Auditing

SUBJECT NUMBER 4

Study Pack

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INSTRUCTIONS FOR STUDENTS

This study guide is intended to assist distance-learning students in their independent studies. In addition, it is only for the personal use of the purchaser, see copyright clause. The course has been broken down into eight lessons each of which should be considered as approximately one week of study for a full time student. Solve the reinforcement problems verifying your answer with the suggested solution contained at the back of the distance learning pack. When the lesson is completed, repeat the same procedure for each of the following lessons.

At the end of lessons 2, 4, 6 and 9, there is a comprehensive assignment that you should complete and submit for marking to the distance-learning administrator.

SUBMISSION PROCEDURE

1. After you have completed a comprehensive assignment clearly identify each question and number your pages.
2. If you do not understand a portion of the course content or an assignment question indicate this in your answer so that your marker can respond to your problem areas. Be as specific as possible.
3. Arrange the order of your pages by question number and fix them securely to the data sheet provided. Adequate postage must be affixed to the envelope.
4. While waiting for your assignment to be marked and returned to you, continue to work through the next two lessons and the corresponding reinforcement problems and comprehensive assignment.

On the completion of the last comprehensive assignment a two-week period of revision should be carried out of the whole course using the material in the revision section of the study pack. At the completion of this period the final Mock Examination paper should be completed under examination conditions. This should be sent to the distance-learning administrator to arrive in Nairobi at least five weeks before the date of your sitting the KASNEB Examinations. This paper will be marked and posted back to you within two weeks of receipt by the Distance Learning Administrator.

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AUDITING COURSE DESCRIPTION

This study pack will introduce the student to the basic principles of auditing and its related theories.

The course will also introduce the student to the concepts of business control which are necessary to check the operation of an organization so as to ensure that its managed properly.

Students will also be able to understand the concept of professional ethics and their implication in the daily life of an accountant.

It will assist the student to design audit procedures for entries in the Profit and Loss account and those in the Balance Sheet, including the application of substantive and compliance tests.

Enable the student to gather audit evidence necessary to draw conclusions from his examination of entries.

In conclusion, to assist the student to write an audit report arising out of his examinations.

RECOMMENDED TEXT BOOK

Principle of Auditing **by Paul N. Manasseh**

LESSON ONE

THE GENERAL AUDIT ENVIRONMENT

CONTENTS:

1. Definition of Auditing
2. Distinction between auditing and accounting
3. Objects of an audit
4. What is true and fair?
5. Benefits of an audit to a public limited company
6. Types of audits
7. Users of audited reports
8. Stages of an audit
9. Reinforcement Questions

DEFINITION OF AUDITING

The explanatory foreword to the ISA International Standards on Auditing describes audit as the independent examination of and expression of an opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation. 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/presented to them is reliable.

The word 'audit' when used will mean the independent investigation into the quality of published accounting information.

DISTINCTION BETWEEN AUDITING AND ACCOUNTING.

Auditing

a) Involves examination of financial statements to prove the true and fair view of company's affairs.
b) It is done mainly at year-end after the directors have prepared the financial statements, although the planning work could be carried out earlier.
c) An audit is mainly governed by the international standards on auditing (ISA).
d) The auditor must be independent of all the stakeholders such as management.
e) It is a statutory requirement that financial statements are audited.

Accounting

a) Involves preparation of books of accounts to aid in decision-making.
b) It is a continuous process carried out through out the financial period.
c) In preparing financial statements and maintaining books of accounts, the accountant is guided by generally accepted accounting standards.
d) Accountancy is a management function aimed at assisting management to run the business in an orderly efficient manner.
e) It is a statutory requirement that all companies must maintain proper accounting records.

The need for an audit

Today most businesses are operated by limited companies, which are owned by the shareholders and managed by directors appointed by such shareholders. The appointed management is faced with a conflict of interest i.e. whether to act in the best interest of the company and by extension the shareholders' interest or to act in their best interest. This is what is referred to as the agency problem.

The separation that exists between the owners and management forces the absentee owners to institute control measures to ensure honesty of their company's stewards (i.e. management). The companies Act attempts to remedy this problem by requiring the management to maintain proper accounting records of all the transactions of the company and to prepare financial statements that show a true and fair view to be presented to the shareholders at the annual general meeting.

However, even with this requirement there still exists the risk that the accounting records maintained and the financial statements prepared by management might not be accurate, free from bias and reflect the true financial position and performance of the company. The companies Act therefore goes further to require that management must have the financial statements subjected to an independent examination and a report issued to the shareholders as to whether the financial statements show a true and fair view. The auditor carries out this independent examination. To ensure independence of the auditor the companies Act gives the power of appointment and removal of the auditor from office to the shareholders.

Objectives of an audit

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. (Financial reporting framework refers to the international accounting

standards, provisions of the companies Act and other relevant statutes and legislation). The auditor expresses an opinion as to whether the financial statements give a true and fair view of the financial position and performance of the company.

Other objectives

a) To give credibility to the financial statements. This arises from the fact that the accounts have been subject to an examination by an independent person.
b) An audit may assist in the prevention and detection of errors and frauds.
c) The auditor's experience will enable him to make recommendations on ways of improving the accounting and internal control system.

What is true and fair?

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. What constitutes true and fair is not defined by the Act. Previously the auditor was required to certify as to the truth and correctness of accounts, the phrase true and correct implying arithmetic accuracy. Such an approach ignored the overall view of the accounts, which are prepared using subjective accounting policies and would be difficult to prove. It is not possible to certify that one set of accounts is the correct set, because many accounting areas are subject to a wide variety of interpretations and therefore presentation. As a result the auditor is only required to express an opinion as to whether the accounts show a true and fair view of the state of affairs of the company and of its profit or loss for the period.

NOTE

The auditor only expresses an opinion on the accounts. He does not certify them as being correct.

Benefits of an audit to a public limited company

a. 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.
b. 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.
c. The auditors experience will enable him to make recommendations on ways of improving the accounting and the internal control system.
d. An audit assists in the prevention and detection of errors and frauds through the moral and deterrent effect.

USERS OF AUDITED FINANCIAL STATEMENTS

The annual accounts and report are primarily prepared by the directors to the shareholders. However, the following parties need financial statements.

i. Those parties with vested interests in a business.

1. Employees.
2. Creditors or suppliers
3. Lenders and debenture holders
4. The management
5. The shareholders to whom the financial statements are addressed.
6. Credit rating agencies.

ii. Those with potential interests

1. Potential shareholders
2. Trustees
3. Suppliers
4. Customers

iii. Those with representative interests

a. Lawyers
b. The government
c. The general public.

iv. Others

i. Competitors
ii. Stock brokers
iii. Statisticians
iv. Financial journalists
v. Trade unions.

TYPES OF AUDITS

Audits can be classified in two broad ways according to: -

a) Terms of engagements i.e. nature of work done
b) Method of approach of work done.

a) Terms of engagement-nature of work done.

Statutory audits
These are carried out as per the requirements of the various statutes e.g. the Companies Act cap 486 requires that all public limited companies must have their financial statements subjected to an independent audit. The objectives of the audit are to express an opinion as to whether the balance sheet and the profit and loss account show a true and fair view. The rights and duties of the auditor are laid out in the Companies Act or the relevant statute. The powers of appointment of the auditor are vested on the shareholders.

Private audits
These are audits that are not governed by the Act. These are performed by an independent auditor because the owners, members or other interested parties require them and not because the law requires them to be carried out. Private audits are carried out for organisations such as NGOs, partnerships, clubs and charities among others. 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.

Comparison between private and statutory audits.

SIMILARITIES

1) Both are carried out by qualified auditors.
2) They involve the assessment of the internal control system.
3) They facilitate detection of errors and frauds.
4) Reports issued by the auditors can be used by third parties.

Differences.

Statutory Audits
1. It is a requirement of an Act of parliament e.g. the Companies Act.
2. The scope and objective of work is defined in the Act
3. The report is addressed to the shareholders.
4. Appointment of the auditor is stipulated in the Act (Sec.159). It can either be by shareholders, directors or registrar of companies.
5. The auditor is liable to third parties.
6. The auditor has full independence.

Private Audits
1. It is not a requirement by the Act.
2. The scope is agreed between a client and the auditor therefore it is limited.
3. Report is addressed to relevant stakeholder.
4. Private appointment by the owner.
5. The auditor is not liable to third parties.

b) Method of approach to work.

Continuos audits
This is an approach whereby the audit is carried out throughout the financial period. The audit work is carried out at predetermined intervals usually around three audit visits. This approach is ideal for large organisations with tight reporting deadlines e.g. multinational banks.

Assuming that the work is carried out in three-audit visits spread over duration of four months, the first audit visit will mainly entail carrying out detailed planning of the audit. Work carried out will include;

a. Obtaining a good understanding of the clients business or updating the business understanding obtained in the previous audits.
b. Identifying any developments in the clients business that could have a significant impact on the audit such as new legislation.
c. Identifying any changes that have taken place at the client's that could have an impact on the audit such as changes in management.
d. Determining the number of staff members to be involved in the audit and the level of experience required and whether there will be need to involve experts.

The second audit visit will be carried out usually half way through the financial period work carried out will include;

a. Ascertaining, recording and testing the clients internal control systems.
b. Concluding on the level of reliance to be placed on the internal control system.
c. Carrying out limited analytical review on the interim financial performance of the company. This will include carrying out ratio analysis.
d. Deciding on the level of substantive testing and the nature of substantive procedures to be carried out.

The final audit visit will mainly entail review of the financial statements at the end of the financial year. Work carried out will include;

a. Carrying out substantive procedures on the various account balances
b. Concluding whether there are any significant misstatements in the financial statements.
c. Final analytical review to verify whether the information obtained is consistent and whether the view presented by the financial statements is consistent with the auditors understanding of the business.
d. Forming an opinion as to whether the financial statements show a true and fair view.

Advantages

1 Accounts are usually kept up to date.
2 Errors and frauds are discovered at an early stage.
3 The auditor gathers sufficient knowledge of the business as a result of his frequent visits.
4 Saves time during final audits.
5 Better report is developed, as time spent is more.

Disadvantages

1. It is expensive to have a continuos audit due to the amount of time spent.
2. Frequent disruptions of the clients work during the audit.
3. The auditor's independence may be adversely affected by the continuous presence at the clients premises.
4. Tendencies to over depend on auditing staff to solve accounting problems.
5. Interference of work, which has already been audited by the client's staff.

Interim audits

This is an audit that is usually carried out mid way through the accounting period. an interim audit usually precedes a final audit and is ideal for large to medium size companies.

1 Work carried out during an interim audit usually include;
2 Obtaining an understanding of the nature of the client's business;
3 Evaluating any significant changes in the clients operating environment that could have a significant impact on the client's financial statements such as change in the management.
4 Ascertaining, recording and testing the clients accounting and internal control system.
5 Concluding on the level of reliance to be placed on the internal control system.
6 Plan and design the substantive procedures to be carried out during the final audit;
7 Reporting to management on any significant weaknesses identified in the internal control system.

ADVANTAGES

1. It is ideal for dynamic businesses.
2. Compared to continuous audits it is cheaper.
3. It facilitates final audits.
4. Up to date accounts are kept.
5. Errors and frauds are prevented and detected at an early stage compared to final audits.

DISADVANTAGES

1. Errors are at an advanced stage compared to continuos audits.
2. Over dependence on audit staff to solve accounting problem.

Note that

An interim audit is usually carried in preparation for the final audit at which the financial statements will be reviewed.

Final audits

Usually done at the end of the year on the financial statements i.e. the balance sheet and the profit and loss account. A final audit can be conducted in two ways;

1 As a continuation of the interim audit for large to medium size organisations;
2 For small organisations the audit could be carried out in one single session after the end of the financial period.

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.

OTHER TYPES OF AUDITS

Procedural audits
Requires an examination of procedures or records for reliability and accuracy. At the end the auditor can add new ones, modify existing ones or scrap old ones. Attention is paid mainly to:

a. Company internal control system.
b. Laid down guidelines and procedures.
c. As changes made without auditors' knowledge.
d. Records of the company.

ADVANTAGES

1. Reveals any inefficient procedures.
2. Identifies strengths and weaknesses in the internal control system.
3. Creates harmony and co-ordination of company decision making process.
4. Identifies any bureaucracies

DISADVANTAGES

1. It is expensive.
2. Management can frustrate the whole process if they do not want to reveal inefficiencies.
3. It could lead to duplication of effort.
4. It is tedious especially when many procedures are involved.
5. Sometimes the auditor may not understand technical procedures.
6. Procedures change to respond to changes in the economy on the social setting.
7. Where the internal control system is weak, it is of limited applicability.

Management audits

This involves investigation of the company's entire management to ascertain whether the management is running the organisation in the best interest of the stakeholders. It investigates company's managerial aspects of the business from high to low management. It assesses the efficiency of management to run the organisation in the most viable way.

ADVANTAGES

1. It improves management quality.
2. Help assists in solving any bureaucracies.
3. Reveals weaknesses of management's.
4. The strengths and weaknesses of the internal control system are also seen.
5. It acts as a check to the efficiency of budgetary system.
6. Corrective measures may be initiated immediately.

DISADVANTAGES

1. It lowers the morale of top management.
2. Management is unlikely to reveal its weaknesses when the auditor is present.
3. It is difficult to identify the department that is inefficient as all of them rely on each other heavily.
5. It could lead to frustration of management as it can easily be biased.
6. It is difficult to monitor human actions and responses.

BALANCE SHEET AUDITS

Tests the strength of the internal control system by working backwards to get the initial transactions. It is based on verification of assets by checking;

- Description: Mainly of recording entries.
- Ownership: Prove of ownership either by use of logbooks for cars or title deeds for land.
- Value: Cost and method of depreciation.
- Existence: Is the asset really there?

ADVANTAGES

1. It is cheap compared to other audits.
2. A balanced opinion can be reached.

DISADVANTAGES

1. It is a partial audit.
2. Applied only to business with strong internal control system.

STAGES OF AN AUDIT

In carrying out an audit the following are the main stages. However, note that the steps followed will vary from client to client and from auditor to auditor.

- Determining the scope of the audit work. For statutory audits the scope is clearly laid out in the provisions of the Companies Act and is formally contained in the letter of engagement.
- Ascertain nature of the client's business. The auditor seeks to obtain some background information of the nature of the client's business.
- Planning the audit; the auditor prepares a planning memorandum that shows the general strategy in to be followed in conducting the audit.
- Ascertaining and evaluating clients accounting systems and internal controls, use of flow charts and evaluating using key questions.
- Carrying out tests of controls: This enables the auditor to determine the level of reliance to be placed on the internal control system and therefore reduce the level of substantive testing.
- Planning the level of substantive testing and formulating the substantive tests to be carried out.
- Carrying out substantive testing on the selecting account balances.
- Carrying out the final analytical review and concluding whether the financial statements show a true and fair view.
- Drafting the audit opinion and any other reports to be issued under the terms of engagement e.g. the management letter.

REINFORCEMENT QUESTIONS

QUESTION ONE

Kasuku Company Limited was established in January 2003, to sell and distribute household products. The directors are unaware at to their responsibilities and the nature of their relationship with the external auditors.

Required

a) Explain to the directors of Kasuku Company why there is need for an external audit.
b) Explain the responsibilities of the directors in relation to the accounting function of the company.

QUESTION TWO

What is a value for money audit? Why is it essential?

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK.

LESSON TWO

THE LEGAL AND PROFESSIONAL REQUIREMENT FOR AN AUDITOR

CONTENTS

1. Appointment-companies Act provisions
2. Qualifications of an auditor
3. Removal of an auditor from office
4. Resignation
5. Rights and duties of an auditor
6. Procedures before and after accepting appointment
7. Professional Ethics
8. International Standards on Auditing
9. Reinforcement Questions
10. Comprehensive Assignment

APPOINTMENT:

S.159 (1) provides that "every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting."

REAPPOINTMENT

S.159 (2)" a retiring auditor shall be deemed to be re-appointed without any resolution being passed unless: -

b. He is not qualified for appointment; or
c. A resolution has been passed at that meeting (i.e. annual general meeting) appointing somebody instead of him or providing expressly that he shall not be re-appointed; or
d. He has given the company notice in writing of his unwillingness to be re-appointed.

According to this provision of the company's Act an appointed auditor is deemed to be automatically re-appointed come the next annual general meeting for another term in office unless any of the three mentioned situations exist.

APPOINTMENT BY REGISTRAR

S.159 (3) "Where at an annual general meeting no auditors are appointed or deemed to be appointed, the registrar may appoint a person to fill the vacancy"
The directors have the duty of informing the registrar of the failure by the company to appoint an auditor.

APPOINTMENT BY DIRECTORS

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.

In default of appointment, the first auditors by the directors the company may do so. Where the directors have appointed the first auditors, the company may at a general meeting remove such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company. Notice of nomination to be given to the members at least 14 days before the date of the meeting.

CASUAL VACANCIES

S. 159 (6) "The directors may fill any casual vacancy in the office of the auditor, but while any such vacancy continues the surviving or continuing auditor(s), if any may act."
A casual vacancy may arise out of any of the following reasons;

1. Death of the auditor
2. Incapacitation
3. Resignation

i.e. a casual vacancy arises when any of the above circumstances arise leaving the office of the auditor vacant before the expiry of the term in office under the contract.
The directors of the company may fill a casual vacancy in the office of the auditor.

QUALIFICATIONS

S.161 (1) " 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'. The conditions set out in the Accountants Act include;

Auditor must meet the following qualifications in Kenya:

1. Must be a CPA finalist (Certified Public Accountant) i.e. has passed all exams that are set by KASNEB. Kenya Accountants and Secretaries National Examination Board.
2. Member of ICPAK (Institute of Certified Public Accountants of Kenya) to ensure adherence to professional ethics.
3. Have post qualification experience in an auditing environment for 2 years.

Having fulfilled these requirements the practising certificate is issued upon application by RAB (Registration of Accountants Board).

PERSONS WHO CANNOT BE APPOINTED

Under s.161 (2) none of the following persons shall be qualified for appointment as auditors of a company.

An officer or servant of the company.

a. A person who is a partner of or in the employment of an officer or servant of the company (unless it is a private company)
b. Persons who are disqualified form appointment as auditor of the company's subsidiary or holding company or subsidiary of the company's holding company and
c. A body corporate.

Note:
The first three persons are disqualified because of lack of independence/ to safeguard the auditor's independence. A body corporate (or company) is excluded because an audit is a personal service. It would be inappropriate for one legal person to oversee the activities of another. A Company has limited liability whereas the auditor must be held personally responsible for the quality of his work and the opinion that he gives.

SUMMARY

Directors may appoint:

i. The first auditors. These powers cease after the company's first AGM.
ii. Auditors to fill a casual vacancy arising from the death, incapacitation or resignation of the company's auditors.

The registrar of companies can appoint the auditors of a company if the shareholders and directors fail to do so.

REMOVAL OF AUDITOR FROM OFFICE

S.160 (1) –(4)

i) The auditor can only be removed from office by the shareholders.
ii) Only an ordinary resolution (over 50% majority) of the company in the general meeting is required to remove the auditor from office, but a special notice (28days) of the intended removal should be given to the company and the auditor.
iii) The auditor can make reasonable representations in writing to the shareholders and they must be circulated at the company's expense to everyone entitled to receive notice of the meeting.
iv) If representations are not circulated for any reason, the auditor has the right to have them read out at the meeting.

In the event that the auditor is removed, he still has a
right to attend the AGM at which his term of office would have expired or any meeting at which it is proposed to appoint someone to fill the vacancy created by his removal. He has a right to speak at such meetings on any matter which concerns him as the retiring auditor.

Reasons Why an Auditor might be asked to step down.

1. Disagreements over accounting policies or audit findings where the directors feel that the auditor is taking an unreasonable stance.
2. A desire by management of the holding company to rationalize the audits of the subsidiaries under one firm of auditors.
3. Basic incompatibility between management and the auditor.
4. The auditor threatens to expose management's fraud or curb management's unrestricted use of the company's resources.

Resignation of Auditors

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. A statement to the effect that there are no circumstances connected with the resignation that should be brought to the attention of the members or the creditors.
b. A statement giving details of any circumstances leading to his resignation that he believes should be brought to the attention of the shareholders.

The Act permits the auditor to request the directors to convene an extraordinary general meeting of the company for considering the auditor's explanations of the circumstances surrounding his resignation.

RIGHTS OF AUDITORS

1. Rights of access at all time to accounting records of the company. This includes;

    a. Rights of access to statutory books of accounts e.g. shareholders register, memorandum of association and minutes of important meetings.
    b. Access to returns from branches and vouchers of the company.

2. To require from officers and employees of the company any information and explanations deemed necessary for the purposes of the audit. This includes all information from clients books and vouchers, management representations e.t.c.

