedure to determine or to discover with certainty. For example, to ascertain the date on which an investment was purchased by examining source documents.

Assertion Management asserts financial statements are correct with regard to existence or occurrence of assets, liabilities or transactions, completeness of information in the financial statements, rights and obligations at a point in time, appropriate valuation or allocation, presentation, and disclosure.

Assess To determine the value, significance, or extent of.

Assurance The level of confidence one has.

Attest (attestation) report In an attest engagement, a practitioner issues a written conclusion about the reliability of a written assertion that is the responsibility of another party.

Attribute sampling The characteristic tested is a property that has only two possible values (an error exists or it does not).

Audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that may not have been detected except through audit procedures.

Audit committee A committee of the board of directors responsible for oversight of the financial reporting process, selection of the independent auditor, and receipt of audit results.

Audit documentation (working papers) are records kept by the auditor of procedures applied, tests performed, information obtained, and pertinent conclusions reached in the engagement. The documentation provides the principal support for the auditor's report.

Audit objective In obtaining evidence in support of financial statement assertions, the auditor develops specific audit objectives in light of those assertions. For example, an objective related to the completeness assertion for inventory balances is that inventory quantities include all products, materials, and supplies on hand.

Audit planning is developing an overall strategy for the audit. The nature, extent, and timing of planning varies with size and complexity of the entity, experience with the entity, and knowledge of the entity's business.

Audit risk A combination of the risk that material errors will occur in the accounting process and the risk the errors will not be discovered by audit tests. Audit risk includes uncertainties due to sampling (sampling risk) and to other factors (nonsampling risk).

Auditing Standards Board Statements on Auditing Standards are issued by the auditing standards board, the body of the AICPA designated to issue auditing pronouncements.

Authorize (authorization) To give permission for. A manager authorizes a transaction by signing a voucher authorizing the disbursement.

Backup A copy of a computer program or file stored separately from the original.

Batch A set of computer data or jobs to be processed in a single program run.

Capitalized Recorded as an asset. A capitalized lease is in substance a purchase to the lessee. An asset is recorded equal to the present value of the lease payments, which is also recorded as a liability. Payments, partly interest and partly principal, are made on the lease liability. The lease asset is depreciated by the lessee as though it were legally owned by the lessee.

Classification Arrangement or grouping. Assets and liabilities are normally classified as current or non current.

Collusion A secret agreement between two or more parties for fraud or deceit.

Comparability Users evaluate accounting information by comparison. Similar companies account for similar transactions in similar ways. Another goal is comparison of one company's information from one period to the next (consistency). Operating trends should not be disguised by changing accounting methods.

Comparative Financial statements of a prior period shown with those of the current period to aid in comparisons between periods.

Compare (comparison) An audit procedure. The auditor observes similarities and differences among similar items such as an account from one year to the next.

Compensating balance An offsetting balance. A requirement by some banks that a borrower maintain a minimum balance in a checking or savings account as a condition of a loan. The offsetting balance increases the effective interest rate to the bank since the net amount loaned is reduced but the interest paid is unchanged.

Competence of an internal audit staff is a function of qualifications, including education, certification, and supervision. Competent audit evidence is valid and reliable.

Completeness Assertions about completeness deal with whether all transactions and accounts that should be in the financial statements are included. For example, management asserts that all purchases of goods and services are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

Compliance Following applicable rules or laws.

Computer controls Internal controls performed by computer (software controls) as opposed to manual controls. Also means general and application controls over the computer processing of data.

Consistency To achieve comparability of information over time, the same accounting methods must be followed. If accounting methods are changed from period to period, the effects must be disclosed.

Consulted Sought advice or information.

Consulting services performed by CPAs include consultations, advisory services, implementation services, product services, transaction services, and staff and support services.

Contingency is an existing condition involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) that will be resolved by future events. Estimates, such as the useful life of an asset, are not contingencies. Eventual expiration of the asset's utility is not uncertain.

Continuing auditor is the auditor of the current year who also audited the financial statements of the client for the previous year.

Control accounts are general ledger accounts that report totals of details included in subsidiary ledger accounts. For example, Accounts Receivable is a general ledger account with a balance equal to the total of the individual receivables included in the subsidiary accounts receivable ledger.

Control A policy or procedure that is part of internal control.