3. Rights in relation to general meetings.

    a. To receive notice
    b. To attend
    c. To speak
    d. To receive notice

        - 21 days notice before an ordinary AGM.
        - 7-14 days notice before an extraordinary general meeting.
        - 28 days for a resolution intended at removing him from office.

    e. Rights to clarify or add to his report any material information which came to his knowledge after the report had been dispatched to shareholders but which is in the interest of shareholders.
    f. Right to make a statement at the AGM clarifying accounts e.g. to correct statements whose impression was given by the board to the shareholders wrongly.

4. Rights associated with attempts to remove him from office or not to re-appoint him.

    a. Rights to send representations to shareholders.
    b. Rights to read representations at the AGM if they are not sent in good time because of the default of the directors.
    c. Receive 28 days notice of the meeting.
    d. To speak at the AGM

5. Rights to require that subsidiaries and their auditors provide such information and explanations as are deemed necessary for the purposes of the audit of the holding company.
6. Right to remuneration. Right to be paid audit fees when due, re-imbursed audit expenses incurred in connection with the audit assignment.
7. Rights to legal and technical advice. An auditor may use the work of an expert to get technical knowledge of what may have taken place in the organization.

DUTIES OF THE AUDITOR

a) To report to the members on each set of accounts laid before the company in the general meeting, whether in his opinion.

    a. The balance sheet gives a true and fair view of the state affairs of the company as at the balance sheet date.
    b. The profit and loss gives a true and fair of the profit (or loss) for the period ended on that date.
    c. The accounts comply with the requirements of the company's Act.

b) Duty to state the following in his report.

    i. Whether the auditor has received all the information and explanations which in his opinion was necessary for his audit.
    ii. Whether he received adequate returns from branches not visited.
    iii. Whether in his opinion proper accounting records have been maintained.
    iv. Whether the accounts are in agreement with the underlying records.

c) Duty to provide working papers.
An auditor has a duty to assist investigators in to the company's affairs by providing his working papers, which are summaries of significant matters identified by the auditor during the course of the audit.

d) Duty to certify a statutory report regarding.

    a) Number of shares sold by the company.
    b) Cash received in respect of allotment.
    c) Duty to certify the P&L and Balance Sheet in a prospectus.

e) To include in his report any required information about the directors remuneration which has been omitted from the accounts.
f) To consider if any information in the directors report is inconsistent with the accounts and to report the facts if there are any such instances.

Procedures that a proposed auditor must undertake before accepting nomination

Upon receipt of a request to accept appointment as auditor of an organisation the auditor should carry out the following procedures before accepting nomination.

Before

1. Ensure he is professionally, legally and ethically qualified to act as an auditor. The auditor must ensure that he has not contravened any provisions of the companies Act in regard to independence.

He must ensure that he is not a servant or in
partnership with a servant of the company. He must also ensure that he has fulfilled all the professional ethical requirements in regard to independence. I.e. he must not have any personal, family or business relationships with the prospective client among other provisions.

2. Establish whether the firm's resources are adequate to service the needs of the new client i.e. staff time with the necessary technical competence.
3. Seek references about the status of the company and its management. Such references will assist the auditor in assessing the potential risk in associating with this new client. Information sought would include the reputation of the company and its directors.
4. Communicate to present auditor.

    a. Communication is important;
    b. To get necessary information that could guide him on whether to accept or reject nomination.
    c. To enquire reasons for the change in auditors
    d. It is a detail of professional courtesy

Request permission before hand to communicate with the outgoing auditor, if not granted decline the nomination.

With regard to this communication ICAEW (Institute of Certified Accountant of England and Wales) has laid down the following comments, which we can borrow from:

1. Purpose of communication.
2. Initiative rests with the new or incoming auditor the existing auditor should not volunteer information.
3. It enables all relevant fact to be known by the member before he accepts nomination.
4. The response should be immediate. However communication can also continue in latter days.
5. Issues as to professional considerations, which arise mainly, provide reasons for change.
6. Discuss issues arising with the client and only if they agree should the auditor agree/accept nomination.
7. If the existing auditor holds some belief about an unlawful conduct of the client but is not certain then he should impart his belief to the new auditor.
8. Where there has been refusal to supply information by the client the existing auditor should inform the proposed auditor.
9. When the existing auditor makes a defamatory statement about the client or any other party dealing with the client and it turnout to be untrue, he is not liable if the statements were made without malice unless:
    a. He doesn't state only what he sincerely believes is true.
    b. He carelessly makes imputations against client and third parties.
    c. If the proposed auditor does not get a reply within reasonable time he has reason to believe that there are unusual circumstances surrounding the proposed change. He should get in touch through other means or send a further letter saying that unless he receives a reply he shall assume that there are no other issues to be considered.

After accepting nomination

i. Ensure that the removal or resignation of existing auditor is properly carried out in accordance with Cap 486.
ii. That the (his) appointment is valid obtain copy of new resolution passed in AGM to appoint him.
iii. Set up a letter of engagement to the directors of company.

Audit engagement letter-ISA 210

Ensure that you read and understand ISA 210
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. It is in the interest of both the

client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement.

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
- 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 that 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.

Main contents of an engagement letter
Refer to ISA 210 Paragraphs 6-8

The form and contents of an engagement letter may vary from client to client but would generally include;

1. Responsibilities and scope of the audit.

    - Responsibilities of client to give/maintain proper record of account and prepare financial statements showing true and fair view.
    - A description of the work to be carried out

1. The form of any reports or other communication of the results of the engagement.
2. The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is unavoidable risk that some material misstatements may remain undiscovered.
3. That the auditor will have unrestricted access to whatever records, documentation and other information requested in connection with the audit.
4. Details of other services to be provided such as taxation and management consultancy work
5. Fee: Basis on which it is computed, rendered and paid.
6. Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
7. Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

Recurring audits

Refer to ISA 210 Paragraphs 10-11
Where the auditor is carrying out an audit for more than one financial period, he should consider whether circumstances require the terms of engagement to be revised and whether there is need to remind the

client of the existing terms of the engagement. The
auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter;

1. Any indication that the client misunderstands the objective and scope of the audit.
2. Where there are changes to the initial terms of engagement.
3. Where there is a change in senior management or ownership.
4. Where there is a significant change in the nature or size of the client's business.
5. Changes in legal requirements e.g. if new legal provisions call for a change in the scope of the work.

8. PROFESSIONAL ETHICS

These are the rules of conduct that govern the behaviour of an accountant. These are issued by ICPAK. The auditor gives credibility to financial statements and to do this he must be credible himself. To be credible, the auditor must possess and be seen to possess certain qualities:

1. **Integrity:** Straightforward honest and sincere in his approach to his professional work. A member must be aware of his role in the society and maintain high standards of conduct and should not certify what he knows is untrue as true and should take caution not to mislead intentionally or unintentionally.
2. **Competence:** He should carry out his work with due care and skill in conformity with professional and ethical standard issued by ICPAK or 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 bookkeeping, auditing, financial management, information technology, receivership, liquidation and bankruptcy law, contract 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 judgement. This is in professional as well as economic issues. He should be a good communicator.
3. **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 clients employer or other proper source 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 orfor the advantage of a third party.
4. **Independence:** The guide states that this is a fundamental concept to the accounting profession. It is essentially an attitude of mind characterised 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 judgement. A member not in practice may be unable to be or seen to be free of any interest which might conflict with the proper approach to his professional work. However this does not diminish his duty of objectivity in relation to that work.

Guidance of matters of Independence
Professional independence is considered to be crucial to the life of a professional accountant. Therefore guidance is given on the best code of conduct in situations where the accountants independence may be compromised or impaired.

i. Fees
It is undesirable for a practice to receive to significant a proportion of recurring fee income
from a client or a group of connected clients. A new or old practice in decline may be unable to comply with the criteria. Therefore when an accountant finds himself with such a client he need not resign immediately but should in the first instance look for opportunities to reduce the significance of that client such as by looking for more work.

ii. Personal or family relationships

These relationships can impair independence. Therefore an accountant should take steps to ensure family or personal relationships do not interfere with objectivity in approach to his work.

iii. Financial involvement with a client.

- Beneficial shareholding: A partner in an accounting firm, spouse of such a partner and minor children of such partners should not have beneficial shares in an audit client. If appointed as auditor when possessing such shares the member should dispose of them at the earliest opportunity. If the company's article of association require that the auditor has qualified 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.
- Loans to and from client: An accounting firm should not accept loans from its clients or give loans to clients. This includes guarantees. A firm may, however accept a loan from a client if it is that clients' ordinary course of business to give loans. Loans thereof should not be accepted on terms more favourable than those available to others.

iv. Goods and Services

Members should resist from accepting goods and services from the client on terms more favourable to the generality of the client's employees. Undue hospitality poses a similar threat to a member's independence.

v. Conflicts of interests.

- 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 that the client takes full responsibility for that work.
- Competing clients in conflict; the member should frankly disclose to both parties and advice them to choose another auditor and then disengage one of the appointments. However he can also provide advice to resolve the conflict.
- 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. If there is a company which a member has been a receiver of and the receivership ends, a member who has the receiver should not accept an appointment unless two years have elapsed. A member who is a receiver of a company which goes into liquidation should not accept an appointment as liquidation 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 2 years have elapsed.

Publicity Advertising and Obtaining Professional Work

Under the Accountancy Act, advertising is prohibited. Members of ICPAK resolved in 1997 to permit advertising.

1. General Consideration

A member may seek to promote the services he/she offers through advertising or other means so long as this is consistent with the dignity of the profession and it does not project an image inconsistent with that of a professional person bound to high ethical and technical standards. A member should use judgement in determining whether a course of action will be inconsistent or not.

2. Advertising

- An advertisement should not mislead through claims that are not substantial and must observe strict standards as to legality, decency, clarity, honesty and truthfulness.

- A member may advertise services subject to the general requirements that the media should not, in the opinion of the council of the institute, reflect adversely on the member, the institute or accountancy profession. The advertisement in itself should not;

  a. As a content or presentation bring the institute into dispute or discredit to the members, the firm or accountancy profession.
  b. Discredit the services offered by other members, whether by proclaiming superiority for the advertisers of the services or otherwise.
  c. Contain comparisons with other members or firms.
  d. Contain testimonies or endorsements.
     Particular care should be exercised if references to size or quality are to be included in the advertisement for example it is difficult to establish whether a claim to be the largest firm is in reference to number of partners or staff, or to offices or the amount of fees income.
  e. A claim to be the best firm is subjective and not sustainable.

- Although advertisement may refer to the bases 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.

1. Publicity

Publicity for members is accepted as long as it does not cast the institute and the accounting profession into disrepute or project the member in any way that is inconsistent with the dignity of the profession.

2. Solicitation

A member may contain or seek professional work by any direct approach to a prospective client.

Charging for professional work

Statement number 9 of ethical guidelines proves that fees for professional services should not be charged on a percentage or similar benefit unless where that source is authorised by statute or is a generally accepted practice for certain specialist's work nor, should instructions be accepted on a contingency basis for example a bonus of 5% on profits. The explanatory not amplifying this statement states that:

The principle is that the independence of judgement of the member should not be impaired by the hope of a financial gain. Therefore any basis of fees which may influence the practising members judgement or findings or which may even subject him in the public eye to the suspicion that his judgement was improperly influenced is to be extended. Therefore, fees should be computed in reference to:

- The skill and knowledge required for the type of work involved for example if the work required an expert the fees would be higher.
- The seniority of the person necessarily engaged in the work.
- The time necessarily engaged on each person on the work.
- Nature of responsibility, which the work entails.

9. 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.

National standards on auditing published in may countries differ in form and content. International Auditing Practices Committee (IAPC) takes cognisance of such documents and differences and in the light of such knowledge issues auditing standards which are intended for international acceptance.

These standards:

a. Are applied in the audit of financial statements or to the audit of other information.
b. Contain basic principles and essential procedures together with related guidance in form of explanatory and other material.
c. Have to be understood wholly and not in part so as to understand and apply them.
e. May be departed from in exceptional circumstance so as to more effectively achieve the objective of an audit.
   Need only be applied in material matters.

REINFORCEMENT QUESTIONS

QUESTION ONE

State how a company may appoint its auditors under the company's Act;

QUESTION TWO

State the procedures that a shareholder intending to remove the auditor must follow under the companies Act.

QUESTION THREE

In additions to the guidelines issued by ICPAK on professional independence, suggest other steps that may be undertaken to improve auditors' independence.

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT NO. 1

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

Answer all the questions

QUESTION ONE

a. Why is an external audit necessary for companies registered under the Companies Act? (4 marks)
b. Under what circumstances is one ineligible for appointment as an auditor of a company? (4 marks)
c. Explain the procedure a company has to follow when changing its auditors. (6 marks)
d. List the rights and duties of an independent auditor. (6 marks)

(Total 20 Marks)

QUESTION TWO

Write down steps to be followed before accepting nomination as an auditor.

(Total 20 Marks)

QUESTION THREE

a. What is the purpose of sending an engagement letter to a new client? (10 marks)
b. Under what circumstances is it necessary to amend a letter of engagement? (10 marks)

(Total 20 Marks)

QUESTION FOUR

List the ethical guideline issued by ICPAK to its members

(Total 20 Marks)

END OF COMPREHENSIVE ASSIGNEMENT NO. 1

NOW SEND YOUR ANSWERS TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON THREE

INTERNAL CONTROL SYSTEMS AND INTERNAL AUDIT

CONTENTS

1. Definition of accounting system, internal control and control environment.
2. Types of internal control.
3. Advantages and disadvantages of internal control systems to the auditor and to the client.
4. Limitations in application of internal control system.
5. Tools and techniques used to assess the strengths or otherwise of internal control system. (Evaluation of ICS)
6. Internal Auditing
7. Reinforcement questions

ACCOUNTING AND INTERNAL CONTROL SYSTEM

Refer to ISA 400

Definitions

Accounting systems

Refers to the systems and procedures that management has put in place to ensure that the company maintains proper books of accounts. The auditor should ascertain the client's system of recording and processing transactions and assess its adequacy as a basis for the preparation of financial statements.
An accounting system provides for the orderly assembly of accounting information and appropriate analysis to facilitate the preparation of financial statements.

The management of an organisation requires complete and accurate accounting and other records to assist in:

a) Controlling the business
b) Safeguarding the assets
c) Preparation of the financial statements
d) Complying with legislation

Internal controls

If the auditor wishes to place reliance on any internal controls he should ascertain and evaluate those controls and perform compliance tests on their operation. If the clients system is evaluating as being effective, the auditor can rely on these controls and reduce the level of detailed substantive work.

Definition

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 of ensuring, as far as practicable the orderly and efficient conduct of its business, including adherence to management policies, safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information. The internal control system extends beyond these matters, which relate directly to the functions of the accounting system.

Control environment ISA 400- Paragraph 8

This refers to the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function can significantly complement specific control procedures. Factors reflected in the control environment include:

a. The function of the board of directors and its committees.
b. Management's philosophy and operating style.
c. The entity's organisational structure and methods of assigning authority and responsibility.
d. Personnel policies and procedures and segregation of duties.

Importance of the internal control system

1. Enables management to carry out the business in an orderly and efficient manner. Internal controls lay out the various procedures to be followed in conducting the affairs of the organisation. E.g. There will be procedures laying out the procedures to be followed in procuring raw materials
2. Ensures adherence to management policies
3. Management policies vary from the broad objectives to the detailed policy matters necessary to make those objectives realisable.
4. Safeguard the company's assets
   Some controls are designed specifically to ensure the assets of the company are protected from theft, destruction and that they are used in the best interest of the company.

This can either be directly through physical locking up or indirectly through recording. It includes assessing assets and ensuring that any access is authorised. Also ensure that accuracy and completeness of accounts is maintained.

5. ICS help in ensuring completeness and accuracy of the records maintained. The company's Act requires that a company keep proper books of accounts. These records are the basis for the preparation of the financial statements.
6. Strong internal controls help in preventing and detecting errors and frauds. The responsibility for the prevention and detection of fraud and error rests with management. This is achieved through the implementation and continuous operation of an adequate system of internal controls. Such a system reduces but does not eliminate the possibility of fraud and error.
7. For the auditor a good system justifies a reduction in the level of substantive testing but does not eliminate it fully.

TYPES OF INTERNAL CONTROLS

This refers to the various types of control procedures that management can put in place in running the operations of the company. The mix of types of controls implemented by management will depend on the control objectives in each accounting area.

(a) Organizational plans/controls

Companies should have proper organisation plans.
They seek to ensure that the entity is properly departmentalised. The functions of every department are specified and the duties of every individual in the department are specified. Delegation of authority and limits of authority should be well and clearly defined. Such a plan boosts accountability within the organisation and reduces duplication of effort.

(b) Segregation of duties

This refers to the separation of the various duties and responsibilities such that one person cannot process and record complete transactions from beginning to the end without being checked by another person. E.g. in the purchase of a company's fixed assets a single individual should not authorise the purchase, place the order, receive the asset and record the transaction in the accounting records.
To minimise the risk of error and/or intentional manipulation of information. In this regard for every transaction the following functions should be performed by different individuals and departments as much as possible and practicable.

1. Initiation
2. Authorisation- different levels of management should be given authority limits as to what they can authorise or commit the company's resources. The authority limit should depend on the position, integrity, qualifications and competence.
3. Execution- transactions should be carried out by persons independent from those who authorise the transactions. If one person authorises expenditure a different person should execute.
4. Custody of the asset- officials authorisin/executing a transaction should not have custody to the assets arising out of the transaction.
5. Recording
6. Segregation of duties also covers internal check which refers to the activities of one person must be complementary to the activities of another or subjected to independent checking.

(c) Physical controls

These are security measures concerned with the custody of assets by limiting access to authorised people only.
Restriction of access to valuable assets to only authorised persons. There should be direct measures and indirect measures.

Direct measures include:-

a. Lock and key
b. Watchmen or guards
c. Proper fence

d. Mirrors
e. Closed circuit TV's

Indirect measures will include documentation of all transactions. Controls aim at restricting valuable, portable, exchangeable and desirable assets.

(d) Authorisation and approval

Authorisation should be done by responsible persons. In other words a transaction that commits organisation's resources should be subject to authorisation and approval by a responsible official. The limits for authorisation should also be specified.

(e) Arithmetical and accounting control.

These are controls within the accounting function, which check that transactions are authorised, correctly and accurately recorded. This is aimed at ensuring completeness and accuracy of the accounting records. Key features are:

i. Use of standardised documentation raised at every stage of the transaction.
ii. Use of pre-numbered documents.
iii. Documents should be issued in sequence.
iv. Monitor movement of documents by use of a register.
v. Production of exceptional reports for example when a local purchase order has been raised and the order has not been fulfilled by the supplier.
vi. Reconciliation between the different accounts and related control accounts.

(f) Personnel

Proper functioning of any system is dependent on the competence and integrity of those operating it. The entity must therefore recruit competent staff who have integrity. Staff should be assigned responsibilities that match their capabilities. Staff should undergo proper training to ensure that the company's operations are carried out in the best way possible.

(g) Supervision

Day to day transactions and their recording should be subjected to supervision by competent responsible officials.

(h) Management controls

These controls are exercised by management outside the day to day routine of the system. They include:

i. Review of management accounts.
ii. Comparison of actual performance with budgets.
iii. Internal audit function.
iv. Any other special review procedures.

(i) Rotation of duties

Duties should be rotated between personnel at the same level. Staff should be encouraged to take annual leave.

(j) Routine and automatic checks.

These are checks conducted on routine duties and operations to ensure that they are operating efficiently. Such checks are conducted on a surprise basis to minimise errors and frauds. These include controls such as 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 systems. Internal audit carries out continuous evaluation of the operating effectiveness of the internal control policies and procedures. The findings and recommendations are reported to management. *Refer below*

Limitations of the internal control system- ISA 400 Paragraph 14

No internal control system, however elaborate, can be by itself guarantee efficient administration and completeness and accuracy of the records nor can it be proof against fraudulent collusion, especially on the part of those holding positions of authority and trust. This is mainly due to the following inherent limitations of an internal control system:

a. Management has to ensure that the benefits expected from an internal control system outweigh the costs. As a result certain important controls might not be put in place due to the costs involved. e.g. a small entity might not have the resources to employ sufficient staff to ensure proper segregation of duties.
b. Most internal controls tend to be directed towards routine transactions rather than non-routine transactions. This leaves gaps that can be exploited.
c. Human error due to carelessness, distraction, mistakes of judgement and misunderstanding instructions could undermine the internal control system.
d. Controls could be circumvented through collusion by a member of management or an employee with persons outside or inside the entity.
e. Abuse of responsibility e.g. a member of management overriding an internal control
f. The possibility that procedures maybe inadequate due to changes in conditions.

ADVANTAGES AND DISADVANTAGES OF INTERNAL CONTROL SYSTEM

Advantages of ICS to the Auditor

a) ICS will reduce the amount of audit work to be done in so far as the auditor will be able to use systems based audits to apply tests which will facilitate his audit work.
b) A strong ICS will minimise chances of errors and frauds, and the introduction of inter-checking supervision and improved custody will in turn minimise liabilities to third parties, who would have depended on his opinion with greater surety and speed.
c) Will reduce the amount of audit evidence to be gathered, because it will facilitate reaching and using a greater variety of audit evidence available within the business. This will enable him to form an opinion with greater surety and speed.
d) The presence of an internal check system strengthens the credibility of audit evidence gathered.
e) ICS minimises the work load and the time need to take in order to produce his report.
f) The preparation of an ICS will identify those areas prone to errors and frauds, which will enable the auditor to plan his audit work so that he allocates more time and effort to those areas where for organisational reasons the internal check system is weakest.
g) ICS emphasises the use of control accounts thus assuring the auditor of up to date account reconciliation information which will facilitate his examinations.
h) ICS enables him reduce the sample size to be tested and thus facilitate his ability to carry out as many varied audit checks as possible.
i) ICS can only be strong normally with support of a strong internal audit function which in turn enables the auditor to use internal auditor's work to facilitate his work.
j) A strong ICS boosts accountability which depends on clearly segregated and defined duties and responsibilities and this will enable the auditor to know who to contact in case of difficulties.
k) It also helps him to give quality advice to management; this in turn may minimise his work load in future audits.
l) ICS enables the auditor to have greater knowledge of his client's business and facilitates the drawing up of a balanced audit opinion.

Disadvantages of ICS to the Auditor

1. The management may over rely on the strength of the ICS and therefore relax their supervision which may leave room for errors and frauds thus exposing the auditor to potential civil liabilities.
2. The presence of ICS may lead to the auditor reducing the volume of examination carried out which may lead to smaller samples of data thus leaving other areas to possibilities of errors and frauds which may expose him to civil liabilities.
3. It may be frustrated by management through collusion and manipulation which may mislead the auditor's opinion leading to biased reports.
4. The presence of ICS is supposed to minimise the auditor's volume of tests but not his liabilities which means that its strength may leave some errors and frauds undetected due to relaxed tests. This will increase his liabilities. ICS may be manipulated so that errors and frauds by the management cannot be easily detected and this may lead to a biased opinion.
5. ICS may reduce the auditor's vigilance and observations with an unfavourable effect on the quality of the audit.
6. ICS may be abused by the internal auditors through collusion with the management and this may lead to the external auditor being mislead.

Advantages of ICS to the Client

a. Safeguarding client's assets against:

    a) Misuse
    b) Misappropriation
    c) Manipulations
    d) Abuse of the Company's assets (for reasons that will not benefit the Company)
    e) Facilitates optimal use of the Company's assets.

b. Reduces audit fees. This is because less audit work is needed and less audit staff.
c. Increased efficiency through management supervision and a defined organisation chart. Routine and automatic checks also increase efficiency.
d. Chances of errors and frauds are minimised.
e. This ensures minimum losses, facilitates audit work and hence early reports and attainment of budgeted performance.
f. Facilitates corrective measures in so far as the objectives of the business are better defined and therefore the facilities available can be suitably directed to their achievements.
g. Facilitates up to date records.
h. This is advantageous in that is prompts decisions through feed back to management which helps detect irregularities.
i. Leads to balanced opinion (unqualified report) improving public opinion of the business.
j. This helps in raising finances by selling shares through public sale and improving investment implementation.
k. It boosts morale of staff through motivation of supervision. This may lead to high output and high profitability.
l. ICS helps in the redress of disastrous decisions especially in high risk situation. This is done through close application of management controls in development situations.
m. ICS assists in the co-ordination of operations. This is done through definition of duties and responsibilities of all employees and it boosts efficiency in the:

    1. Carrying out of operations,
    2. Efficiency in delegation,
    3. Efficiency in execution.

Disadvantages of ICS to the Client

a. ICS is expensive to install and maintain. For example, the physical control security systems require qualified personnel to maintain them and constant servicing.
b. ICS could lead to a problem of over reliance on the ICS. This may lead to relaxation in supervision and allow manipulation of accounts and assets and can also bring about inefficiencies. Maintaining controls requires constancy and consistency.
c. If not well instituted it may encourage over staffing.
d. Rigid implementation may lead to a slow down in the operation of the business.
e. The ICS requires continuos updating as the organisation changes, if not the ICS may become increasingly obsolete.
f. Use of wrong controls may expose the Company to more problems, e.g. errors and frauds. These are more easily perpetrated if the ICS used is inappropriate.
g. ICS may be frustrated if through changes in company organisation the checks become uncoordinated.

Ascertaining, recording and evaluating systems of internal control by the auditor

The auditor will need to ascertain and record the internal control system in order to make a preliminary evaluation of the effectiveness of its component controls and to decide the extent of his reliance thereon. 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 limitations of even the most effective internal control system, it will not be possible for the auditor to rely solely on its operation as a basis for his opinion on the financial statements.

Ascertaining

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

- Utilising the clients accounting and control manuals which describe the accounting and internal controls.
- Obtain and rely on systems records and descriptions prepared by internal audit.
- Interview responsible officials as to the nature of their duties, the control procedures they are responsible for.
- Observing procedures being performed in order to perceive clearly the nature of the controls involved.
- Rely on prior year's system notes.

Recording the system of internal control

- Having identified the controls that management has put in place it is important to create a documentary record of the internal control system. The following approaches are used in recording the system.
- Flow charts
- Narrative descriptions
- Questionnaires

Flow Charts

These are diagrammatic presentations of the Company's procedures and processes and are designed to show the movement of documents through the originating and checking function.

Standardised symbols are used to represent the flow of documents and information through the system. This makes understanding easier and eliminates the need for lengthy narratives in explaining the system. Flow charts should be kept simple, so that the overall structure or flow is clear at first sight.

Advantages of using flow charts

- Easy to prepare
- Since the information is presented in a standard form, flow charts are easy to follow and review.
- They generally ensure that the system is recorded in full, all the documents have to be traced from beginning to the end.
- They eliminate the need for lengthy narratives and can be very effective in highlighting the salient features of internal controls and any weaknesses in the system.

Disadvantages

- They are only suitable for describing standard systems, procedures for dealing with unusual transactions will normally have to be recorded using narrative notes..
- They are useful for recording the flow of documents but once the records or assets to which they relate have become static they can no longer be used for describing the controls involved. E.g. controls over fixed assets.
- It is difficult to make major adjustments to the recorded system without the need to re-draw the entire system.

Use of questionnaires

These comprise a list of questions designed to determine whether the internal control system is designed with 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. A yes answer implying that desirable controls have been put in place and a no answer implying a weakness in the internal control system. There are two types of questionnaires

- Internal control evaluation questionnaire- ICQ
- Internal control evaluation questionnaire –ICEQ

Internal control questionnaire

This refers to a list of questions that are designed to establish whether the the company has put in place desirable control to ensure that the affairs of the company are carried out in an orderly efficient manner. Examples of questions that may be included in a ICQ over cheque payments

- Are all cheques crossed? Yes/No
- Are unused cheque books kept in safe custody? Yes/No
- Is the function of drawing cheques independent from those of ordering goods?
- Are supporting documents attached and verified before cheques are prepared and presented for signature?
- Yes/NO
- Are at least two signatures required on all cheques drawn? Yes/No

Internal control evaluation questionnaire

These questions seek to establish whether specific errors or frauds could occur rather than establishing whether certain desirable controls are present. Only few key control questions are used concentrating on the significant errors or omissions that could occur at each phase of a transaction cycle.

E.g. an ICEQ over sales

Is there reasonable assurance that:

- Sales are properly authorised? Yes/No
- All goods despatched are authorised? Yes/No
- All invoices are accurately prepared? Yes/No
- All invoices are recorded? Yes/No

Narrative descriptions

This refers to the recording the accounting system in narrative form. Narrative descriptions are preferable for very simple systems where all the documentation/transactions are handled by only one or two persons or for recording specific aspects of the system in large companies. Narratives could be used to explain procedures recorded on flow charts. Narratives are easy to record but are difficult to change. The purpose is to describe and explain the system, at the same time make any comments or criticisms which will help to demonstrate an intelligent understanding of the system.

Confirming the system

Having recorded the system, the auditor then needs to confirm whether the system recorded exists and is operational and he has the correct understanding of the system. This is done by use of walk through tests. A walk through test consists of tracing a few transactions, in each accounting area from initiation through the final recording.

Evaluating the system

Having documented the accounting and internal control system and confirmed its operation by means of walk through tests the auditor will commence his evaluation. The auditor evaluates the client's system in order to decide if the system is suitably designed and constitutes a reliable basis for the preparation of the financial statement. The evaluation will normally be carried out concurrently with the 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 in evaluating the system. The questionnaire is based on key control questions. Key control questions seek to establish whether certain desirable controls exist and whether certain errors and frauds could occur.

Examples of key control questions that could be applied in the evaluation of the system of accounting for sales, debtors and receipts:

- Can goods be despatched or leave the premises without being invoiced?
- Can goods be sold to a bad credit risk?
- Can errors occur in raising the invoices?
- Can sales be invoiced but not recorded?

Examples of ICEQ/Key control questions over wages and salaries

- Can employees be paid for work not done?
- Can bonuses or commissions be wrongly paid?
- Can P.A.Y.E, NHIF and other staff deductions be wrongly recorded?
- Can the wages and salaries be inflated by inclusion of ghost workers?
- Can wages and salaries be paid at the wrong rates?

Examples of ICEQ/Key control questions over purchases, creditors and payments

- Can the company incur liabilities for goods/services which are either not authorised or not received?
- Can liabilities be incurred but not recorded?
- Can liabilities be over/under stated?

Note

ICQs and ICEQs are used:

- As a method of ascertaining the system.
- Enabling the auditor to review and assess the adequacy of the system.
- Enabling the auditor to identify areas of weakness.
- Enabling the auditor to design compliance tests/tests of controls and to familiarise themselves with the system quickly and comprehensively.

ICEQ operate on the basis of key control questions, which are designed to cover the principal objectives of any control system. The key control questions seek to determine what errors of frauds could occur if proper controls are not put in place to address the key control objectives.

Performing tests of controls on the system/compliance tests

If the system is evaluated as suitably designed the auditor then plans to carry out tests of controls/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 throughout the period.

The auditor carries out tests of controls 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 a tests of controls but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and consequently serve as tests of control.

Tests of controls may include:

- Inspection of documents supporting transactions and other events to gain assurance that internal controls have operated properly e.g. inspecting a purchase order to verify that it has been signed as evidence of authorisation.
- Inquiries about and observing of internal controls which leave no audit trail. E.g. Observing that appropriate security measures are undertaken during the pay out of wages.
- Re-performance of internal controls e.g. reconciliation of the bank accounts to ensure that the client's bank reconciliation statements are accurately prepared.

When obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation of controls recognises that some deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in the volume of transactions and human error.

Action taken when weaknesses are identified in the ICS

- The auditors should bring this to the attention of the management immediately and discuss remedial and corrective measures (this precedes the management letter).
- The auditor should consider changing his audit approach by increasing the level of detailed substantive testing.
- The auditor should increase the sample size, i.e. test as many entries as considered necessary to avoid leaving errors and frauds undetected.
- He should record significant weaknesses in the management letter, and should also give his recommendations.
- If the weaknesses are persistent and significant, he must mention this to shareholders for appropriate action to be taken.
- If the ICS is extremely weak such that he cannot depend upon it to apply any tests, then he should qualify his report or at best give a disclaimer opinion.

Management letters

Although the statutory reporting requirements of the companies Act only call 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 the strengths and weaknesses of the accounting and internal control system as well as material issues arising from the review of the financial statements.

Purpose of the management letter

- To enable the auditor to give his comments on the accounting records, accounting system and related controls examined during the audit. Weaknesses in the ICS that have come to his attention and might lead to material errors should be highlighted and brought to management's attention. The auditor should also give recommendations on ways of improving the system.
- To provide management with advice e.g. suggest how resources could be utilised more efficiently.
- To communicate matters that have come to the auditor's attention that might have an impact on future audits. E.g. introduction of a new accounting standard.

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 the audit. Before documenting the weaknesses in the management letter, the auditor should discuss these with appropriate officials involved. this will eliminate the possibility that the auditor may have misunderstood the operation of the system and will also enable the company to make quick corrective action. The management letter should be addressed to the board of directors or the audit committee.

The timing of the report will vary. It will often be useful to complete the compliance testing before submission, in order that weaknesses in the accounting system may be included. However, serious weaknesses discovered should be reported immediately. This might make it necessary to submit more than one letter. in most instances a management letter is usually sent after each audit attendance and finally one should be sent after the end of the audit.

This letter acts as effective feedback that assists management in running their company more efficiently and this in turn helps to promote a constructive relationship between the auditor and client's management, which will assist in the conduct of future audits.

Such a report would also protect the audit firm should things go wrong because if weaknesses are merely discussed without confirmation in writing, there is always the danger that the client could blame the auditors for any subsequent problems resulting from failure to rectify the weaknesses.

The letter should be both objective and constructive. The auditor should request for comments from management to all the points raised, indicating what action management intends to take as a result of the comments made in the report.

The Auditor and the ICS

1. Before an auditor begins any part of his audit work, he must assess the strength of the ICS on which he intends to place reliance and this is even more important under systems based audits because the ICS will influence his audit plan, sample size, and above all the quality and number of audit assistants he intends to use.
2. If reliance is to be placed on the ICS the auditor should ensure that there is sufficient evidence to show that the ICS or controls on which he intends to place reliance have been working properly or effectively throughout the period under review.
3. The extent of reliance upon the ICS will depend on such factors as:

- His past experience with the Company's ICS.
- Any increase in the volume of business transactions.
- Changes in line managers or other top management officials. Such changes may effect the implementation of existing controls.
- Changes in accounting policies and practices.
- Changes in the size of the Company, i.e. through contraction or expansion.

In all, the presence of a strong ICS can serve to reduce the auditor's work load, i.e. enable him to apply tests but this does not reduce his liabilities.

INTERNAL AUDITING- ISA 610

Definition- refer to ISA 610 Para 3

This is an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things to, examining, evaluating and monitoring the adequacy and effectiveness of the accounting and internal control systems. Internal audit entails independent and constant appraisal of the company's activities, operations and controls so as to safeguard the company's assets, ensure reliability of the company's records and efficiency of operations all of which are aimed at assisting the management to manage the business better. It acts as a watchdog over the company's entire controls although it can be regarded as one of the controls in itself.

Scope and objectives of an internal audit function

The scope and objectives of internal audit depends on the size and structure of the entity and the responsibility assigned to it by management. Ordinarily these would include the following:

a) Review of the accounting and internal control systems. Management is responsible for establishing an internal control system. These systems demand proper attention and continuous review, a function that is usually assigned to internal audit. The internal audit function designs a work plan that shows the areas and control procedures that will be reviewed during the year.
b) Carrying out examination of financial and operating information. This may include detailed testing of transactions and accounting and operating procedures.
c) Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
d) Review of the entity's compliance with laws and regulations. The internal audit function reviews whether the company has put in place appropriate procedures to ensure that all the relevant laws and regulations are adhered to. This will include review of adherence to laws such as taxation legislation, stock exchange listing regulations among others.
e) Review of the entity's compliance with management policies and other internal requirements.
f) Carrying out independent investigations into the affairs of the company as required by management. The internal audit function will carry out investigations e.g. where frauds are suspected, where there is suspected inefficiency in the use of the company resources e.t.c

Comparison of the internal auditor with the external auditor

Although there are a lot of similarities between the internal and external auditor, the internal auditor is part of the management of the company and does not therefore meet the prime criteria required of an external auditor.
Areas of common interests include:

a. Both are interested in the effective operation of the internal control system.
b. Both are interested in ensuring that the company has maintained complete and accurate accounting records.
d. Both are interested in ensuring that the assets of the company are safeguarded.

Differences

- 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.

Placing reliance on the work of the internal auditor by the external auditor.

Before deciding whether to rely on the work of the 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 hence how much reliance that can be placed on the work that it carries out. The external auditor can only rely on the work of the internal auditor as one element of the internal control system.

Evaluation criteria

In evaluating this function the external auditor should consider the following factors:

1. Organization status

Since internal audit function is part of the entity it cannot be totally independent. To boost it's independence the status of the function within the organization should be such that the internal auditor reports to the highest level of management. The internal auditor should also be free of any other operating responsibility such as performing accounting functions, which may conflict with his role as an independent watchdog of controls and operations of the entity. There should be no restrictions placed upon his work by management. Such restrictions could impair the effectiveness of the function.

2. Scope of the function

The external auditor should ascertain the nature and depth of coverage of internal audit assignments. He should also ascertain whether management considers and acts upon internal audit recommendations. Where the recommendations are not acted upon this represents a weakness in the function and hence the level of reliance should consequently be reduced.

3. Technical competence

The external auditor should ascertain whether internal audit work is performed by persons having adequate technical training and proficiency as auditors. Qualifications and experience of the internal audit staff should be considered.

4. Due professional care

The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. Exercise of due professional care is evidenced by the existence of adequate audit manuals, work programs and working papers.

5. Internal audit reports

The external auditor should consider the quality of the internal audit reports prepared and submitted for management action. He should ascertain whether management considers, responds to and acts upon internal audit reports and whether there is evidence to prove that action.

6. Level of resources available

The external auditor should consider whether internal audit has adequate resources to be able to carry out their duties effectively. Such resources would include staff and computer facilities.

Benefits/advantages for the Internal Auditor

Gains by co-operating with external auditor:

1. The IA will benefit from the management letter as it will be used to boost the strength of ICS and may in particular reinforce the internal auditor's recommendations to the BOD.
2. The IA may use the contents of the management letter with authority to facilitate change in the company and thus increase the company's efficiency.
3. The IA will use the experience of the external auditor which accrues to him from wide exposure to various companies and such experience will be used by the IA to improve the company's operational efficiency and its controls.
4. This co-operation will boost the confidence of the management in the IA which will help in conducting efficient internal audits.
5. The external auditor can advise him on ways to improve not only the ICS but also tests and programmes.

Advantages of Internal Audit Functions to a Business

a. The IA function reinforces the application of ICS and thus enables the company to run in an orderly manner.
b. The presence of this function acts as a deterrent measure to errors and frauds through, for instance, the maintenance of ICS and boosting of accounting staff morale.
c. It safeguards the assets against misuse. Using the ICS and periodic verification of assets.
d. It assists the company to achieve its objective through adherence to laid down policies and in particular through the use of constant reviews of budgets and forecasts. This will assist in the decision making process so enhance efficiency.
e. The department assists the management in implementation of policies through reporting on the degree of adherence to laid down policies and the nature of any deviation there from.
f. The IA will assist the external auditor in highlighting areas with weak ICS. This minimises audit time that would have been necessary under normal circumstances to complete the external audit task.
g. The department acts as a preventive measure against errors and frauds through periodic comparison of budgets and actual situations investigating the variance, routine and surprise checks on sensitive assets, also using responses from third parties as independent confirmation of company accounts.

Limitations of Internal Audit Function to the Business

i. The cost of installing and maintaining the department is high, in particular for large companies, as they may need to employ qualified accountants to manage their activities. In small companies, the department may not be justifiable.

ii. The management may ignore reports or recommendations by this department thus:

- Frustrating efforts of the department and this may lead to apathy in the internal auditing function and thus inefficiencies.
- This may lead to errors and frauds left undetected due to the frustration mentioned above.
- Other departments which it is supposed to appraise may ignore it and this may lead to inability to undertake independent appraisal.

iii. Lack of recognition by the management.
Top management may not utilise the department for purposes for which it was intended either by not taking its recommendations seriously or by not according it a chance to undertake serious appraisals of their activities.

iv. The following may cause apathy:
The department is keen on pointing out problems without giving out solutions.
It concentrates on a specific department without giving attention to other departments.
If it intimidates other departments.

v. The management may deny IA function its due independence and this may lead to:
Requiring the internal audit function to carry out accounting duties such recording of transactions or performing control duties such as preparing bank reconciliation statements.
The department may be over relied on by the management who may reduce managerial reviews and controls. This may frustrate the objectives of departments, leading to inefficiencies, misuse of assets, errors and frauds and lack of co-ordination of the company's activities.

Factors responsible for the Growth of the Internal Audit Function

1 Increase in size of business
As businesses grow in size and increase the level of operations it becomes necessary to have a function that over looks the all the internal controls that have been put in place.

2. Dynamic business
Due to changes in technology a number of companies have become so dynamic such that their controls are updated on a continuous basis and this calls for constant feed back on those controls that necessitate updating. This meant that, to cope with these demands companies had to improvise and use expert advice, which was available from the Internal Auditor.

4. **Legislation and regulatory requirements**
As the concept of corporate governance gains roots in business management, the need for internal audit is increasing. The function is looked plays a critical role in ensuring that management has put in place adequate systems of internal controls. Companies are now required to have audit committees to overlook the operation of controls within the organizations. The internal auditor reports to the audit committee.