Control environment is the attitude, awareness, and actions of the board, management, owners, and others about the importance of control. This includes integrity and ethical rules, commitment to competence, board or audit committee participation, organizational structure, assignment of authority and responsibility, and human resource policies and practices

Control policies and procedures Control activities are the policies and procedures that help ensure management directives are carried out. Those pertinent to an audit include performance reviews, information processing, physical controls and segregation of duties.

Control risk The risk that material error in a balance or transaction class will not be prevented or detected on a timely basis by internal controls.

Corroborate (corroborating) (corroboration) (corroborative) To strengthen with other evidence, to make more certain.

Cumulative effect of changing to a new accounting principle is the effect on retained earnings at the beginning of the current period. It is included in net income after extraordinary items. Only the direct effect (net of income tax effect) is considered.

Cutoff Designating a point of termination. An auditor uses tests of cutoff to obtain evidence that transactions for each year are included in the financial statements of the appropriate year.

Detection risk The risk audit procedures will lead to a conclusion that material error does not exist when in fact such error does exist.

Detective control A control designed to discover an unintended event or result.

Disclosure Revealing information. Financial statement footnotes are one way of providing necessary disclosures.

Discovery sampling Acceptance sampling (sampling to determine whether internal control compliance is greater than or less than the tolerable deviation rate) when the expected attribute occurrence rate is zero.

Document (documentary) (documentation) Written or printed paper that bears information that can be used to furnish decisive evidence. Could also be a recording, computer readable information, or a photograph.

Edit check Reasonableness, validity, limit, and completeness tests that are programmed routines designed to check input data and processing results for completeness, accuracy and reasonableness.

Effective internal control Reasonable assurance that the entity's operational objectives are achieved, that published financial statements are reliably prepared, and applicable laws and regulations are complied with.

Effectiveness Producing a desired outcome. An audit procedure is effective if the evidence supports a correct conclusion.

Efficiency The ratio of the audit evidence produced to audit resources used.

Engagement letter A letter that represents the understanding about the engagement between the client and the CPA. The letter identifies the financial statements and describes the nature of procedures to be performed. It includes an explanation of the objectives of the procedures, an explanation that the financial information is the responsibility of the company's management, and a description of the form of report.

Error Unintentional misstatements or omissions in financial statements. Errors may involve mistakes in gathering or processing accounting data, incorrect estimates from oversight or misinterpretation of facts, and mistakes in application of principles relating to amount, classification, presentation or disclosure.

Estimation sampling is sampling to estimate the actual value of a population characteristic within a range of tolerable misstatement.

Evidence (evidential matter) includes written and electronic information (such as checks, records of electronic fund transfers, invoices, contracts, and other information) that permits the auditor to reach conclusions through reasoning.

Except for a qualified opinion. An auditor can qualify the audit opinion for both departures from GAAPs in the financial statements and restrictions on the scope of the audit. The opinion paragraph of the qualified report is worded "In our opinion, except for..."

Execute (execution) To carry out an internal control procedure, such as to sign and mail a check after inspecting supporting documents.

Existence Assertions about existence deal with whether assets or liabilities exist at a given date. For example, management asserts that finished goods inventories in the balance sheet are available for sale.

Flowchart A schematic representation of a sequence of operations in an accounting system or computer program. Also called a flow diagram or flow sheet.

Fraud A deliberate deception to secure unfair or unlawful gain. False representation intended to deceive relied on by another to that person's injury. Fraud includes fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud, and misappropriation of assets, sometimes called defalcations.

GAAP or Generally Accepted Accounting Principles According to Rule 203 of the AICPA Code of Professional Conduct, GAAP for non government entities include (in a conflict the source earlier in the list prevails): 1. FASB Statements and Interpretations, APB Opinions, ARBs. 2. FASB Technical Bulletins, AICPA Guides and AICPA Statements of Position. 3. Positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins. 4. AICPA accounting interpretations, FASB staff "Qs and As", and widely recognized industry practices. 5. FASB Concepts Statements, textbooks, articles.

General controls Policies and procedures to assure proper operation of computer systems, including controls over data center and network operations, software acquisition and maintenance, and access security.

General ledger A record to which monetary transactions are posted (in the form of debits and credits) from a journal. It is the final record from which financial statements are prepared. General ledger accounts are often control accounts that report totals of details included in subsidiary ledgers.

Generalized audit software Packaged computer programs used on a variety of computers during audit field work to read computer files, select information, perform calculations, create data files, and print reports in a format specified by the auditor.

Going concern assumption assumes the company will continue in operation long enough to realize its investment in assets through operations (as opposed to sale). Presenting assets at historical cost is justified by assuming productive assets will be used rather than sold. This makes market values irrelevant and supports accounting methods that match the actual cost of an asset to periods benefited.

Gross margin percentage The gross margin from an income statement divided by net sales revenue.

Hardware A computer and associated physical equipment involved in data processing or communications functions as opposed to software (the computer programs that provide instructions the computer follows).

Hardware control Computer controls built into physical equipment by the manufacturer.

Immaterial Of no importance. Something in financial statements that will not change decisions of investors.

Implicitly Implied or understood even though not directly expressed.

Independent In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditors. This means freedom from bias, which is possible even when auditing one's own business (independence in fact). However, it is important that the auditor be independent in appearance (that others believe the auditor is independent).

Information systems consist of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data.

Inherent limitation The potential effectiveness of an entity's internal control is subject to inherent limitations. Human fallibility, collusion, and management override are examples.

Inherent risk The susceptibility of a balance or transaction class to error that could be material, when aggregated with other errors, assuming no related internal controls.

Input control Computer controls designed to provide reasonable assurance that transactions are properly authorized before processed by the computer, accurately converted to machine readable form and recorded in the computer, that data files and transactions are not lost, added, duplicated or improperly changed, and that incorrect transactions are rejected, corrected and, if necessary, resubmitted on a timely basis.

Inspect (inspection) As an audit procedure, to scrutinize or critically examine a document. As part of a CPA firm's quality control system, to monitor the effectiveness of the system.

Integrity Consistent adherence to an ethical code. If client management lacks integrity the auditor must be more skeptical than usual.

Interim audit procedures are done during the year under audit, before year-end.

Interim financial information is financial statements of a time period less than a full year.

Internal auditors are employees of the client responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board. An important responsibility of internal auditors is to monitor performance of controls.

Internal control Policies and procedures designed to provide reasonable assurance that specific entity objectives will be achieved. It consists of: the control environment, risk assessment, control activities, information and communications, and monitoring.

Internal control questionnaire A list of questions about the existing internal control system to be answered (with answers such as yes, no, or not applicable) during audit fieldwork. The questionnaire is a part of the documentation of the auditor's understanding of the client's internal controls.

Internal control weakness A defect in the design or operation of internal controls. A material weakness is a reportable condition that does not reduce to a relatively low level the risk that material errors or fraud would not be detected in a timely manner by employees in the normal course of their duties.

Introductory paragraph The first paragraph of the auditor's standard report, which identifies the financial statements audited, states the financial statements are the responsibility of management and that the auditor's responsibility is to express an opinion on the financial statements based on the audit.

ISB Independence Standards Board.

Journal A book of original entry in a double-entry system. The journal lists all transactions and the accounts to which they are posted.

Liquidity The availability of cash or ability to obtain it quickly. Debt paying ability.

Management controls are controls performed by one or more managers.

Management representation letter A letter addressed to the auditor, signed by the client's chief executive office and chief financial officer. During an audit, management makes many representations to the auditor. Written representations from management in the letter confirm oral representations given to the auditor, document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding.

Manual controls are controls performed manually, not by computer.

Material (materiality) Information important enough to change an investor's decision. Insignificant information has no effect on decisions, so there is no need to report it. Materiality includes the absolute value and relationship of an amount to other information.

material weakness A condition in which internal controls do not reduce to a relatively low level the risk that material errors or fraud may occur and not be detected in a timely period by employees in the normal course of their duties.

Misstatement Stated wrongly or falsely. Untrue financial statement information.

Mitigating Reducing in force or intensity.

Narrative A written description of an internal control system.

Negative assurance A statement of what the CPA does not know as opposed to what the CPA believes (positive assurance). A statement that the CPA was "not aware of material modifications that should be made to financial statements for them to conform with generally accepted accounting principles" is negative assurance used in review reports.

Negative confirmation request The negative form of accounts receivable confirmation asks the client's customer to respond only if the customer disagrees with the balance determined by the client. The positive form asks the customer to respond whether the customer agrees or disagrees with the client's receivable balance. The negative form is used when controls over receivables are strong and accounts receivable consists of many accounts with small balances. The positive form is used when controls are weak or there are fewer, but larger, accounts.