5. **Competition**
Under perfect competition companies can only survive if they are operationally efficient and this calls for stronger controls and cost effectiveness, which is only possible with the assistance of IA.

7. **Evolution of IT**
Of late many companies have computerised their operations and controls. There is need therefore for continuous review of the operation of controls over these computerized systems.

REINFORCEMENT QUESTIONS

QUESTION ONE

Define control risk and tests of control.

QUESTION TWO

What is a control environment?

QUESTION THREE

What are control procedures?

QUESTION FOUR

What is the importance of an internal control system to the client?Whose responsibility is it to put in place an internal control system?

QUESTION FIVE

Why does the auditor ascertain, record and evaluate the client's internal control system?

QUESTION SIX

List down in point form an internal control system for the raw materials purchasing system of a large manufacturing firm.

QUESTION SEVEN

What is a management letter and what function does it serve?

QUESTION EIGHT

The directors of one of your growing clients have decided to create an internal audit function in their organizational structure.

QUESTION NINE

a. List and briefly describe the duties you would expect the internal audit staff to perform.
b. List and explain the criteria you would consider before deciding to rely on the work of the internal audit function
c. State the extent to which you, as the external auditor can rely on the work of the internal audit function

CHECK YOUR ANSWERS WITH THOSE PROVIDED IN LESSON 10 OF THE STUDY PACK

LESSON FOUR

ERRORS, FRAUD AND OTHER IRREGULARITIES

CONTENTS

2. Definition of Errors and types of errors
3. Frauds, defalcations and other irregularities
4. Detection, correction and prevention
5. Errors and frauds in specific areas in a business.
6. Reinforcement questions
7. Comprehensive Assignment

FRAUD AND ERROR

Refer to ISA 240

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.

Error

It 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.

Types of Errors

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 the wrong person's account. For debtors the correct class of accounts may be used but the wrong personal entries are entered.

Errors of omission: where a transaction is completely omitted from the books.

Error of principle: where an item is entered in the wrong class of account for example a fixed asset is debited to the expense account.

Compensating errors: where errors cancel each other out. The errors usually have occurred on opposite sides of the account that is on the credit side and the debit side with an equal amount. The errors in question are totally independent.

Error or original entry: when the original figure is incorrect and the double system entry is still observed.

Complete reversal of entries: where correct accounts are used but each item is shown on the wrong side of the account. For example crediting a sale in the debtor account and debiting the sales account.

2. FRAUD, DEFALCATIONS AND OTHER IRREGULARITIES

Irregularity

It 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.

FRAUD

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

Common types of fraud include:

- Manipulation, alteration or falsification of records or documents.
- Misappropriation of goods.
- Misappropriation of accounting policies.
- Suppression or omission of effects of transactions on documents.
- Recording fictitious transactions.

DETECTION, CORRECTION AND PREVENTION

RESPONSIBILITY FOR THE DETECTION OF FRAUD AND ERROR

The responsibility rests with management. This is implemented through the implementation and continuous operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error. The auditor seeks reasonable assurance that fraud or 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. 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.

The auditor is and cannot be held responsible for the prevention of fraud and error.

Risk of fraud and error

In addition to weaknesses in the accounting and internal control system events which the risk of fraud and error include:

- Questions in respect to the integrity or competence of management. Where management is not honest and could misappropriate the company's assets;
- Unusual pressures within an entity e.g. pressure on management to report a certain level of profits;
- Unusual transactions;
- Difficulties in obtaining sufficient appropriate audit evidence.

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

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

Auditor's general responsibility with regard to prevention of fraud

The primary responsibility for the prevention and detection of fraud rests with management. Management meets this responsibility by putting in place an internal control system that is aimed at preventing and detecting such fraud or error. E.g. segregation of duties is aimed at reducing changes of employees defrauding the company.

For the auditor prevention and detection of errors and fraud is only a secondary objective. The auditor seeks reasonable assurance that fraud or error, which may be material to the financial statements, has not occurred or if it has occurred that the effect is properly reflected in the financial statements.

Inherent limitations of an audit.

An audit is subject to the unavoidable risk that some material misstatement of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the ISA. The risk of not detecting misstatements resulting from fraud is higher than the risk of not detecting a material misstatement resulting from errors. This is because fraud involves acts designed to conceal it such as forgery and deliberate failure to record transactions. Unless the audit reveals evidence to the contrary, the auditor is entitled to accept representations from management as truthful and the documents as genuine.

However, the auditor should plan and perform his work with professional scepticism, recognising that conditions or events may be found that indicate that fraud or error may exist. Existence of an internal control system reduces the probability of misstatements in the financial reporting occurring due to frauds and errors but there is always a risk that the system may fail to operate as designed.

General Detection

The following procedures could be applied as general leads to where frauds or errors have taken place:

- Compare the company's balance sheet with those of previous two years.
- Calculate ratios from the two balance sheets. The ratios to be calculated can be leverage ratio, activity ratios, performance ratio and profitability ratios.
- Use searching inquiry to poise questions to management and the accounting staff.
- Audit in depth such that the audit trail is established. Audit trail facilitates the checking a transaction recording process from the initial stage to the final stage of a transaction. For example an item like debtors one checks the date the sale took place, the invoice issued, the cash received at the date of

sale, any other cash receipts after the date of sale and the balance. The balance the auditor gets should correspond with the one in the accounts.

- Consult third parties in and out of the firm for example by use of debtors circularisation or lawyers letters.
- Use surprise checks and visits.
- Compare budgeted and actual results. Investigate in-depth the cause of any variances.

Detection of errors.

- Compare previous year's figures with the current figure and ascertain that all changes are in order and authentic.
- Cast the trial balance figures and ensure they balance.
- Check the names of the accounts in ledgers and those recorded in the trial balance to ensure that there are no omissions.
- Compare debtors and creditors from ledgers and those in trial balances. Debtors and creditors accounts are easily a source of confusion for incompetent staff especially when they involve many transactions.
- Ensure that the totals of self-balancing accounts agree.
- Count items in trial balance in the current account and compare those in the previous account. Investigate any differences.
- Check totals of subsidiary books.

Prevention of errors and frauds

(i) Strong internal control system that will ensure that assets are safeguarded and check collusion between employees.
(ii) Proper remuneration of staff.
(iii) Proper segregation of duties
(iv) Overall supervisory controls by management.
(v) Use of budgets to control the company's activities. At the year-end the actual and budgeted results should be compared.
(vi) Rotation of duties so that employees do not establish very close and absorbing relationships that could lead to collusions.
(vii) Institute or establish an internal auditing function.
(viii) Mechanise the system to avoid errors of casting and small omissions or commissions.
(ix) Employing staff that are qualified, of integrity and reliable.

Auditors interest in detection and prevention of errors and irregularities.

1. The existence of errors and frauds may imply that the accounting system is not a reliable basis for financial statement preparation. As such the auditor can conclude that proper books of account have not been kept.
2. Too many errors and frauds also indicate that the internal control system is not operating as it is expected to. As such an auditor who had intended to place reliance on the controls and performance of compliance tests may have to change his approach to increase the detailed substantive tests. If he is to obtain relevant and reliable audit evidence.
3. Errors and frauds if they are of sufficient magnitude and are not properly disclosed in financial statements could affect the true and fair view given by those financial statements with the possibility that the auditors conclusion might be wrong.

How ICS is used to prevent frauds:

a) Management supervision:
This will serve to prevent frauds by boosting the awareness of senior employees who will refrain from committing frauds by virtue of the constant review of activities.

Also the periodic review of Company operations makes it difficult or impossible for Company's employees to perpetrate frauds: constant review of actual performance against budget will deter perpetration of errors and frauds.
In addition, management will prevent errors and frauds by supervising other controls such as division of duties within the accountancy departments, providing routine and automatic checks supplemented by the use of the internal audit function to continuously review the level of such internal checks.

b) Physical controls

The controls are used such that they limit access to Company's portable, exchangeable, desirable assets, which would have been misused, for personal gains.
They work as follows:

a. Use of strong locks or doors to limit access to Company's assets.
b. Use of cash registers to increase accountability and ensure all cash receipts are recorded.
c. Use of pre-numbered documents kept under lock and key to avoid their misuse for personal gains and consequent misappropriation of Company's assets.
d. Use of closed circuit Tvs to warn off would be fraudulent individuals who will then keep away from misappropriating the Company's assets.

All physical controls make it difficult to misuse the Company's assets by limiting access.

c) Segregation of duties

Various duties are segregated to minimise chances of frauds by boosting automatic checks, accountability and supervision e.g. The employee receiving cash should not be the same one banking the cash collected.
Authorisation and approval should not be in the hands of a person who will execute that duty. Recording should not be done by a person who authorised the transaction.

However, this segregation of duties should be done so that appropriate duties are given only to those with competence and necessary qualification to enforce such controls effectively.

d) Arithmetic and accounting controls

Proper recording of transactions according to the principles of Generally Accepted Accounting Principals (GAAP) will prevent frauds such as manipulation of accounts. Periodic balancing of entries, that is reconciliation, will boost the awareness of accounting staff who may then refrain from committing frauds. It will also include the continuos review of monthly accounting statements which will serve to prevent frauds as exorbitant expenditure should be identified and investigated.

e) Personnel

Any ICS should be implemented by qualified, competent and efficient personnel as they are less likely to perpetrate frauds if they have such personal qualities. The Company's employees should be motivated and properly remunerated - two features that serve well to prevent frauds. The careful selection of employees taking into account human qualities (honesty and integrity) serve to prevent fraud as such virtues will increase the quality of the management team. Career development prospects will also be important factor in this regard.

f) Routine and automatic checks

This control will minimise frauds through:

i. Boosting awareness that work will be continuously checked.
ii. Increasing accountability by reducing the possibilities of successful deception.
iii. Boosts the importance of being honest within the business.

g) Control of documents

Sensitive documents will be kept under lock and key and this serves as a deterrent measure against frauds because it limits access to assets that these documents represent. The documents should be serially numbered or pre-numbered to avoid their misuse and to monitor the movement of receipts and other documents.

Also controlled authorisation of the use of the documents makes fraudulent conversion much harder for the aspiring criminal who will be forced to produce sophisticated plans in order to overcome internal controls of the business.

h) Rotation of duties

This control works to prevent frauds by ensuring a sense of responsibility among the personnel to be rotated and also increasing visibility of their work to their supervisory management as an indirect check on the employee concerned. Additionally, he will also be checked by the person taking over from him which will additionally serve to prevent fraud.

How ICS is used to detect frauds:

Managerial supervision and reviews

During periodic reviews the management will possibly detect frauds through investigating variances from planned performance. Variances are revealed through the comparison of various performance parameters. Such comparisons of related but independently prepared statistics should be an essential internal check procedure. Strong supervision will detect frauds at their earliest stages. The supervisors will check unfavourable or irregular performance in the work place and identify those situations which, if allowed to develop, may expose the Company to losses.

Physical controls

These may enable management to detect frauds. Some of these controls such as automatic bells, automatic alarm systems, closed circuit TV will reveal frauds during the process of their perpetration.

Segregation of duties

In the process of executing transactions frauds will be revealed by personnel checking their colleagues and this will be brought to the attention of the senior management. By segregating duties company personnel are made aware of their duties and responsibilities, they will be motivated to advise their supervisors as soon as irregularities are discovered, and not cover them hoping that they will pass without notice.

Rotation of duties

This is effective in detection of frauds because the personnel taking over from their colleagues will necessarily report existing irregularities if they wish not to be blamed forthem. This ensures that errors are discovered at early stages rather than when they are already advanced.

Routine and automatic checks

In so far as these are on a surprise basis, they may reveal frauds in their initial stages. The checks are made at a time least expected by the employees and they are caught unawares.
This lowers the possibility of initiating a fraud.

Compulsory leave

The period of absence can be used by the management to assess the volume of work in a particular position and through the report of the employee temporarily working in that position any corrupt practice can be independently revealed.

Authorisation and approval

Authority limits are used to define the authority of an individual to execute or approve a specific transaction. If such authority is abused, then it is possible to identify who was responsible for any fraudulent conversion of frauds or misuse of assets that may have taken place.

Arithmetic and accounting controls

These are used to detect frauds as follows:

a. Comparison of suppliers statements with the creditor's ledger balance.
b. Reconciliation of bank statements with cash at bank account.
c. Accounting entries which do not agree either with Generally Accepted Accounting Principals (GAAP)or reasonable situations differing from the expected or budgeted situation.
d. Reconciliation of customer's statements with debtor's account.
e. Reconciliation of control a/c's to detailed ledger totals i.e. stores ledger.

4. ERRORS AND FRAUDS IN SPECIFIC AREAS IN A BUSINESS

SALES CYCLE

Potential errors or irregularities

1. Goods despatched without being invoiced. Services rendered without being invoiced, goods in transit or a consignment about not recognised in the books.
2. Goods being sent to bad credit risk customers
3. Overdue account without follow up.
4. Invoicing errors; sales invoiced but not recorded in the books.
5. The receipt of cash/cheques not being recorded including teeming and lading.
6. Cash sales not recorded.
7. Improper crediting of debtors account.

Implications of the above errors

1. Understated sales, wrong management accounts, loss of assets of company and accounts without true and fair view.
2. Bad debts and loss of assets.
3. Increased incidents of bad debts.
4. Misstatement of sales and debtors, loss of money increased disputes with customers due to errors in invoicing.
5. Misappropriation of cash, exposure to theft and loss of interest due to delayed banking.
6. Misappropriation of readily realisable assets.
7. Unreliable records, increased incidents of bad debts, dispute and customers loss of organisation.

Preventive measures

a. Sales orders should be pre-numbered so as to initiate audit trail and minimise disputes with customers Discounts are approved by the officer responsible. Pass order to credit department to assess the credit worthiness of the customer. The sales order is approved after goods are confirmed to be present in the store. Then despatch - raise documentation to evidence it. Despatch notes should be pre-numbered.
b. Matching of all delivery and despatch notes by an independent clerk.
c. Establish credit control department to examine orders. Review long outstanding debts and investigate why payment was not made.
d. Use pre-numbered sales invoices and issue invoices in sequence.
Establish proper sales journals and debtors ledger. Checking invoices raised by clerks for arithmetic accuracy pricing, discounts allowed coding and cross referencing to the customer's

e. Opening mail is only by Managing Directors secretary in the presence of the messenger. Prepare a pre-list for all cheques received by mail.

- Pre-numbered receipts.
- For all money raised a receipt must be issued.
- Receipts entered should be prompt.
- Regular bank reconciliation.
- Compare pre listed cheques and pay-in-slips from the bank by an independent clerk.

f. Pre-numbered cash sales receipts.

- Restricting number of people who can handle cash.
- Filed of returns daily.
- Quantity reconciliation.
- Supervision of cash handlers.
- Encourage use of cheques or credit card payment.
- Surprise cash count.
- Reconciliation and support records.

g. Coding of customers

Types of frauds that become possible without controls.

i. Collusion between customers and sales invoicing departments controlled by sequential issue of delivery notes and independent check and despatch documentation to invoices.
ii. Failure to raise despatch documentation i.e. goods leave the premises without delivery notes.
iii. Improperly raised credit notes to cover misappropriation of cash and reduce customers debts.
iv. Cashiers - teeming and lading. Bank all monies collected and have a pay in slip as a proof of deposit.

PURCHASES AND CREDITORS

Potential errors or irregularities

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

Implications of the above errors

- Loss of resources because of paying for goods never received. Unreliable records being kept.
- Understatement of liabilities hence disputes with suppliers.
- Paying for services and goods not received.
- Overstatement of expenses and creditors.
- Misstatement of various expense and accounts that do not show the true and fair view.
- Overstatement of purchases. Loss of receipts due to the company.

Preventive measures

- Improve inspection procedures at goods inwards stage.
    1. Specific employees should have authority and power for the requisition of goods.
    2. Requisitions should be serially numbered.

3. Central buying system which ensures; buy in bulk discount, avoid clerical costs & small orders, know reliable suppliers, plan of Economic order quantity (EOQ) & lead times.
4. Order should have delivery date and prices.
5. LPO serially numbered.
6. Good received note should be serially numbered.
7. Before payment of invoices take them for approval.

- Pre-numbered goods received notes. (GRN)
    1. Matching of goods received note and suppliers invoices.
    2. Pre-numbered Local Purchase Order (LPO)
    3. Investigate unmatched GRN and LPO
- Before approval original documents must be completed. Once payment is made stamp "PAID" on the documents.
- Code all expenses and or amounts. Use budgetary control measures.
- Claims subject to numerical control. A genuine cheque can be presented for a second payment. This is a collusion between employee and supplier. Cheques should be immediately despatched to the payee and never go back to anyone who had to do with it especially the cashier.

Cash payments

Best system is an imprest system where a fixed amount is assigned to a cashier and more is only given on production of vouchers paid. Advantages are:

- Fixed amounts prevents escalation of amounts held so risk is kept small.
- It is a self checking system.
- Reconciliation of a petty cash book is made easier - regular surprise checks.

WAGES

Potential errors include:

- Dummy workers. Fraudulent double payment for workers.
- Payments for work not done and unclaimed wages being misappropriated.
- Occurrence of payroll errors: starters, leavers, rate changes, hours worked
- Improper deductions being made or being misappropriated.
- Inflation of the payroll in other ways.

Implications of the above errors

1. Over valuation of stocks using wrong labour cost

    - Loss of resources to services never rendered.

2. Overstatement of stocks.
3. Misstatement of various expense accountsWrong stock valuations.
4. Making double payments to authorities. Complaints by employees.
5. Unreliable records.
6. Misstated expense and stock accounts.

Preventive measures

1. Establish a Human Resources Management department to hire and fire and to regulate pay.
    - Have serially numbered documents.
    - Clock cards and time sheets to record time.
    - Clock cards and time sheets should be approved before payment.
    - Payroll approved by senior management committee.

2. Clock cards and time sheets.
3. Document all deductions. Check documents against payment to ensure agreement.
4. Monthly reconciliation of payroll by an independent clerk.

Other matters

1. Maintenance of stock records should be performed by a person who does not have physical access to stock and is not involved in sales or purchases recording.
2. Have segregated lockable areas.
3. Reconciliation of physical quantities of stock to records discrepancies should be referred to the highest level of authority and investigated immediately.
4. Writing of damaged obsolete and slow moving stocks. Senior independent officer should do it based on available documentation evidence.
5. Scrap and waste products; Budget estimated scrap and waste and reconcile to actual amounts.
6. Concealment of theft by write off.

FIXED ASSETS

Authorisation and approval of capital expenditure
Done by senior management and limits to authority. Major capital expenditure authority left to the board.

Accounting records.

Done by a person who has no access to the fixed assets and no responsibility for authorising sales or purchases.

Plant registers

Records on location and value of fixed assets.

Scrapping, sale or transfer of assets.

Highest level of management's affair only on the basis of documentation that is properly approved.

- Appropriate measure at all points of access into the company.
- Reconciliation of plant points of access into the company.
- Segregation of duties.

INVESTMENTS

1. Authorisation of purchases and sales should be done by very senior level management and should have no connection with cash and custody of titles.
2. Maintain investment register; Done by clerks who has no access to documents of title and no authorisation for sale or purchase.
3. Maintenance of records; Share transfer, rights issue, bonuses, dividends and interest capital repayment.
4. Document of title; adequate custody must be maintained.

REINFORCEMENT QUESTIONS

QUESTION ONE

Define errors, irregularities, frauds and illegal acts.

QUESTION TWO

Explain the dictum an auditor is a watchdog not a bloodhound.

QUESTION THREE

To whom should an auditor report when fraud or errors are detected?

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK.

COMPREHENSIVE ASSIGNMENT NO. 2

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

Answer all the questions

QUESTION ONE

What is an internal control system and what is the importance **(Total 20 Marks)**

QUESTION TWO

The following questions have been selected from an internal control questionnaire for wages and salaries.
Internal control questionnaire-wages and salaries

i. Does an appropriate official authorise rate of pay?
ii. Are written notices required for employing and terminating employment?
iii. Are formal records such as time cards used for time keeping?
iv. Does anyone verify rates of pay, overtime hours and computations of gross pay before the wage payments are made?
v. Does the accounting system ensure the proper recording of payroll costs in the financial record?

Required:

a) To describe the internal control objective being fulfilled if the controls set out in the above questions are in place. (5 marks)
b) Describe the audit tests, which would test the effectiveness of each control. (10 marks)
To identify the potential consequences for the company if the above controls were not in place. (5 marks)

(Total 20 Marks)

QUESTION THREE

a. Who is charged with the responsibility for the prevention and detection of frauds and errors? (10 marks)
b. What action should the auditor undertake if he detects errors and frauds while carrying out a review of the client's financial statements? (10 marks)

(Total 20 Marks)

QUESTION FOUR

a. Distinguish between internal audit and internal check. (4 marks)
b. Explain the matters you would consider and the work you would perform to enable you assess the extent to which you would rely on the work of the internal audit department of your client (12 marks)
c. Give four examples of internal audit work that may be used by the external auditor. (4 marks)

(Total 20 Marks)

QUESTION FIVE

State the main features you would expect to find in the system of internal control in the following areas:
1. Approval of customers orders
2. Approval of sales prices and quantity discounts
3. Authorisation of despatch of goods to customers
4. Writing of bad debts;
5. Issue of credit notes.

(Total 20 Marks)

END OF COMPREHENSIVE ASSIGNMENT NO.2

NOW SEND YOUR ANSWERS TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON FIVE

AUDIT PLANNING, CONTROLLING AND RECORDING

CONTENTS:

i. Audit planning
ii. Advantages of good audit planning
iii. Sources of information on nature of client's business
iv. Factors to consider when formulating an audit plan
v. Audit planning memorandum and audit programs
vi. Quality control
vii. Audit documentation
viii. Reinforcement Questions

Audit planning, controlling and recording

Planning

Refer to ISA 300

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

Advantages of good audit planning

ix. It establishes the intended means of achieving the objectives of the audit.
x. 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.
xi. 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.
xii. It helps to ensure that audit work is completed expeditiously through more efficient use of time and proper allocation of work to audit staff.
xiii. Ensures proper division of work between interim and final audit to avoid repetition of work already done.
xiv. 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.

Audit planning covers;

- Developing an overall plan for the expected scope and conduct of the audit. The overall plan is recorded in a planning memorandum.
- Developing an audit programme showing 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 need to understand the nature of the clients business, its organization, its methods of operating and the industry in which it operates. This is to enable the auditor appreciate which events and transactions are likely to have a significant effect on the financial statements.

Sources of information on the nature of client's business

Refer to ISA 310
In performing an audit on the financial statements, the auditor should have or obtain knowledge of the business sufficient to enable him to identify and understand events, transactions and practices that in the auditor's judgment may have significant effect on the financial statements or on the audit report. Prior to accepting an engagement, the auditor would obtain a preliminary knowledge of the industry and of the 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 auditor can obtain knowledge of the industry and the client from a number of sources;

- Previous experience with the entity and the industry;
- Discussion with people within the entity e.g. directors and employees;
- 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;

- Publications related to the industry e.g. journals;
- Visits to the entity's place of business and plant facilities
- Documents such as minutes of meetings, annual financial reports, operations & systems manuals, budgets, marketing and sales plans.

Using the knowledge

Knowledge on the nature of clients business assists the auditor in;

- Assessing risks and identifying problems that could affect the audit;
- Coming with a good plan as to how the audit will be carried out effectively and efficiently;
- Evaluating audit evidence obtained;
- Providing better service to the client.

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

Factors to consider when formulating the audit plan

The auditor should consider the audit approach he wishes to adopt, including the extent to which he may rely on internal controls and any aspects of the audits, which need particular attention. Matters to consider by the auditor in developing overall audit plan include;

- Understanding the accounting and internal control systems
- the auditor should seek to understand the accounting policies adopted by the entity and changes in these policies. The auditor's cumulative knowledge of the accounting and internal control systems and the relative emphasis expected to be placed on tests of control and substantive procedures.
- Reviewing matters raised in the previous year's audit, which may have continuing relevance in the current year. This is done by reviewing previous year's working papers. The auditor will be able to identify areas noted as having weak controls or specific accounting problems. Attention should be paid to such areas in the audit plan.
- Assessing the effects of any changes in legislation or accounting practice affecting the financial statements of the company. The audit plan should include a review of these changes and whether the client has complied.
- The auditor should consult with management and staff of the organization about current trading circumstances and any significant changes in the business carried on and the management of the enterprise. E.g. changes in management might weaken the internal control system.
- Identify any significant changes in the clients accounting procedures such as installation of a new computer information system. Changes to a computerized system could result in weak controls.
- Conditions requiring special attention such as the existence of related parties.
- Consider any current or impending financial difficulties, which could face the company. E.g. shortage of raw materials or failure to raise working capital.
- The auditor 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 annual general meeting, stock taking, dates when management reports are available.
- Set materiality levels for audit purposes and in particular identify areas with material transactions, which call for more audit work.
- The assessment of internal audit department and level of reliance to be place on its work.
- The auditor should also determine the number of audit staff required, experience and special skills required and the timing of the audit visits.

Audit planning memorandum

Having considered the above factors the auditor should prepare the audit-planning memorandum. This sets out;
The outline audit approach;

- How, by whom and when each item in the financial statements will be audited;
- Timing requirements to be met for each item;
- Staff usage with time budgets for each set of audit work
- Contents of an audit-planning memorandum

The nature of information contained in an audit-planning memorandum will vary from one audit to the other, but generally may include:

- A summary of the terms of engagement to lay out the nature and scope of the work;
- Job timetable giving the provisional dates of the timing of the audit e.g. date of planned commencement of the audit.
- Record of any changes in the client since the last audit e.g. changes in the nature of the client's business, change in management structure;
- Details of the planning decisions such as areas identified as having weak internal controls requiring more detailed audit work, areas where the advise of an expert is needed e.t.c
- Extent of reliance expected on internal audit;

Audit programs

Refer to ISA 300 Para 10 & 11

ISA 300 Para 10 "the auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan. The program serves the following purposes;

- As a set of instructions to audit assistants involved in the audit;
- As a means to control and record the proper execution of the work

An audit program contains;

- The audit objectives for each area being audited;
- The audit procedures to be carried out in meeting the objective;
- A time budget in which hours are budgeted for the various audit areas or procedures

Problems encountered in developing and implementing audit plans

- A firm may have many clients with similar year- end making time and staff allocation difficult.
- Abrupt changes in the client's business may call for more audit time outside the planned time e.g. changes in accounting and internal control systems.
- Lack of co-operation from the client e.g. providing information in good time.
- Staff turnover.

Steps to safeguard these problems

- Close liason with the client. This will aid in reducing delays in receiving the required information for the audit.
- Continuous staff recruitment by the firm.
- Long term strategic project planning.

Audit controlling

Refer to ISA 220 – Quality control for audit work

Audit control refers 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 the firm's own quality standards.

ISA 220 Para 2 " quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits"

Objectives of quality control policies and procedures at the level of the audit firm

(a) To meet professional requirements- audit staff employed by the firm should adhere to the principals of independence, objectivity, confidentiality and professional behavior.
(b) Skills and competence
The audit firm should be staffed by personnel who have attained and maintain the technical standards and professional competence required to enable them to fulfil their responsibilities with due care.
(c) Assignment
Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
(d) 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.
(e) Consultation
where necessary consultations within or outside the firm should be carried out with those with appropriate knowledge.
(f) 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. The integrity of the client's management should be considered.
(g) Monitoring
The firm should continuously monitor the adequacy and operational effectiveness of quality control policies and procedures.

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 and procedures are understood and implemented.

Quality control policies and procedures at individual audit

The following factors should be considered;

- **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 the required technical competence required.
- **Direction**
  Audit assistants to whom work is delegated should be given appropriate instructions/directions. This involves informing assistants of their responsibilities and the objectives of the procedures they 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, timing and extent of audit procedures to be performed.
- **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.
  - Establish whether assistants understand the audit instructions

- Ensure that work is being carried out in accordance with the overall audit plan and the audit program.
- To identify and address any significant accounting and auditing questions raised during the audit.
- Resolve any differences of professional judgment between personnel

- **Review**
  Work performed by each staff member should be reviewed by a person of equal or higher competence, to consider;

  - The work has been performed in accordance with the audit program
  - The work performed and the results obtained have been adequately documented.
  - All significant audit matters have been resolved or are reflected in audit conclusions.
  - The objectives of the audit procedures have been achieved; and
  - The conclusions expressed are consistent with the results of the work performed and support the audit opinion.

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 work products such as financial statements.

Objectives of Peer Review

1. To promote compliance with professional standards and other technical pronouncements.
2. To provide reasonable assurance to users of financial statements that professional standards have been complied with in the performance of audit and related services.
3. To gain increased user confidence in the reliability of audited financial statements.
4. To promote uniform application of generally accepted methods of professional practice.
5. To establish a mechanism of continuous quality improvement in professional practice and a self-regulatory framework for policies and procedures.
6. To enhance the status and image of CPA's to the public through the assurance of compliance and quality in the performance of audit and related services.
7. To help ensure that auditors are competent and independent and to identify potential problems in these regards at an early stage for necessary corrective action to be taken.
8. To help identify weaknesses in the audit process and provide technical assistance for professional development.

Reasons for introducing peer review

a. There is a desire on the part of professional bodies worldwide today to ensure that their members apply and observe professional standards.
b. The institute deems it appropriate to ensure adherence to existing technical standards through this mechanism of monitoring compliance.
c. It is better for professional bodies to be self-regulating than to be government regulated.

Audit recording

Refer to ISA 230- documentation

Recording refers to documentation in the form of working papers prepared or obtained by the auditor and retained by him in connection with the performance of his audit. Audit working papers should always be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit to ascertain the work that was performed supports the conclusions reached.

The auditor should record all relevant information known to him at the time, the conclusions reached based on that information and the views of management.

Why the need for preparing good working papers?

(a) The reporting partner needs to satisfy himself that work delegated by him has been properly performed. This is only possible by reviewing detailed working papers prepared by the audit staff who performed the work. This also aids in supervision and review of work done by audit assistants.
(b) Working papers provide details of problems encountered together with evidence of work performed and conclusions drawn there from in arriving at the conclusions reached. These details can also serve as a good reference point for future audits.
(c) Preparation of working papers encourages the auditor to adopt a methodical approach to his work.
(d) Working papers assist in the planning and performance of audits in future financial periods.
(e) If sued for negligence working papers act as evidence of work done.
(f) They are used for training of audit staff. Working papers contain audit programs and specimen schedules, which audit assistants can refer to when conducting an audit.

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

(a) Information of continuing importance to the audit such as letter of engagement, memorandum of association e.t.c.
(b) Planned audit approach as contained in the planning memorandum.
(c) Auditor's assessment of the client's accounting system, his review and evaluation of internal controls.
(d) Details of audit work carried out, notes of errors or exceptions noted and action taken together with conclusions drawn by the audit staff.
(e) Evidence that the work of staff has been properly reviewed.
(f) Record of relevant balances and other financial information that is subject of the audit.
(g) Analysis of significant ratios and trends
(h) Copies of communications with other auditors, experts and other third parties
(i) Letters of representations received from management.

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

The Permanent File

The permanent file usually contains documents and matters of continuing importance, which are required for more than one financial period. Information contained in a PAF include:

a. Statutory material: governing the conduct, accounts and audit of the enterprise for companies a Companies Act (Cap 486). For a quoted company a copy of the Nairobi Stock Exchange regulations (NSE) is required.
b. Rules and regulations of the enterprise. The Memorandum and Articles of Association. For a partnership, a partnership agreement.
c. Copies of documents of continuing importance and relevance to the auditor.

- Letter of engagement and minutes of appointment of the auditor.
- Trade license.
- Debenture deeds.
- Leases.
- Guarantees and indemnities entered into.

d. Addresses of the registered office and all other premises with a short description of the work carried on at each.
e. An organisation chart showing: -

- Principal departments and subdivision thereof.
- Names of responsible officials showing lines of responsibility.

f. List of books and other records and where they are kept names, positions, specimen signatures and initials of persons responsible for books and documents account codes and classifications should be held.
g. An outline of history of the organisation special mention or reserves, share capital,
h. Prospectus, acquisitions of businesses and provisions.
i. Accounting policies used for material areas such as stock, work in progress, depreciation, research and development.
Notes of interviews and correspondence of internal control matters and all past management letters.A note of the position the company in the group and all subsidiaries and associated companies with holding therein.
j. A list of directors their shareholdings and service contracts.
k. A list of company's advisors, bankers, stockbrokers, solicitors, valuers.

The Current File

This file will contain matters pertinent to the current year's audit. It will contain:

1. A copy of the accounts being audited signed by the directors.
2. An index to the file.
3. A description of the internal control system inform of questionnaires, flowcharts or written documents together with specimen documents.
4. Audit programme.
5. A schedule of each item in the balance sheet. Each schedule should show:

    - Balance at the beginning of the year, changes during the year and balance at the end of the year.
    - Details of its existence, ownership and appropriate disclosure have been verified.

6. A schedule for each item in the profit and loss account showing its make up.
7. Check list for compliance with statutory disclosure requirements. Accounting standards and auditing standards.
8. Record of queries raised during the audit and coming forward from previous audit.
9. Schedule of important statistics e.g. output, net profit margin, gross profit margin, sales composition, liquidity ratios.
10. A record or abstract from the minutes of:

    - The company
    - The directors
    - Any internal committee of the company whose deliberations are important to the auditor.

11. Letters to the client setting out weaknesses in the internal control.
12. Letters of representation.

Other Working Papers

a) **Manuals**: Most audit firms of any size have printed audit manuals which complement internal instruction given to staff. They contain general instructions on the firm's method of auditing in each area and on the audit firm's procedures generally.
b) **Audit notebooks.** These were common at one time but now most notes made by audit staff are incorporated in the current or permanent files.
c) **Time sheets:** These are not strictly a part of the audit working papers but are of great importance in controlling the work of audit staff and making proper change to the clients.

d) **Audit control and review sheets.** These again are usually incorporated in the working files.

Standardization working papers

This refers to predetermined format of presenting/documenting audit findings formulated by individual audit firms e.g. specimen letters, checklists e.t.c

Advantages of using standardized working papers

- This improves the efficiency the efficiency with which they are prepared.
- They act as guidelines or instructions to audit staff and facilitates 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 area are addressed.

Disadvantages

- It is not appropriate to follow mechanically a standardized approach to the conduct and documentation of the audit work without regard to the need to exercise judgment.
- Work becomes mechanical
- Client's staff may become familiar with the method.
- The initiative of the audit staff may be stifled.

REINFORCEMENT 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. (8 marks)
b. How does audit planning assist in the conduct of an audit? (5 marks)
c. Explain the following controlling procedures in a well planned audit:
d. Direction and supervision of work (2 marks)
e. Review and co-coordinating of work (2 marks)
f. Quality controls (3 marks)

QUESTION TWO

What should be included in an audit-planning memorandum?

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK

LESSON SIX

AUDIT EVIDENCE

CONTENTS:

1. Definition of audit evidence
2. Reliability of audit evidence
3. Obtaining audit evidence
4. Management assertions
5. Methods of obtaining audit evidence
6. Audit sampling
7. Representations by management
8. Using the work of an expert as audit evidence
9. Reinforcement questions
10. Comprehensive Assignment

AUDIT EVIDENCE

Reference should be made to ISA 500- Audit evidence
" 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.
The sources and amount of evidence needed to achieve the required level of assurance is determined by the auditor's judgment. His judgment will be influenced by the materiality of the item being examined, the relevance and reliability of evidence available from each source and the time and cost involved in obtaining it.
Audit evidence is obtained from an appropriate mix of tests of controls and substantive procedures.
Where the internal control system is considered weak, evidence maybe obtained entirely from substantive procedures.

Tests of controls

Compliance tests are procedures performed to obtain audit evidence about the effectiveness of the:

(a) Design of the accounting and internal control system i.e. whether it is suitably designed to prevent and correct material misstatements.
(b) Operation of the internal controls throughout the period.

Substantive procedures

These 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.

Meaning of sufficient appropriate audit evidence

Sufficiency is the measure of the quantity of audit evidence.
Appropriateness is the measure of the quality of audit evidence and its relevance to a particular assertion and its reliability. In forming an opinion the auditor does not examine all the information available but uses judgmental or statistical sampling procedures to form conclusions on account balances, class of transactions or controls.
Factors influencing the auditor's judgment as to what is sufficient appropriate audit evidence.

1. The degree of risk of misstatement- this may be affected by;

    - The nature of the item e.g. cash has a greater degree of misstatement than fixed assets
    - Strength of the internal control system, where the system is weak there is a greater risk of misstatement.
    - Nature and size of business being carried out.
    - Financial position of the company.

2. Materiality of the item being examined in relation to the financial statements as a whole.
3. The auditor's experience with the client gained during the previous audits e.g. the reliability ofmanagement and accounting records.
4. Results of other audit procedures including fraud or error, which may have been detected.
5. Sources and reliability of information available.

Meaning of relevance of audit evidence

Relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on the financial statements. To achieve this objective the auditor needs to obtain evidence to enable him to draw reasonable conclusions on various management assertions made in

preparing the financial statements. Relevance therefore refers to the ability of the evidence to assist the auditor in testing management's assertions.

Refer latter on in this lesson for the meaning of management's assertions.

Reliability of audit evidence

The reliability of audit evidence refers to the credibility of the source of the evidence.
This credibility is influenced by its source; whether from internal sources or external sources and by its nature; whether visual, documentary or oral. Reliability of the evidence depends on individual circumstances but we can make the following generalizations:

1. Audit evidence from external sources e.g. a third party (e.g. a debtor) confirming amount owing to the company is more reliable than evidence generated internally.
2. Audit evidence generated internally e.g. from accounting records is more reliable when the related accounting and internal controls are effective.
3. Evidence obtained by the auditor himself is more reliable than that obtained from the entity.
4. Evidence in the form of documents and written representations is more reliable than oral representations.

The auditor seeks evidence from different sources. Evidence is more persuasive when evidence from different sources is consistent. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor should perform further procedures to resolve the inconsistency.

When in doubt as to any assertion of material significance, the auditor should attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence, he should express a qualified or a disclaimer of opinion.

Obtaining audit evidence

Audit evidence is obtained by carrying out compliance (tests of control) and substantive tests. In carrying out compliance tests (tests of controls), the auditor is concerned with;

a. Whether controls exists
b. The effectiveness of those controls.
   Substantive procedures are defined as those tests of transactions and account balances, which seek to provide audit evidence as to the completeness, accuracy and validity of information contained in the accounting records or in the financial statements. Substantive tests sre of two types;
c. Tests of details- these are designed to substantiate individual items in the accounts and to gain assurance about their validity or the details that underlies the account balances.
d. Analytical review procedures

Management assertions

When preparing financial statements the management is making certain explicit or implicit assertions about the financial affairs of the company. Consequently when the auditor is obtaining evidence from substantive procedures, he is concerned about testing or substantiating the truth of these assertions. These assertions are categorized as follows;

i. Existence- that an asset or liability exists at a given date. E.g. that closing stock physically exists.
ii. Rights and obligations- an asset is a right of the entity and a liability is an obligation of the entity. E.g. land belongs to the company and the title documents are in the name of the company.
iii. Occurrence- that a transaction or event took place which pertains to the entity during the period.
iv. Completeness- there are no unrecorded assets, liabilities, transactions or undisclosed items.
v. Valuation- that a transaction is recorded at an appropriate carrying value. E.g. that land and buildings are carried at an appropriate value.

vi. Measurement- that a transaction is recorded at the proper amount and revenue and expenses allocated to the proper period.
vii. Presentation and disclosure- an item is disclosed classified and described in accordance with the applicable with the applicable financial reporting framework.

The auditor seeks to obtain audit evidence to prove each financial statement assertion. The nature, timing and extent of substantive procedures to be carried out to prove the financial assertions varies. One substantive procedure can prove evidence about more than one assertion. E.g. collection of an amount owed by debtors may provide evidence as to both existence and valuation of the debt.

METHODS OF OBTAINING 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 the presence of a reliable internal control system and therefore reduce the extent of substantive testing. The auditor obtains evidence in performing compliance and substantive procedures using the following methods;

- **Inspection**
  This consists of examining records, documents or tangible assets. The reliability of the evidence obtained from inspection of records and documents depends on the nature, source and effectiveness of the internal control system. Inspection of tangible assets provides evidence with respect to their existence but not as to their value and ownership.
- **Observation**
  This involves looking at procedures being performed by others. E.g. observing the counting of stock by the client's personnel.
- **Inquiry and confirmation**
  Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. This ranges from formal written inquiries addressed to 3rd 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 an enquiry to corroborate **information contained in the** accounting records.
- **Computation**
  This involves checking the arithmetical accuracy of source documents and accounting records or performing independent computations. E.g. re-computing the amount of provision for depreciation and comparing this against that computed by the client.
- **Analytical procedures**
  The analysis of relationships such as between items of financial data to identify consistencies and predicted patterns or significant fluctuations and unexpected relationships and the results of investigations thereof.

  Refer to ISA 520 on the nature and purpose of analytical review.

AUDIT SAMPLING

Definitions

Sampling

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.

Population

This refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. E.g. all items in an account balance or class of transactions constitute a population. The individual items that make up the population are known as sampling units.

Sampling risk

This arises from the possibility that the auditor's conclusion based on the tests performed on the selected sample may be different from the conclusion reached if the entire population was subjected to the same procedure.

Non sampling risk

Arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample e.g. use of inappropriate audit procedures leading to failure to identify an error.

Tolerable error

Refers to the maximum error in the population that the auditor is willing to accept and still conclude that the results from the sample have achieved the audit objective. Tolerable error is considered during the planning stage and is related to the auditor's judgment on materiality. The smaller the tolerable error the larger the sample size.