Non sampling risk is audit risk not due to sampling. An auditor may apply a procedure to all transactions or balances and fail to detect a material misstatement. Non sampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve a specific objective. For example, confirming recorded receivables cannot reveal unrecorded receivables. Non sampling risk can be reduced to a negligible level through adequate planning and supervision.

Objective A goal.

Objectivity The internal auditors' objectivity depends on the organizational status of the internal audit function, whether the internal auditor has direct access and reports regularly to the board, the audit committee, or owner-manager, and who oversees internal auditor employment decisions.

Obligations Assertions about obligations deal with whether liabilities are obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

Observe (observation) Watch and test a client action (such as taking inventory).

Occurrence Assertions about occurrence deal with whether recorded transactions have occurred during a given period. For example, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.

Online Access to a computer for immediate processing without having to wait for a batch of transactions to be processed at a later time.

Operating effectiveness How an internal control was applied, the consistency with which it was applied, and by whom.

Opinion A CPA's conclusion held with confidence but not substantiated by positive knowledge or proof.

Opinion paragraph The paragraph in the audit report that expresses the auditor's conclusions. The wording of the standard, unqualified opinion paragraph is: "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company at December 31, year A, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles."

Order is a listing of goods or services requested from a supplier with specifications and desired delivery method. A company starts the purchase process internally with a requisition, which results in an order being transmitted to a supplier. When the supplier ships the goods or provides the service, an invoice is sent to the customer telling the customer the specifications, delivery method, and price of those goods or services.

Overall review The objective of the overall review stage of the audit is to assess conclusions reached, and evaluate the overall financial statement presentation. The overall review includes reading the financial statements and notes and considering adequacy of evidence gathered in response to unusual or unexpected balances. Results of an overall review may indicate the need for additional evidence.

Parallel processing is the simultaneous performance of multiple operations, usually in reference to computer systems.

Password A sequence of characters required to gain access to a computer system. Passwords are used to restrict computer system access to only authorized persons.

Payroll Department that determines amounts of wage or salary due to each employee.

Peer review A practice monitoring program in which the audit documentation of one CPA firm is periodically reviewed by independent partners of other firms to determine that it conforms to the standards of the profession.

Permanent audit documentation includes items of continuing accounting significance, such as the analysis of balance sheet accounts and contingencies. Such information from a prior year is used in the current audit and updated each year. Sometimes called the continuing file.

Personnel The department that maintains records of each individual's employment.

Persuasive Having the power to influence. Most audit evidence is persuasive, but not conclusive.

Pervasive Having the ability to permeate. An error is pervasive if it is material to more than one of the primary financial statements.

Piecemeal opinion Expression of an opinion on an item in financial statements is not permitted as part of a disclaimer or adverse opinion on the financial statements as a whole because it would tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

Plan Audit planning is developing an overall strategy for conduct and scope of the audit. The nature, extent, and timing of planning vary with size and complexity of the entity, experience with the entity, and knowledge of the business. In planning the audit, the auditor considers the entity's business and its industry, its accounting policies and procedures, methods used to process accounting information, the planned assessed level of control risk, and the auditor's preliminary judgment about audit materiality.

Population size The number of items in the population from which a sample is drawn.

Positive assurance A statement as to what the CPA believes. An example is an opinion that the financial statements are presented fairly in conformity with U.S. GAAP. The opposite is negative assurance, a statement about what the CPA does not know. A statement that the CPA was "not aware of material modifications that should be made to financial statements for them to conform with. generally accepted accounting principles" is negative assurance used in review reports.

Positive confirmation (positive request) The positive form of receivables confirmation asks the customer to respond whether the customer agrees or disagrees with the client's reported receivable balance. The negative form of accounts receivable confirmation asks the client's customer to respond only if the customer disagrees with the balance determined by the client. The negative form is used when controls over receivables are strong and accounts receivable consists of many accounts with small balances. The positive form is used when controls are weak or there are fewer, but larger, accounts.

Predecessor auditor The auditor of a client for a prior year who no longer audits that client.

Presentation Assertions about presentation deal with whether particular financial statement components are properly classified and described. For example, management asserts that long-term liabilities in the balance sheet will not mature in one year. Similarly, management asserts that extraordinary items in the income statement are properly classified and described.

Preventative control A control designed to avoid an unintended event.

Probable A contingent loss is probable if it is uncertain but likely to happen.