Confidence level

Refers to the degree of confidence that the auditor requires that the results of the sample are indicative of the actual error in the population.

Stratification

This is the process of dividing the population into sub-populations so that items within each sub population are expected to have similar characteristics in certain aspects e.g. same monetary value.

Why auditors adopt a sampling approach

A complete check of all transactions and balances of a business is no longer required by/ of an auditor. The reasons are:

a. Economic - The cost in terms of expensive audit resources would be prohibitive.
b. Time - The complete check would take too long such that financial accounts would be of no use by the time the audit is completed.
c. Practical - Users of accounts do not expect or require 100% accuracy. Materiality is important in auditing as well as in accounting.
d. Psychological - A complete check would so bore the audit staff and their work would end up being ineffective.
e. Fruitfulness: A complete check would not add much to the worth of figures if, as would be normal, a few errors are discovered. The emphasis of audits should be on completeness of record and their true and fair view.
   The objective of auditing sampling is to enable the auditor carry out procedures designed to obtain sufficient appropriate audit evidence to determine with reasonable confidence whether the financial statements are free of material misstatement.
f. The use of sampling with properly thought out objectives and properly constructed tests allows more valid conclusions to be reached than when as many transactions as possible are test ed. This is because detailed testing is carried out on the sample units.use of sampling enables the auditor to give more precise information to the client in the management letter.

Stages in audit sampling

(a) Planning the sample

When planning how to carry out the sampling the auditor should consider the following:

- The objective of the test and the combination of audit procedures which are likely to achieve these objectives;
- The population and sampling units. The population should be appropriate to the objective of the sampling procedure. E.g. if the auditor's objective is to test for overstatement of debtors an appropriate population would be the debtors listing;
- Definition of errors in substantive testing and deviations in compliance testing. Before performing tests on the chosen sample, the auditor should define clearly those test results and conditions that will be considered errors or deviations by reference to the audit objective. For substantive testing the auditor should project monetary errors found in the sample to the population and should consider the effect of the projected error on the particular test objectives.

(b) Determination of the sample size

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

- The tolerable error or deviation rate- the larger the tolerable error or deviation rate, the smaller the sample size.
- Auditor's assessment of inherent risk. The higher the auditor's assessment of inherent risk, the larger the sample size. Higher inherent risk implies that there is a greater risk that the financial balance will be misstated. To reduce this risk the auditor will need to extend the level of testing. This is achieved by testing a larger sample.
- Auditor's assessment of control risk. The higher the auditor's assessment of control risk, the larger the sample size. A high control risk implies that little reliance can be placed on effective operation of internal controls. To reduce the audit risk the auditor will need to extend the level of testing, this is achieved by increasing the size of the sample.
- Expected error. This refers to the total error that the auditor expects to find in the population. The greater the amount of error the auditor expects to find in the population, the larger the size of the sample needed in order to make a reasonable estimate of the actual amount of error in the population.
- Auditor's required confidence level. The greater the degree of confidence that the auditor requires that the results of the sample are in fact representative of the actual amount of error in the population, the larger the sample needs to be.

(c) Selecting the items to be tested

The sample selected should be 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 methods of selecting samples include:

- Random sampling by use of random number tables or use of computers to select sampling units
- Systematic selection
- Haphazard selection

(d) Testing the items

After selecting the sample units, the auditor should carry out the pre- determined audit tests on each item.

(e) Evaluating the results of the tests

The following procedures should be followed in evaluating the results of the tests:

- All errors identified and deviations should be evaluated;
- Projection of error. The auditor should estimate the expected error or deviation rate in the whole population by projecting the results of the sample to the population so as to obtain a broad view

of possible error or deviation rates in the entire population. This will then be compared with the established tolerable error or deviation rate;

- Assessing the risk of incorrect conclusion. In general the expected error or deviation is rarely a precise measure of the actual error or deviation rate present in the population. Actual error rate may be greater or smaller than projected error. The auditor must therefore consider on the basis of his sample results and relevant evidence obtained from other audit procedures, the possible levels which the actual error or deviation rate might take and particularly the likelihood that the actual error or deviation rate may exceed tolerable error or deviation rate.

Approaches to sampling

The two main approaches that can be applied in sampling:

- Judgmental sampling:
- Statistical sampling

Judgmental sampling also known as non-statistical sampling

Involves using experience and knowledge of clients business and circumstances to select and test the sample without any mathematical or statistical tools. The auditor does not rely on probability theory and requires the use of judgment in making sampling decisions.

Advantages of judgmental sampling

- Its well understood and refined by experience.
- Opportunity to bring expertise and knowledge into play in selecting and testing sample units.
- No special statistics knowledge required.
- No time wasted on the mechanics of statistical tools. More time is spent on auditing the sample units and less on the mechanics of constructing the sample and computing the mathematical implications of the results obtained.

Disadvantages

- Unscientific it does not form a strong basis for defense, i.e., it is difficult to justify why one selected some items and left out others.
- Wasteful and large samples are selected. This is because in an effort to reduce the sampling risk the auditor attempts to select as many items as possible as opposed to statistical sampling where the size of the sample is precisely determined using probability theory.
- Samples may not be representative of the population and the results cannot be extrapolated.
- Danger of personal bias in sample selection.

Statistical sampling

Statistical sampling involves:

- Use of random selection of a sample;
- 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 sampling risk and to evaluate the sample results.

Advantages

- It is scientific and defensible. The auditor can justify the items selected because these are selected randomly.
- Elimination of personal bias. The sample selected is unbiased.

- Efficient as small samples are picked. Probability theory is applied in determining the precise sample size required.
- Uniformity in different auditing firms hence comparisons are made possible.

Disadvantages

- Difficult to extract samples especially if documents are not sequentially numbered.
- The need to follow a predetermined statistical approach may stifle initiative and the need to apply judgment.
- The results may be misunderstood if the audit staff are not properly trained in the use of the technique.
- It may not be suitable for all applications. Probability theory works best for large populations and therefore cannot be applied for small populations.
- It is expensive due to the need for staff training.

Factors to consider before adopting statistical techniques.

- Number of clients to whom it is appropriate as set up and training costs are high.
- Large populations must exist, as statistics is the science of large numbers.
- Adequate controls must exist where there are no controls it is impossible to use statistical techniques.
- Population being tested must be homogenous in materiality. Some system of control must exist in each of them.
- Too many variables cannot be tested at once.
- Items must be separately identifiable therefore sequential numbering is essential.
- Expectation of error must be low, i.e. that the internal control system must be reliable.
- Risk factor; the level of risk allowable and the degree of risk attached to the item being tested.

QUALITIES OF A GOOD SAMPLE.

- **It should be random:** A random sample is one in which each item in the sample has an equal chance of being selected. Statistical inferences may not be valid unless the sample is random.
- **It should be representative:** the sample should be representative of the differing items in the whole population. For example it should contain a similar proportion of high and low value items of the population.
- **Protective:** Protective of the auditor. More intensive auditing should occur on high value items known to be high risk.
- **Unpredictable** - client should not be able to know which items will be examined.

Factors to consider whether or not to sample

- **Materiality:** Expenditure such as motor vehicle expenses may be so small that no conceivable error may affect the true and fair view of the accounts as a whole.
- **The number of items in a population.** If these are few (for example land and buildings) 100% check may be economical.
- **Reliability of other forms of evidence:** Analytical review (e.g. wages relate closely to number of employees, budgets, previous years) -Proof in total (VAT calculations). If other evidence is very strong, then a detailed check of population (100% of a sample may be necessary).
- **Cost and time consideration**: Can be relevant in choosing between evidence seeking methods.
- A combination of evidence seeking methods is often the optimal solution.

When not to sample

i. When populations are small. In cases it is more economical and effective to test the entire population.
ii. For transactions, or balances, though few in number are of great significance in terms of materiality.

iii. Any situation where the auditor is put on enquiry as a result of earlier tests or information received. E.g. where the auditor has received some indication of material fraud in a certain accounting area.
iv. For statutory disclosure items such as directors salaries where a full audit check will be desirable despite the relative materiality of the items concerned.
v. For non-homogeneous populations where sorting of the information will have to take place before sampling can be attempted.

Using the work of an expert

An expert is a person possessing specialised skills, knowledge and experience in another field other than auditing and accounting. From his training and experience an auditor only has general knowledge on matters outside his profession and he is not expected to have the shills of a person trained or qualified to work in another profession. Consequently the auditor may need advice of other experts e.g. lawyers in arriving at the legal interpretation of legal cases against a client

Situations where the auditor may require advice of an expert

1. Legal interpretation of contracts, laws and regulations
2. Valuation of certain types of assets e.g. land and buildings, precious stones and minerals.
3. In determining quantities and physical condition of assets e.g. underground minerals/quarries.
4. Actuarial valuations
5. Measurement of work completed/to be completed in contracts.

When deciding whether to use the work of an expert the auditor should consider:

1. The materiality of the item being examined in relation to the financial statements as a whole;
2. Nature and complexity of the item, including the risk of error or misstatements;
3. The other audit evidence available with respect to the item.

Factors to consider before relying on the work of an expert

The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial statements. The auditor should consider;

a. The skills and competence of the expert
b. The auditor should consider the expert's skills and competence in the particular profession. This is done by considering the expert's professional qualifications, license or membership of an appropriate professional body. The experience and reputation in the field in which the auditor is seeking evidence.
c. Objectivity and independence of the expert
d. 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, or where he is related financially with the client.
e. The sources of 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.
f. The assumptions and methods used.
g. 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

It should cover matters such as:
i. Objectives and scope of his work.
ii. Outline of items the auditor expects to be covered in the report.

iii. Intended use by the auditor and disclosure to third parties as to expert's identity and extent of involvement.
iv. Access of records and files by expert.
v. Clarification of expert's relationship and client.
vi. Confidentiality of client's information.
vii. Assumptions and methods intended to be used by the expert.
viii. Recording of any further information as audit evidence.

REPRESENTATIONS BY MANAGEMENT

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 judgement which are difficult for the auditor to prove objectively e.g. there is no need to obtain a letter of representation on the bank balance as this can be proved objectively but there is need to obtain a representation that all contingent liabilities have been properly stated because this is difficult to prove.
Management makes various oral representations throughout the audit in response to specific inquiries. The auditor should not rely on unsupported oral representations of management as being sufficient reliable evidence when they relate to matters that are material to the financial information. The auditor should obtain written representations from management on matters material to the financial information when other sufficient appropriate audit evidence cannot reasonably be expected to exist.
After receiving representations from management the auditor should;

- Seek other audit evidence from sources inside or outside the entity that supports or disprove the representations given.
- Evaluate whether the representations made by management are consistent with other audit evidence available.
- Consider whether the person making the representation appear to be well informed on the matter in question.

Representations by management should not be taken as a substitute for other evidence that the auditor could reasonably expect to be available, it is simply an additional source of evidence. If the auditor is unable to obtain sufficient appropriate evidence regarding a matter, which has a material effect on the financial statements, this constitutes a limitation in the scope of the audit even if representations have been obtained.
Representations by management are mainly used where no other evidence exists or would reasonably be expected to exist, where a matter is material to the financial statements and written confirmation is required or where the auditor is seeking evidence to support other audit evidence gathered using other means.
If a representation by management is contradicted by other evidence, the auditor should investigate the circumstances and where necessary reconsider the reliability of other representations made by management.
A written representation is better audit evidence than oral representations and can take the form of;
A letter of representation addressed to the auditor and signed by management.

- A letter from the auditor explaining the auditor's understanding of management's representations duly acknowledged and accepted by management.
- Relevant minutes of the board of directors.

The auditor should inform management at an early stage i.e. in the letter of engagement that he might require written representations from time to time to avoid refusal by management in providing such representations.

REFUSAL BY MANAGEMENT TO GIVE REPRESENTATIONS

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

If management disagrees with the auditor's statement of representation, 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 the matter up to try to ensure that his understanding of 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 refusal by management to co-operate, or because management properly declines to give representations required on the grounds of its own uncertainty regarding that particular issue. In such circumstances the auditor may have to conclude that he has not received all the information and explanations required and consequently may need to consider qualifying his audit report on the grounds of limitation in the scope of the audit.

REINFORCEMENT QUESTIONS

QUESTION ONE

What is audit evidence?

QUESTION TWO

What does sufficient appropriate audit evidence refer to?

QUESTION THREE

What are management assertions and what is the importance to the auditor?

QUESTION FOUR

i. What is audit sampling
ii. Distinguish between audit risk and sampling risk
iii. What conditions are necessary to carry out sampling?
iv. What are management representations and when does the auditor seek such representations?
v. What should the auditor consider before relying on the work of an expert?

CHECK YOUR ANSWERS WITH THOSE PROVIDED IN LESSON 10 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT NO.3

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

Answer all the questions

QUESTION ONE

a. " The auditor should adequately plan, control and record his work'
Why is audit planning considered so important? (8 marks)
b. The most effective plan is one that is reduced in writing in a planning memorandum. Name four items that should be included in this memorandum (4 marks)
c. Suggest the practical problems, which are encountered in implementing audit planning and how you would endeavor to minimize these. (8 marks)

(Total 20 Marks)

QUESTION TWO

a. What is audit documentation? (2 marks)
b. What are standardized working papers and what are their advantages? (6 marks)
c. What is quality control (12 marks)

(Total 20 Marks)

QUESTION THREE

ISA 500 *Audit Evidence* requires that 'auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion'. The standard identifies five procedures for obtaining audit evidence and also gives guidance on assessing the reliability of audit evidence.

Required:

a) Identify and describe the procedures for obtaining audit evidence. (5 marks)
b) For each of the procedures, describe an audit test using that procedure to obtain evidence as to the balance of plant and machinery including the related balances of accumulated depreciation and charges to profit and loss. (5 marks)
c) For each of the procedures, discuss considerations affecting your judgement as to the reliability of the evidence with particular reference to the tests described in your answer to (b). (10 marks)

(Total 20 Marks)

QUESTION FOUR

Outline the benefits that can be derived by an auditor from the successful employment of statistical sampling techniques as opposed to non- statistical sampling. **(Total 20 Marks)**

QUESTION FIVE

Write short notes on the following:
a. Materiality (5 marks)
b. Control environment (5 marks)
c. Control risk (5 marks)
d. True and fair view (5 marks)
e. Peer review (5 marks)

(Total 20 Marks)

END OF COMPREHENSIVE ASSIGNEMENT NO. 3

NOW SEND YOUR ANSWERS TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON SEVEN

COMPUTER BASED ACCOUNTING SYSTEMS AND THEIR CONTROLS

CONTENTS

1. Introduction to Computer Accountancy Systems.
2. Introduction to Computers and the way they process data.
3. Programs & Operating Systems.
4. Introduction to Computer Control.
   Types of controls in a computerized system.

   (a) General controls.

   - System development controls.
   - Organisational controls.
   - Access controls.
   - Other controls.

   (b)Application controls.

   - Input controls.
   - Processing controls.
   - Output controls.
5. Auditing in a Computerised Environment.

   - Planning the audit in a computerised environment.
   - Testing the internal controls in a computerised environment.
   - Substantive testing in a computerised environment.

6. The auditor's Approach
7. Auditing around the computer
8. Auditing through the computer
9. Real time and On-line Systems
10. Reinforcement Questions

1. INTRODUCTION TO COMPUTER ACCOUNTING SYSTEMS

Computers are sometimes described as:
(a) Mainframe
(b) Mini
(c) Micro

A **Mainframe Computer** is one that can undertake many tasks simultaneously and will be linked to many different input and output devices.

A **Micro Computer** is intended to be used by one operator for one task at a time, and comes bundled with a limited range or Visual Display Unit (VDU). However, modern microcomputers are far more powerful than mainframe computers and if linked together in a network they can form a basis of a sophisticated computer accounting system. Due to invention of increasingly powerful microcomputers the term mini computers has disappeared.

Computerized accounting systems fall into 2 broad types.

1. Centralized systems: Where processing of data takes place in a specialised computer department.
2. Distributed systems: Where processing of data takes place in the user computer department.

These 2 types are not mutually exclusive. Therefore in centralised systems, data may bepartly processed in the user departments using remote terminals; and in distributed systems, the user department computers may be linked or networked with some of the data being further processed centrally.

In smaller businesses there is often a single micro computer, which is used for all accounting routines and is located within the general accounts office. For audit purposes this is regarded as a distributed system as the computer is operated by accounts personnel rather than specialist computer personnel.

2. INTRODUCTION TO COMPUTERS AND THE WAY THEY PROCESS DATA

A computer system requires procedures to: -

i. Convert the data to machine-readable form.
ii. Input the data into the computer.
iii. Process the data.
iv. Store the data in machine-readable form.
v. Convert the data into a desired output form.

For these procedures, a mixture of hardware and software is needed. The hardware will consist of:
a) Input
b) Processing
c) Storage &
d) Output devices.

Input devices will include: Keyboards, optical readers, and bar code scanners
Processing devices are the computers themselves.
Storage devices include: Hard disk, diskettes, and magnetic tape
Output devices include: Visual Display Unit (VDU's), printers.
The software consists of programmes and operating systems. These contain the instructions that determine how data is to be processed, organised and stored in computer files and then output.

Computer Files

These are the equivalent of books and records in a manual system and are described either as:

Transaction files
Master files.

Transaction Files

Are the equivalent of journals such as the sales journal or the purchases journal or the cashbook. 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, in case of errors or computer malfunctions during processing of data to master file.

Master Files

These contain what is referred to as standing data. They may be the equivalent of ledgers but may also contain semi-permanent data needed to process transactions e.g. a debtors master file will be the equivalent of debtors 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 e.g. cumulative analysis of sales to that customer.
When such master files are up-dated 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 2 files can be compared and differences agreed to the control total on 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 transactions file are retained until the master file is updated once 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 debtors system include current sales price list and in the case of personnel department, a personnel file giving details of wage rates, authorised deductions and cumulative record of amounts paid to date for the purpose of providing tax certificates.

A special class of transactions are those amending standing data held in the master file such as sales price and wage rate. These transactions require special control 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 mis-priced in sales price list will mean all sales will be charged to customers at the wrong price.

3. PROGRAMS & OPERATING SYSTEMS

Programs are the instructions telling the computer how each type of transaction is to be processed. These instructions include routines of checking & controlling data matching data with master files and performing mathematical operations on the data, e.g. for a sales transactions. Matching routines will enable the computer to identify the right sales price from the sales price master file and the right customer from debtors master file, mathematical routines include calculating the total debtors amount and updating customer's balance on the debtors' master file.

Operating Systems

Relate 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 files need to be created for further processing e.g. with a batch of sales transactions, the sales price file and the debtors 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 also provide details of further processing runs within the same system. So, for example, in sales these will include updating the general ledger, processing cash receipts and
credit notes to the debtors file, printing out monthly statements and printing out an 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.

Documentation
Each system should be fully documented. This documentation should include:

i. The initial specification, objectives and authorisation of the system.
ii. Overall flowchart of the flow of information through the system including the manual procedures.
iii. An indication on the flowchart of the programs and files involved in the system.
iv. For files, the contents of each file and the way the data is stored within the file.
v. For programs, a logic flowchart as well as complex details.
vi. Copies of input and output documents.
vii. Operator instructions including error messages.
viii. Data used in testing the system and the results.
ix. Changes in the system and any of the component parts and the authorisation of the changes.

4. INTRODUCTION TO INTERNAL CONTROLS IN COMPUTERISED INFORMATION

The main features of a computerised information system which requires the implementation of adequate alternative controls, which could pose additional challenges to the auditor include:

a. Consistency
If properly programmed computer will process transactions consistently accurately and likewise if there is a programming error this will affect all transactions processed.
The auditor must test the system to ensure that it is processing transaction correctly.
b. Concentration of function and controls
Due to the use of computers few people are involved in the processing of financial information. This results in weak internal controls and in particular poor segregation of duties. Certain data processing personnel maybe in a position to alter programs or data while stored or during processing. Many control procedures that would be performed by separate individuals in a manual system may be concentrated under one person in CIS.
c. Programs and data are held together increasing the potential for unauthorized access and alteration.
Computer information systems are designed to limit paper work. This results in less visible evidence. Data may be entered directly into the computer system without supporting documents e.g. in some online systems a sales transaction may be initiated through the computer without a sales order being raised, the amount is then directly charged to the customer's account without a physical invoice being raised.
d. Lack of visible transaction trail/ loss of audit trail.
An audit trail refers to the ability to trace transactions through the system by examining source documents, books of accounts and the financial statements. This is possible in a a manual system where various stages of a transaction are evidenced by physical documents are maintained in magnetic files which are overwritten over time. This results in loss of visible audit trail.
e. Lack of visible output
In some CIS systems the results of transaction processing are not printed out, only the summary data maybe printed. This data can only be accessed through the machine.
f. 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 for unauthorized access to and alteration of data and programs. This could result in fraud or manipulation of accounting records.

g. Programmed controls
in CIS environment controls are programmed together with data processing instructions. E.g. protection of data against unauthorized access maybe by way of passwords or computer programs containing limit checks.
h. A single input to the accounting system may automatically update all records associated with the transaction e.g. when a credit sale is made on line the system will credit the sales account, reduce the stock levels and debit the debtors account simultaneously. Thus an erroneous entry in a system creates errors in the various affected ledgers.
i. Data and programmes are usually stored in portable magnetic disks and tapes, which are vulnerable to theft, loss, and intentional and accidental destruction.
j. Systems generated transactions
many systems are capable of generating transactions automatically without manual intervention e.g. calculation of interest on customers' accounts maybe done and charged to income automatically. This lack of authorization and documentation can result in significant misstatement or errors in financial statements.