Procedure An action, such as a step performed as part of an audit program or as part of the client's internal controls.

Processing control is an internal control included in computer software designed to assure that all transactions are handled as authorized and none omitted or added.

Proficiency as an auditor includes the auditor's formal education and subsequent experience. The independent auditor must undergo training adequate in technical scope, including commensurate general education. The assistant entering an auditing career must obtain experience with proper supervision and review of his or her work by a more experienced superior.

Program An audit program is a listing of audit procedures to be performed in completing the audit. A computer program (software) is a listing of steps to be performed in processing the data.

Programmed controls are built into computer software and include reasonableness tests, control totals, and sequence checks.

Pronouncements of the FASB and GASB are rules that determine the principles for external financial reporting and disclosure.

Prospective financial statements are either financial forecasts or financial projections. Prospective financial statements may cover a period that has partially expired. Statements for periods that have completely expired are not prospective financial statements.

Qualified (qualify) An audit opinion that the financial statements as a whole are presented in conformity with. GAAP, with the exceptions noted.

Qualitative Relating to the quality of a trait, as opposed to quantitative, which means expressed as a number.

Quality control systems provide a CPA firm with reasonable assurance that personnel comply with professional standards and the firm's standards of quality, independence, integrity, and objectivity. It covers personnel management, acceptance and continuance of clients, engagement performance, and monitoring.

Quantitative (quantitatively) expressed as a number, as opposed to qualitative measurement.

Questionnaire An internal control questionnaire is a list of questions about the internal control system to be answered (with answers such as yes, no, or not applicable) during audit fieldwork. The questionnaire is part of the audit documentation of the auditor's understanding of the client's internal controls.

Ratio The relation between two quantities expressed as the quotient of one divided by the other. The ratio of 8 to 2 is written 8/2 and equals four. Financial statement ratios are used in analytical procedures in audits.

Reasonable assurance (in audit report) An auditor works within economic limits. The audit opinion, to be economically useful, must be formed in a reasonable time and at reasonable cost. The auditor must decide, exercising professional judgment, whether evidence available within limits of time and cost is sufficient to justify an opinion.

Reasonable assurance (in internal control) An internal control, no matter how well designed and operated, cannot guarantee that an entity's objectives will be met because of inherent limitations in all internal control systems.

Reconcile (reconciliation) A schedule establishing agreement between separate sources of information, such as accounting records reconciled with the financial statements.

Related parties are those with whom the client has a relationship that might destroy the self-interest of one of the parties (accounting is based on measurement of arm's length transactions). Related parties include affiliates of the client, principle owners, management (decision makers who control business policy) and members of their immediate families.

Reliable (reliability) Different audit evidence provides different degrees of assurance to the auditor. When evidence can be obtained from independent sources outside an entity, it provides greater assurance of reliability for an independent audit than that secured solely in the entity. More effective internal controls provide more assurance about reliability of the accounting data and financial statements. The independent auditor's direct personal knowledge, from physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

Remote A contingency with only a slight chance of occurring. In computer processing of information, a distant computer.

Reperformance The repeating by the auditor of a computation made by the client to check its accuracy.

Representation A letter from management to the auditor representing that the financial statements are fairly presented. The letter is addressed to the independent auditor, and dated at the date of the auditor's report. It is signed by members of management whom the auditor believes are responsible for, and knowledgeable about, matters covered (chief executive officer and chief financial officer).

Requisition A formal written request for something needed. A purchase by a company is initiated internally by a requisition, resulting in the issuance of a purchase order to the outside supplier.

Review To examine again. The overall review of audit documentation is completed after field work. A peer review is a practice monitoring program in which audit documentation of one CPA firm is periodically reviewed by independent partners of other firms to determine that they conform to professional standards. An analytical review is a type of substantive audit procedure. A review of financial statements of a nonpublic company is an engagement that results in the expression of less assurance than an audit, but more than in a compilation. A review of interim financial statements of a public company consists of analytical procedures and inquiries.

Rights Assertions about rights deal with whether the entity has rights to the asset at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property.

Risk analysis An analysis of the possibility of suffering loss.

Sample size The number of population items selected when a sample is drawn from a population.

Sampling error Unless the auditor examines 100% of the population, there is some chance the sample results will mislead the auditor. This risk is sampling error. The larger the sample, the less chance of sampling error and the greater the reliability of the results.

Sampling risk The possibility that conclusions drawn from the sample may not represent correct conclusions for the entire population.