Internal controls in a CIS environment

Internal controls over computer processing include both manual procedures and procedures built into the computer programs. These controls can be divided into:

a) General controls
b) Application controls

General controls

These are controls, which relate to the environment within which computer-based accounting systems are developed, maintained and operated aimed at providing reasonable assurance that the overall objectives of internal controls are achieved. These controls could either be manual or programmed.

The objectives of general controls are to ensure proper development and implementation of applications and the integrity of program and data files and of computer operations. General controls will be considered under the headings of:

1. Systems development controls
2. Organisational controls.
3. Access controls
4. Other controls

a. Systems development controls

These relate to:

1. Review, testing and approval of new systems.
2. Parallel running
3. Program changes
4. Documentation procedures.

Review, testing and approval of new systems

The basic principles of these controls are that:-

a. Systems design should include representatives of user department, accounting department and internal audit.
b. Each proposed system should have written specifications that are approved by management and user department.
c. Systems testing should involve both user and computer department.

d. The computer manager, the user department,
dbase administrator and the appropriate level of management should give final approval to the new system before it is placed under operation and offer reviewing the completeness of documentation and results of testing.

Program Changes

Similar requirement apply to changes as well as to new systems although the level of testing and authorisation will vary with the magnitude of changes. It is particularly important that the documentation be brought up to date. A common cause of control breakdown is the unsuspecting reliance of new staff on out of date documents.

Documentation Procedures

Adequate documentation is important to both the auditor and management.
For management documentation provides a basis for:

i. Reviewing the system, prior to authorisation
ii. Implementing smooth personal changes and avoiding the problem that key employees might take with them all the knowledge on how the system works.
iii. Reviewing existing systems and programmes.
iv. For the auditor documentation is necessary for preliminary evaluation of the system and its control.

Parallel running

Before switching to the new system, the whole system should be tested by running it parallel with the existing system. Parallel running refers to running the new and old system along each other for a specified period of time say month. This is important because;

a) It provides the users with the opportunity to familiarise themselves with the new system while still having the old system available to compare.
b) Provides for an opportunity for the programmers to sort out any problems with the new system.

b. Organisational controls

These relate to: -

a. Segregation of functions.
b. Policies and procedures relating to control functions.

Segregation of functions

The principal segregation in a centralised system is between the user and computer departments. Those who process the data should have no responsibilities for initiating or altering the data. The following segregation's are important:

1. The computer department manager should report to an executive who is not regularly involved for authorising transactions for computer processing.
2. Computer staff should not correct errors in input data.
3. Computer staff should not initiate transactions or have custody of resulting assets.
4. Within the computer department there should be segregation of duties along the Following lines.

Job title and responsibilities

1. The computer department manager responsibility exercises overall control over running of the department.
2. Systems analyst responsibility: Monitors existing systems, designs new systems and prepare specifications for programmers.

3. Programmer: Responsibility: Develops, debugs and documents programs.
4. Computer operator: Operates the computer in accordance with operating instructions.
5. Data entry operator: Keys input data into the computer.
6. Librarian: Maintains custody of systems documentation and off line programs and files.
7. Data control group: This co-ordinates activities between the computer department and the user department and monitor and control input and output.
8. Database administrator: Designs the contents and organisation of the dbase and access to the dbase.

Policies and Procedures relating to control functions

A particular worry is that the operation of program controls could be interfered with during the running of the system by someone with necessary skills. For these reasons:

a. Programmers and systems analysts should not be allowed to operate the computer except for testing purposes.
b. Operators duties should be rotated so that the same operator is not responsible for the same procedure.
c. For similar reasons, the computers operating system should be set up and keep a record of programs and files operated on. This record should be checked regularly by the computer department manager and the internal audit. There should also be procedures ensuring the completeness and validity of all input and output. In a centralised system, the data control group may be established for this function.

c. Access control

Computer systems are often dependent on accuracy and validity of data held on file Access controls to the computer hardware, software and data files are therefore vital. Access controls are both physical and programmed. Physical controls apply to both hardware and data files stored in form of magnetic disks or diskettes. Example of access controls.

d. Only authorised personnel should be permitted access to the computer which should be in a secure room. This may not be possible with single microcomputers or even terminals.
e. Control over computers located in the user department should be improved by making sure that vital data or programs are not left running when the computer is left unattended.
f. Passwords should be issued to all staff, whether for access to mainframe or single microcomputers. This is supported by requirement that each user can only log into the computer by keying-in their passwords, the computer then knows the identity of the user and it is programmed so as to only accept instructions only from authorised users. System of passwords makes it possible for each user to have limited access to files and that access may further be designated as Read Only or Read and Write. In this way employees are given access to information contained in files only. Computers should also be programmed to record names of all those accessing the computer for purpose of adding, altering or deleting data. Passwords should be changed regularly and access to password data held in the computer should be subject to stringent controls.
g. The computer has no way of knowing whether the user is the authorised user of a particular password. Hence users should be issued with machine readable evidence e.g. magnetic stripped cards. For access then the user will have to use the card and the password.
h. Access to computers is usually via telephone lines. Computers should be programmed with telephone numbers of such users. On receiving a call, the computer should be required to call back on the authorised number and not receive calls directly.
i. Programs and data files which need not be on-line should be stored in a securelocation with a computer department librarian. Systems programs and documentation should be locked away with limited access.

d. Other controls

They include controls over:

i. Unauthorised use of computers.
ii. Back-up facilities in the event of breakdown. There should be adequate back up procedures e.g. maintaining duplicate programs and information at different locations, protection against natural disasters such as situating computer rooms in rooms protected against floods. There should be maximum possible physical security where computers are installed. Important files should always be stored in duplicate. Standby procedures should be put in place in the event of computer breakdown.
iii. File retention procedures e.g. retaining copies of essential data on separate.

(ii) APPLICATION CONTROLS

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. These relate to the transactions and standing data pertaining to each computer based accounting system and are therefore specific to each such application. With the increasing sophistication of computer operating systems it is becoming more common for controls to be programmed as part of each application. Application controls are generally divided into:

- Input controls.
- Processing controls.
- Output controls.
- Controls over master files and standing data.

Input controls

Most errors in computer accounting systems can be traced to faulty input. Controls over the completeness and validity of all input are therefore vital. Some controls affect both completeness and validity and therefore will be considered separately. These include controls over data conversion, controls over rejections and the correction and the reprocessing of the rejections, batch controls and computer edit controls.

Completeness

These controls ensure that all transactions are recorded. That all sales for example are recorded in the cash register or all purchase invoices are posted to the accounting records. They are particularly important over the recording of revenue and receipt of assets.

Validity

Controls over validity ensure that only actual transactions that have been properly authorised are recorded. These controls are most important over the recording of liabilities such as wages, creditors etc. As in a manual system, control is established by the written authorisation on input documents such as the departmental managers signature on employees time cards. It is important that there is adequate separation of duties such that those who initiate a transaction or who have access to cash, cheques or goods as a result of the transaction being entered should not have the responsibility for entering the transaction. As with completeness, the computer can be programmed to assist in this control in which case some of the requirements above can be relaxed for example the computer can initiate purchases when stock levels reach a pre-determined re-order level. It can then validate the payment by matching the invoice with the order and goods-inward notes.

Access controls as discussed earlier play an important role in validity in that the computer is programmed to accept input only from authorised users. The computer can also be programmed to verify authority limits as well.

Data Conversion

There must be controls to ensure that all data on source documents is properly entered into the computer. In the early days, when entry was by punched card, each card was verified as punched by a second machine operator. But now that most data is entered using a keyboard or a terminal other controls are more common.

The most common input controls are edit controls. Examples of edit controls include;

Type of edit control	Description of control	Objective
Missing field check	Checks that all essential data fields are present and are of the right length	Ensures accuracy of the processed data. Transactions cannot be properly processed if necessary data is missing
Valid character check	Checks that data fields appear to be of the right type eg all alphabetic, all numerical or mixed.	Ensures correctness of input data
Limit/reasonableness checks	Checks that data falls within predetermined reasonability limits e.g. hours worked do not exceed a certain limit, maybe 8 hours a day.	Ensures accuracy and validity of input data
Master file checks	Checks that all codes match those on master files e.g. employee's number matches an employee number on the personnel file.	Ensures that data is processed against the correct master file.
Check digit	Applies an arithmetic operation to the code number and compares the result to the check digit	To ensure accuracy of data by checking keystroke errors.
Document count	Agrees the number of input records in a batch with the total on the batch control form	Ensures that all documents are input

Processing controls
Processing controls ensure that transactions are:

- Processed by the right programs.
- Processed to the right master files.
- Not lost, duplicated or otherwise improperly altered during processing.
- Processing errors are identified and corrected.

Processing controls include:
- Program file identification procedures, which enquire whether, the right master files are in use.
- Physical file identification procedures in the form of labels physically attached to files or diskettes to ensure that the right files are in use.
- Control totals which are progressively expanded as the data is processed, for example the hash total of quantities shipped can be expanded to a gross sales total as items are priced and to a net sales total as customer discounts are determined. These totals should be carried forward with the transaction data as run-to-run totals.
- Limit and reasonableness tests applied to data arising as a result of processing.
- Sequence tests over pre-numbered documents.

c) Output controls
Are necessary to ensure that:-
- Output is received from input.
- Results of processing are accurate
- Output is distributed to appropriate personnel.

These controls include:

- Logging of all output.
- Matching or agreeing all output to input, such as for one matching, or control totals.
- Noting distribution of all the output.
- Output checklists aimed at ensuring that all expected reports are processed and forwarded to the relevant department or personnel.

Controls over master files and standing data

These are aimed at ensuring completeness, accuracy and authorisation of amendments to master files and standing data files. These controls are similar to controls over input. E.g. controls to prevent the deletion of any account, which contains a current running balance. Once standing data has been written onto a master file, it is important that there are adequate controls to ensure that the data remains unaltered until an authorised change is made.
Examples of controls

- Periodic printouts of standing data for checking with manually held information.
- Establishment of independent control totals for periodic verification with computer generated totals.

AUDITING IN A COMPUTERISED ENVIRONMENT

The use of computers in the processing of financial information by the client affects the general approach of the auditor to his work. 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.

PLANNING THE AUDIT IN A COMPUTERISED ENVIRONMENT

When planning for an audit in a computerised system the following factors must be considered:

- Auditors need to be involved in computerised 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 computerised 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 laptops to aid in preparing audit working papers 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.

TESTING THE INTERNAL CONTROLS IN A COMPUTERISED ENVIRONMENT

The auditor tests internal controls when he wishes to place reliance on the controls in determining whether the accounting records are reliable.

A computerised 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 controls are tested 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 management, auditors must seek for ways to test the performance of the programs by auditing through the computer.
- Use of CAAT'S - Computer Assisted Audit Technique's
  Test data is mainly applied in testing computerised information systems.

SUBSTANTIVE TESTING IN A COMPUTERISED 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 2 basic approaches both of which will be used.

(a) Manual Testing Techniques

- Review of exception reports: The auditor then attempts to confirm these with other data for example the comparison of an outstanding despatch note listing with the actual despatch notes.
- Totalling: Relevant totals for example of debtors and creditors listings can be manually verified.
- Re-performance: The auditor may re-perform a sample of computer generated calculations for example stock extensions, depreciation or interest.
- Reconciliation's: These will include reconciliation's of computer listings with creditors statements, bank statements, actual stock and personnel records.
- Comparison with other evidence such as results of a debtors circularisation, attendance at stock take and physical inspection of fixed assets.

(b) Computer Audit Programs sometimes called generalised computer audit software. Computer audit programs are computer programs used by an auditor to:-

- Read magnetic files and to extract specified information from the files.
- To carry out audit work on the contents of the file.

These programs are sometimes known as Inquiry or Integration programs.

Uses of computer audit programs:

1. In the selection of representative or randomly chosen transactions or items for audit tests.
2. The scrutiny of files and selection of exceptional items for examination e.g. on wages payments over Shs.1000 or all stock items worth more than Shs.100,000 in total.
3. Comparison of 2 files and the printing out of the differences e.g. payrolls at 2 selected dates.
4. Exception reports can be prepared using these programs e.g. overdue debtors.
5. Stratification of data such as stock items or debtors with a view to examination only of materialitems.
6. Carrying out detailed tests and calculations.
7. Verifying data such as stock or fixed assets at the interim stage and then comparing the examinedfile with the year end file so that only changed items need to be examined at the final audit.

6. THE AUDITOR'S APPROACH

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

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

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

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

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

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

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

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

Changes in audit approach:

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

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

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

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

The Control File:

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

(a) Copies of all the forms which source documents might take, and details of the checks that have been carried out to ensure their accuracy.

(b) Details of physical control over source documents, as well as of the nature of any control totals of numbers, quantities or values, including the names of the persons keeping these controls.

(c) Full description of how the source documents are to be converted into input media, and the checking and control procedures.

(d) A detailed account of the clerical, procedural and systems development controls contained in the system (e.g. separation of programmers from operators; separation of control of assets from records relating thereto).

(e) The arrangements for retaining source documents and input media for suitable periods. This is of great importance, as they may be required for reconstructing stored files in the event of error or mishap.
(f) A detailed flow diagram of what takes place during each routine processing run.
(g) Details of all tapes and discs in use, including their layout, labelling, storage and retention arrangements.
(h) Copies of all the forms which output documents might take, and details of their subsequent sorting and checking.
— The auditor's own comments on the effectiveness of the controls.

7. AUDITING AROUND THE COMPUTER

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

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

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

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

So although it may be reasonable for management to have faith in their systems and programs, such faith on the part of the auditor would be completely misplaced and may reflect very adversely on his duty of care. This is the first situation on the loss of audit trail.The other situation where loss of audit trail is noted where the computer generates, totals, analyses and balances without printing out details. It therefore becomes necessary for the auditor to find a way to audit through the computer rather than around it. But before we go on to that, the loss of audit train can be overcome as follows:

(a) We can have special print outs for auditors, remember the need to be consulted at the design stage.
(b) Inclusive audit facility. This means putting in the programs special audit instructions that enable the computer to carry out some audit tests and produce print outs specially for the auditor.
(c) Clerical recreation: Given unlimited time and man power, maintain the possibility to recreate manually the audit trail. This would obviously be a very tedious exercise.
(d) Total testing and comparison: It is possible to compare results with other data, budgets, previous periods and industry averages.
(e) Alternative tests: We can perform stock takes, debtors circularisation and examination of the condition of fixed assets.
(f) We can use test packs to verify program performance.

8. AUDITING THROUGH THE COMPUTER

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. These methods are ordinarily referred to as computer assisted audit techniques (CAATs).

Test data

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

(a) Live testing has the following disadvantages:

i. If the data is included with normal data, separate test data totals cannot be obtained. This can sometimes be resolved by the use of dummy branches or separate codes to report the program's effects on the test data.
ii. Side effects can occur. It has been known for an auditor's dummy product to be included in a catalogue.
iii. Client's files and totals are corrupted although this is unlikely to be material.
iv. If the auditor is testing procedures such as debt follow up, then the testing has to be over a fairly long period of time. This can be difficult to organise.

(b) Dummy testing has the following disadvantages:

i. Difficulties will be encountered in simulating a whole system or even a part of it.
ii. A more detailed knowledge of the system is required than with the use of live files.
iii. There is often uncertainty as to whether operational programs are really being used for the test.
iv. The time span problem is still difficult but more capable of resolution than with live testing.

Computer audit programs (Audit software)

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

Uses of computer audit programs:

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

Advantages:

1. Examination of data is more rapid;
2. Examination of data is more accurate;
3. The only practical method of examining large amounts of data;
4. Gives the auditor practical acquaintance with live files;
5. Overcomes in some cases a loss of audit trail;
6. Relatively cheap to use once set up costs have been incurred;

Disadvantages:

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

Use of audit software raises the visibility of the auditor in the eyes of the company. It makes the audit more credible. Deficiencies in the system are often discovered and can be reported to management. This also makes the audit more credible. Packages are not however usually available for small machines.

9. REAL TIME AND ON-LINE SYSTEMS

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

i. hardware constraints e.g. necessitating the use of a key of magnetic-strip badge or card to engage the terminal, or placing the terminal in a location to which access is carefuly restricted, and which is constantly monitored by closed-circuit television surveillance systems;
ii. the allocation of identification numbers to authorised terminal operators, with or without the use of passwords; these are checked by the mainframe computer against stored records of authorised numbers and passwords;

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

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

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

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

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

REINFORCEMENT QUESTIONS

QUESTION ONE

A medium size firm which has been your client for several years has changed from a manual accounting system to computerised 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

The auditor of a company with an Electronic Data Processing (CIS) based accounting system should remember that if the quality of the input is controlled, the output will "look after itself".

(a) Discuss the application of this statement, citing suitable examples. (4 marks)
(b) Describe six major procedural controls which the auditor would expect to find in operation, three relating to input and 3 to output. (12 marks)

QUESTION FOUR

The usual implication of on-line computer systems is that the user can have direct access to the master files within the system, through the medium of a terminal.

(a) Describe the potential control weaknesses, specific to on-line systems.
(b) Detail the methods that can be adopted to overcome these weaknesses.

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK

LESSON EIGHT

AUDIT TESTS

CONTENTS:

a. Substantive Tests
b. Directional Tests
c. Analytical Review
d. Vouching Audit

- Practical illustrations:
- Interest Paid
- Interest Received
- Dividends Received
- Rent Received

e. Vouching Audits of different types of business

- Insurance Premiums Received
- Subscriptions Received
- Hire Purchase Instalments received

f. Audit of Salaries and Wages
g. Verification of assets and liabilities
h. Reinforcement Questions

1. 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.

Existence:

For tangible assets existence can be confirmed through physical inspection. During the inspection the auditor also considers the condition of those tangible asset as valuable evidence to the reasonableness of valuation.
For liabilities and assets such as debtors, cash at bank; the auditor would be satisfied with third party confirmations. Intangible assets such as goodwill and deferred development expenditure; the prevailing circumstances give guidance as to whether that intangible asset exists.

Right of obligations:

The ownership rights to assets can be confirmed through the inspection of title documents to confirm that such the title documents are in the name of the company. Documents of title include: title deeds and motor vehicle registration. Where there is no document of title proof of purchase and possession will suffice. That is evidence that the client ordered for the goods, paid for them or is acknowledging liability for them, they are in his possession and there's no evidence to indicate any other party has a claim to those goods then the client has a right to those goods.

Occurrence:

Testing for occurrence involves verifying that a transaction actually took place during the year. This is tested through inspection of the documents raised in carrying out the transaction. E.g. the occurrence of a purchase transaction can be verified by inspection of the purchase order raised at the initiation of the transaction and the resulting purchase invoices raised by the supplier.

Completeness:

Completeness tests are designed to confirm that there are no unrecorded assets, liabilities or transactions.

1. For documents that are pre-numbered the auditor can test for the numerical sequence investigating any missing numbers.
2. Cut-off procedures are performed to confirm that transactions with their related movement of assets have been fully recorded in the same and correct accounting periods.
3. Review of reconciliation between control accounts and subsidiary records and between subsidiary records and third party records.

Valuation:

Most balances are valued at cost plus or minus a provision. Both cost and provision will involve an accounting policy considered most appropriate by the client for their circumstances:
The auditor will:

1. Determine the clients accounting policy
2. They will then test the suitability of that policy
3. If suitable test the application of that policy.

Measurement:

It involves determining that recorded events or transactions have been recorded in the correct amounts and if it's revenue or expense it has been allocated to the correct period.
Measurement is closely related to occurrence and valuation and in addition therefore to the procedures discussed under occurrence and valuation the company's capitalization policy is critically reviewed for its continued suitability.

Presentation and Disclosure:

The categorization, classification, description and disclosure of transactions and balances in the books of accounts or financial statements may be governed by the company's act disclosure requirements, accounting standards or other regulations. Usually by use of a checklist the auditor compares the clients presentation and disclosure with the presentation and disclosure requirements.
Analytical review tests, which are included in the description of substantive tests, provide evidence as to the completeness and occurrence and measurement of events and balances.

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 tests give indirect evidence to the auditor and if the conclusion from them is 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.