Scope The type of engagement. The scope of an engagement might be a review, an audit, or a compilation. A scope limitation is a restriction on the evidence the auditor can gather.

Scope paragraph The paragraph in the audit report that explains the scope of the engagement. The wording of the standard scope paragraph is: "We conducted our audit in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material 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."

Segregation of duties means assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties reduces the opportunities for one person to both perpetrate and conceal errors or fraud.

Software Programs and languages that control computer hardware.

Specialist An expert at activities not usually done by auditors (such as an appraiser for valuation).

Standard deviation A statistic used to measure dispersion equal to the square root of the arithmetic mean of the squares of the deviations from the arithmetic mean.

Statistical Making inferences in uncertain situations using applied mathematics. Measurements from a small group, the sample, are used to infer the behavior of a larger group, the population. Probability theory determines how well the sample represents the population.

Stratify To arrange a population or a sample in distinct layers. Stratified sampling is used in auditing to select a greater percentage of accounts with high balances than of accounts with low balances.

Subject to Years ago there was a type of qualified audit opinion that was worded "In our opinion, subject to....." Auditors are no longer permitted to issue such opinions.

Subsequent events affect the client and occur between the balance sheet date and issuance of the financial statements. Some such events provide additional evidence about conditions that existed at the balance sheet date, such as the bankruptcy of a customer with a history of financial difficulty. The financial statements are adjusted to reflect this evidence. Evidence about conditions that did not exist at the balance sheet date, such as fire that destroyed the client's plant after the balance sheet date, may be so significant as to require disclosure.

Substantive A substantive audit procedure is a direct test of a financial statement balance.

Sufficiency (sufficient) A measure of the quantity of audit evidence. The independent auditor's objective is to obtain sufficient competent evidence to provide a reasonable basis for forming an opinion.

Supervise Supervision is directing efforts of assistants in the audit and determining whether objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of problems, reviewing work performed, and dealing with differences of opinion among firm personnel. The appropriate extent of supervision depends on the complexity of subject matter and qualifications of persons performing the work.

Suppliers provide goods or services to an audited entity. Sometimes called vendors.

Test A sample from a population to estimate characteristics of the population.

Test data is run through a computer program to test the software. Test data can be used to test compliance with controls in the software.

Test of controls (tests of the operating effectiveness of internal controls) Auditors evaluate the design of controls, then determine if the controls are in operation. In order to rely on the controls they must also obtain evidence as to whether the controls are operating effectively.

Tolerable error When planning a sample for a substantive test of details, the auditor considers how much monetary misstatement may exist without causing the financial statements to be materially misstated. This maximum misstatement is called tolerable error for the sample.

Trace Follow a transaction through the steps of the system.

Trend analysis An analysis of the change in something over time. Analytical procedures, which compare financial statement ratios of different years, are an example of trend analysis.

Trial balance A statement of open debit and credit accounts in a ledger to test their equality.

Unqualified An audit opinion that the financial statements are in conformity with GAAP.

Update (updated) If an auditor notices events that affect financial statements on which an audit report has been issued, they are considered when updating the report on the prior statements.

If those statements are changed, the report says they have been restated and expresses the appropriate opinion. If an updated opinion differs from the previous opinion, an explanatory paragraph preceding the opinion paragraph explains that the report has been updated, discloses the date and type of opinion previously expressed, and events that caused the revision.

Validity check Software control over input of data to a computer system. Data is compared with the type of data properly included in each input field, e.g., only letters in a name field.

Valuation An assertion made by management that each asset and liability is recorded at an appropriate carrying value.

Variance A statistical measure of dispersion in a population. The variance is the square of the standard deviation. The standard deviation equals the square root of the arithmetic mean of the squares of deviations from the arithmetic mean.

Vendors provide goods or services to an audited entity. Also called suppliers.

Verify (verification) Prove accuracy of numbers or existence of assets.

Vouch Prove accuracy of accounting entries by tracing to supporting documents.

Voucher A document in support of expenditure. The signature of an appropriate official on the voucher is authorization for the treasurer to issue a check.

Working papers (written audit documentation) Records kept by the auditor of procedures applied, tests performed, information obtained, and pertinent conclusions in the engagement.

Write-off Cancellation of part or all of a balance. Costs incurred that have no future utility are charged (written-off) to an expense or loss account, not carried forward as an asset.

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