2. DIRECTIONAL TESTS:

A general assumption that audit firm have, that companies overstate assets and understate liabilities. It 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:

i) **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.
ii) **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.
iii) **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.
iv) **Reviewing reconciliation of creditors statements** with the creditors individual ledger accounts ensuring that any reconciling items are valid and genuine.
v) **Reviewing lending contracts** or agreements for breach of contract accusations to determine where claims would be made against the company.
vi) **Reviewing correspondence with professional advisers** e.g. lawyers for claims that they may have made against the company but not recorded.

3. ANALYTICAL REVIEW-ISA 520

Analytical review can be defined as the study of relationships between element of financial information expected to conform to a predictable pattern based on the organization's experience and between financial information and non-financial information.
Under analytical review information is compared with comparable information for prior records with anticipated results and with information relating to similar organizations.

In an actual case, analytical review can be applied by examining: -

a) Increases in magnitude corresponding to inflation
b) Changes in amounts consequent on changes in output levels
c) Comparison with previous periods
d) Trends and ratios
e) Comparisons with budgets and forecasts
f) Comparisons with other similar organizations e.g. inter-firm comparison

The Timing of Analytical Review Techniques

This will be applied throughout the audit but the specific occasions will include:

a. **At the planning stage:** at this stage the auditors will hope to identify areas of potential risk or new developments so that he can plan his other audit procedures in these areas.
b. **During the audit as a substantive procedure for obtaining audit evidence**: modern audits with their emphasis on efficiency and economy depend heavily on analytical review as a valid audit technique used alone on in conjunction with the internal control reliance and substantive testing. It can be reasonable to obtain assurance of the completeness, accuracy and validity of transactions and balances by analytical review as by other types of audit evidence. E.g. if the relative amounts under different expense headings repeat the pattern of previous years, the auditor will have evidence of the accuracy of expense invoice coding.
c. **At the final review stage of the audit:** analytical review techniques can provide support for the conclusions arrived at as a result of other work. E.g. indications from external sources that profit margins have declined by 10% may support the declined profit figure in a segment of the company whose figures have audited by other means and found to be correct. The techniques are also used to assess the overall reasonableness of the financial statements taken as a whole.

Extent of use analytical review procedures

The factors which might affect the extent of use of analytical review include:

1. **The nature of the entity and its operations:** e.g. a long established chain of similar shops which changed little in the period under review will offer many opportunities for analytical review to be used as a primary source of audit evidence. Conversely a newly established manufacturer of high-tech products will not provide such an opportunity.
2. **Knowledge gained from previous audits of the enterprise**: the auditors will have experience of those areas where errors and difficulties arose and those areas of greatest audit risk.
3. **Management's own use of analytical review procedures**: if management has a reliable system of budgetary control then the auditors will have already made source of explanation for variances. If management uses information that has been subjected to internal audit review, the reliability of that information is enhanced. If the staff who produce the information are competent and have integrity again the reliability of information is enhanced.
4. **Availability of non-financial information** to back up financial information
5. **The cost effectiveness of the use of analytical review in relation to other forms of evidence**: in general analytical review is cheap but requires high quality staff. Some techniques can be expensive if they involve statistical techniques.
6. **Availability of staff**: analytical review requires high quality staff with much intelligence, experience and training.

The auditor's procedures:

a) Identify the factors likely to have an effect on items in the accounts
b) Ascertain or assess the probable relationship between these factors and the items.
c) Predict the value of the item in the light of the factors.
d) Compare the predicted value with the actual recorded amount.

e) Consider the implications of significant fluctuations, unusual items, or relationships that are unexpected or inconsistent with evidence from other sources. Similarly consider the implications or predicted fluctuations that fail to occur.
f) Discuss with management any significant variations therefore management will usually have an explanation for the variation. Seek independent evidence to support management explanations.
g) React to significant fluctuations or unexpected values. The auditors reaction depends on the stage of the audit at which he is carrying out analytical review. If at the planning stage- plan suitable detailed substantive tests. If during the audit-then further audit tests will be indicated. All fluctuations and unexpected values must be fully indicted and sufficient audit evidence obtained.
h) As with all audit work analytical review procedures should be fully documented in the working papers. Files should include:-

   a) The information examined with detailed calculations and explanations ofinfluences expected.
   b) The management explanation of significant fluctuation
   c) The verification of these explanations
   d) The conclusions drawn by the auditor
   e) Details of further tests if any

Please note the following:

- Any relationship perceived between variables must be plausible ie the relationship found should be reasonable and relevant to audit objectives. E.g. debtors and sales have a plausible relationship but there's no plausible relationship between selling expenses and work in progress (W.I.P.) in a manufacturing account.
- Also note that the nature of analytical review includes the comparison over time and the use of past experience on the audit therefore it is desirable for the auditor to build up a picture of the organisation and the relationship between magnitudes in the permanent audit files.
- Materiality is very important thus those areas not judged to be material, the auditor will very often rely wholly on analytical review to conclude. But material areas require a combination of compliance testing, analytical review and detailed substantive testing.

Analytical review in practice:

1. The auditor will always establish a trend analysis most common trend analysis being a 5-year side-by-side balance sheet and detailed profit and loss account.
2. A trend analysis of key profit and loss figures within the year under review such as a monthly summary of the sales and related expenses.
3. Ratio analysis: for the profit and loss account growth in percentage terms of key figures will be worked out.

The figures will also be compared with the budget with variations being expressed maybe in percentage terms. The previous years figures may also be put alongside. Gross profit margin is also a figure that is worked out along the same lines. Gross profit margin will be compared to that of the previous year and that of the budget usually the Gross profit margin is expected to be steady. If it has fluctuated significantly then the components that make up the Gross profit figure particularly sales, purchases and closing stocks are further investigated.
The proportion to sales of those items that have a plausible relationship with sales is worked out. These could include selling and distribution expenses such as advertising and motor vehicle running expenses.
If industry averages are available the organisation's figures are also compared to those averages.

Balance sheet ratios that are usually considered:-

a. Fixed Assets (FA):
   (i) The utilisation 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.

(ii) Global depreciation ratio is also 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 of 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 organisation 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 days sales in 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:

- The current ratio
- The acid test ratio

e. For cash at bank an additional measure is consideration of the overdraft limit for trade creditors. The percentage increase is worked out and compared with the increase in the cost of sales. Also the number of days purchases in creditors worked out to measure the difference between credit taken and credit allowed by suppliers.
f. The gearing ratio is worked out to measure the company's exposure or the cost of external capital to the organisation.

4. 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:

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

Method:

a. 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:
b. The transaction was authorised by management
c. The transaction came within the aims and objects of the organisation
d. The transaction was correctly and adequately described by the entry in the books.
e. The entry is correctly incorporated in the final accounts

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 authorisation to obtain the loan and to service it.
  The authorisation 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 organisation
The auditor should check the reason for obtaining the loan(s) and ensure that they are in accordance with the aims of the organisation.
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.

- Recompute the interest and ensure it is correctly calculated.
- Check the recording of this interest in the ledger
- Obtain the couterfoils 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 this 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

1. 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.)

2. 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.

3. Ensure that this transaction was properly recorded.

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

4. 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 organisation
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 so the auditor should ensure that they are recorded in the period they relate to.
   - Check the recording of 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

i) Check the minutes of the BOD and or AGM to ascertain authority for obtaining the property and for renting the property out.
ii) 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 eg monthly, quarterly
   - Terms of maintenance of the property could be maintained by the landlord or tenant
   - Ensure that these are in agreement with the organisations objects.

iii) 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 ie a valuer.
Trace the item to the cash book and bank statement
iv) Ensure that the profit and loss account has the correct amount and item is for the correct period.

5. 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 of different types of makes 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 specialised guidelines giving a general knowledge about the enterprises 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.

1. Obtain the authority for accepting the cover. This should be from the appropriate official and if necessary from a BOD resolution.
2. 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.
3. Calculate the premiums and compare this amount to the amount received.

    - Check the period which relates to 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 policies
        - Date due
        - Any defaults-check the entries in the ledger for this.

4. 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 organisations.

1. Obtain authority for admitting the members whose subscriptions are being audited. The auditor should obtain the constitution of the club or organisation.
2. 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.

3. Obtain the ledger and ensure that subscriptions 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.
4. 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 Installments 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 installment
- Provision for default

Ensure the hire purchase terms are in agreement with the policy of the organisation

c. Find out the amount of installments and when they should be paid and get the ledger recording of these installments. Ensure that capital payments are separated from revenue payments. 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 account for proper recording.

6. 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:

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

The auditor should check the following areas carefully:

- Time workers- who come in shifts who work for a certain number of hours a day.
- Piece workers-employed to do a 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/dummy workers or any similar fraud.
- Check the procedure of employment and dismissal of employees, which should be authorised by a responsible officer.
- Verify that there is proper recording of wages.
- For time basis check time records.
- Check authorisation of overtime.
- Verify authority for deductions and ensure proper recording.

- Check castings of wages.
- Ensure all stages of preparation of payment of wages is properly authorised.
- Check total of wages paid to control account
- Check unclaimed wages book with entries in wages sheet
- 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.

1. 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 Para 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 a true and fair view.

Management assertions

Refer to the topic on audit evidence and ISA 500 Para 13
Financial statement assertions are assertions by management, explicit or otherwise that are embodied in the financial statements. They are categorised 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 judgement. 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.

1 (a) VERIFICATION OF NON-CURRENT ASSETS

In an average company the non-current assets that will be encountered 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 & machinery.

Freehold Land & Buildings

Audit objectives

- To verify that there was proper authorization to acquire the land and the buildings.
- That land and buildings 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 to acquire the assets in question.

b) Existence

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 any charges. E.g. the land title deed should not be charged as security for a loan. If this is the case then such information should be disclosed in the financial statements.

d) Valuation

Freehold land should be disclosed as cost. Leasehold land 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 proper 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;
- Proper authorisation to acquire the asset
- Valuation
- Existence
- Ownership rights
- Presentation and disclosure

Cost

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

Authorisation

Check in the directors' minutes or AGM minutes for proper authorisation 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 Register.

Fixed Asset Register

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

- Ordering or authorising the purchases of fixed assets.
- The custody of the fixed assets.
- Authorising the disposal of fixed assets.
- Maintaining general ledger accounts.
- Custody of readily realisable assets.

The register contains the following information:

i. Fixed asset number.
ii. Fixed asset location & responsibility for custody.
iii. Nature and description of the asset.
iv. The cost and date of purchase.

v. The estimated useful life and the 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 & Machinery, it is usually implied and unless there is clear evidence to 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, e.t.c. 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 authorisation for disposal.
- Also the auditor tries to ensure that the value obtained was reasonable either by engaging an expert or by looking at the values obtained and related values for assets of that nature.

1. (b) 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 organisations refrain from maintaining substantial cash amounts in their premises due to the risks involved.

Audit Objectives

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

Audit procedures

These audit objectives are fulfilled by carrying out the following procedures:

i. 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 authorised IOU's, stamps & cheque drafts as well.

ii. If the company has different cash collection centres cash in all entries must be counted simultaneously to avoid a shortage in one centre being made up with balances from other centres.
iii. The counting should be in the presence of the cashier 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.
iv. 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.
v. If there is cash held by third parties he should request for a certificate of balance from them.
vi. 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.
vii. 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;

    - Verify that the reconciliation is accurately prepared
    - Ensure that the correct balances as per the bank statement and the cash book have been picked in the reconciliation.
    - Verify that the reconciling items have subsequently cleared
    - Ensure that there are no unexplained variances
    - 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.

      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 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.

Stocks and Work-In-Progress

Stock includes;

- Finished goods held for sale 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

1. The amounts involved are invariably material.
2. 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.
3. Stock does not derive from the normal double entity system, it is arrived at by stock taking carried out at the year- end.
4. Stocks are portable and valuable opening themselves to pilferage and deterioration either intentional or accidental.
5. The number of items involved is usually numerous creating verification problems as far as existence and condition is concerned.
6. Although stocks are valued at the lower of cost and net realisable value, what constitutes cost can vary from one management to another and the basis of determining that cost can be subject to so many different methods all resulting in different values for the same items.
7. It is an area that is susceptible to manipulation by management provision for obsolescence, slow moving and damaged stocks is a question of judgement therefore it is easy for the auditor to disagree with management.
8. 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.
9. 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 realisable 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 organisation 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 is correctly applied.

Valuation

Stock should be valued at lower of cost and net realisable value where net realisable value is defined as the amount that could be realised 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 realisable 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 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 unfavourable 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 must verify existence. This is chiefly through the client arranging for a stock take and 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 not 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 it's stock and it's stock records. Definite instructions preferably in writing should be issued in all cases for the guidance of those who will be engaged in the actual stock taking. The instructions should contain:

a. Identification of the stock items and their ownership.
b. Counting, weighing or measuring.
c. Reporting of stocks which are damaged/defective.
d. The following issues should be addressed:
    - Stocktaking 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 specialised knowledge is necessary to identify, quality and quantity of stock.
    - Cut off procedures should be performed i.e. despatch documents for all goods belonging to customers and still held by client and those that have already passed to the customer. Exclude these from stock take.
    - Include all 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 the 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 completed and those cancelled and 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:

i. Study of the clients stock taking instructions and recommend for changes or improvements if the auditor consider them inadequate.
ii. Familiarisation with the location of the stocks and the opportunity to plan for the work to be undertaken.
iii. Familiarisation with the nature and volume of stocks and especially with high value items.
iv. Review of previous years working papers and discussions with the managers of any significant changes from the previous year.
v. Consideration of the location of stocks and likely points of difficulty e.g. cut off.
vi. Consideration of any involvement of the internal audit department and the extent of reliance to be placed upon their work.
vii. Arranging to obtain from third parties confirmation of stocks held by them.
viii. Establishing whether expert advice may be needed.

Duties during the stock take

- The main task is 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 of the stock take exercise.
- He must form a conclusion as to whether the stock take can be relied on.
- Get photocopies 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 stocks 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 count sheets issued were returned.
- Check the final stock sheets for pricing, extensions, casting, summarisation 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 an 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 most probably would lose the stocks and money. This was accepted practice for centuries.

The Romalpa case rules that transactions can be made subject to reservation of title until such a time as the buying company makes payment. The case further ruled that such a reservation should be clearly stated in the appropriate sales documentation and that the rights of the selling company over unpaid for stocks can even extend to goods produced from the store and the sale proceeds therefrom.

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 paid for.

Accounting treatment acknowledge 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 of 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 stocks 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 the right to claim the goods if they are not paid for. The total of such suppliers included in creditors in the balance sheet was Kshs. X.

Accounting policies must be disclosed and changes therein as well.

Work In Progress

This items 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 auditors 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 outputs of products and expectations.
- Enquiry into checks that are made as part of the system on statistical data concerning inputs of materials and outputs 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 organisation constructs intentionally some of its own fixed assets, the auditormust 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 years 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 the 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 circularisation
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:

1. The adequacy of the International Control System (ICS) for approval of credit and follow up of poor payers.
2. The period of credit allowed and taken.
3. 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 fromthose debtors.
4. Examine the evidence justifying the need for a provision. This include: debtors, payment record, 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.
5. 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' cirularisation

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.

Purposes for Circularisation

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

Types of Circularisation

Negative Circularisation

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 circularisation 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 satisfy themselves with regard to the purposes of circularisation the negative method should not be used.

Positive Circularisation

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 is the preferred method of circularisation.

The approach for circularisation is as follows:

1. Obtain the client's consent to send the requests to the debtors.
2. Select the date at which you desire to perform the circularisation.
3. Select the debtors you wish to circularise and confirm management's acceptance of those debtors.
4. Draft a circular, which should be from the client to the debtor with the request that the debtor should reply direct to the auditors.
5. Send reminders to non-repliers.
6. Evaluate the replies. This involves comparing the amount acknowledged in the reply with what appears in the clients ledger and investigating any differences.
7. Perform alternative tests to non-repliers.
8. Conclude on whether the objectives of the debtors circularisation have been achieved.

Selecting the debtors for circularisation

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

1. All large debtors would be circularised i.e. debtors above the materiality level set for debtors.
2. 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 not credit balances.
3. Debtors who seem to have exceeded their credit limits in terms of amounts or time may also be selected.
4. 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.
5. Newly opened accounts also tend to be circularised. The remaining accounts tend to be selected on a random basis.
6. Long outstanding balances. This helps in assessing the need to create a provision for irrecoverable balances.
7. Accounts in dispute.

Alternative tests

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

a. Review of the after-date payments: because if the debtor has subsequently paid then there is evidence that the debtor was in existence.
b. Review of supporting evidence for the invoices that make up the balance. These include: Customer orders and acknowledgement or receipting of the goods.
c. 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 tests 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.

2. VERIFICATION OF LIABILITIES

The auditors duties with regard to liabilities can be summarised as:

- To verify the existence of liabilities shown in the balance sheet and that these are genuine obligations of the company.
- To verify the correctness/accuracy of the money amount of such liabilities.
- To verify the appropriateness of the description given in the accounts and the adequacy of the disclosure.
- 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 e.t.c.
- 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 procedures 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 for 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 be 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 accounts 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 event review with regard to liabilities.

2. (a) CURRENT LIABILITIES

Taxation;

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

a) Obtain or prepare the tax computation.
b) 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 years' returns.
c) Vouch instalment payments to the cashbook and the receipts from the Income Tax Department.
d) Obtain, 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 forward.

   - Balance brought forward should be in agreement with the balance for the previous year.
   - The amount paid in the year should be agreed with the cash flow statement and cash book.
   - Balance carried forward to the draft balance sheet.

e) The auditor should ensure that disclosure is adequate. A note to the accounts should explain the basis for arriving 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;

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

Audit procedures

1. Obtain a creditors listing and verify that the total per the listing agrees with the total per the ledger.
2. 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.

3. 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.
4. 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 provisions 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 provisions 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 creditors 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. Considerable attention needs to be paid to accruals as like prepayments they are not checked by the double entry system and therefore open themselves to distortion of the accounts by the senior management.
d. The auditor must ensure that last years accruals are written back
e. Accruals do not alter much from year to year and therefore comparison of last year's and this year's listing is an essential audit procedure and any that are substantially greater or lesser would call for investigation.

2. (b) 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 e.t.c.
- 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 books 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 references to and indications of possible claims.
- Making appropriate enquiries 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 directors 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.

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:

a. Ensure the issue is within the limits authorised by memorandum and articles of association.
b. Ensure the issue was subject to a director's minute.
c. Ascertain and evaluate the system for control of issue.
d. 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.
e. When the issue was one which was contingent upon permission to deal being received from stock exchange then:

   i. Ensure that permission has been obtained. If it has not been given, all the money subscribed must be returned.
   ii. Ensure all the money was kept in a separate bank account until all conditions were satisfied.
   iii. Ensure that the minimum subscription has been received. If there are not enough s subscribers then the whole is returnable.
   When the issue is not for cash but for other consideration vouch the agreement and ensure that all entries are properly made.

g. Vouch the payment of underwriting and other fees. When no new issue of shares has been made the audit work will include:
   i. 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.
   ii. Test the balances in the share register with the list and vice versa.
   iii. 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.
   iv. 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, register of debenture holders, etc.
v. Vouch repayments with debenture deeds. (terms are correctly interpreted) cashbook, register of debenture holders etc.
vi. Vouch interest payments with debenture deed, cash book and see amount paid is correctly shown as a percentage of amount outstanding.
vii. Agree total amount outstanding with register of debenture holder.
viii. If loans are secured, verify charge is registered at companies 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.

3. CONCLUDING THE AUDIT

GOING CONCERN CONSIDERATIONS

Going concern assumption is one of the 3 fundamental accounting assumptions whose appropriateness is assumed in the preparation of financial statements.
It describes the assumption that it is assumed that the entity will continue in operational existence for the foreseeable future or the financial statements assume that there is no intention nor necessity to liquidate or significantly curtail the scale of operations; or put more simply - the entity can meet its financial obligations as they fall due.

The importance of the assumption

If the going concern assumption was to be abandoned some of the following implications for the financial statements would become apparent:

a. **Fixed assets:** Fixed Assets are classified as fixed assets therefore they have a future benefit to the organisation. If therefore the organisation is not a going concern, then there is no such future benefit. Fixed assets (FA) would have to be classified therefore as current assets (CA). FA are valued for accounts purposes at depreciated cost values which values may have no relationship to the market value of those assets. If the entity isn't a going concern, FA would have to be valued at realisable amounts.
b. **Prepayments & Intangibles:** If the organisation ceases to be a going concern, some prepayments and intangible assets cease to exist and to have any value.
c. **Long term liabilities** crystalise and become immediately payable meaning that they become current liabilities.
d. **New liabilities** may appear requiring to be recognised such as closure costs, redundancies or even leave pay.
e. If a fundamental accounting assumption is departed from then the departure must be explained and justified in a note to the accounts and must also be referred to in the Auditors Report.

The Auditor's duty

Because management will assume the appropriateness of the going concern assumption while preparing the financial statements, the auditor must obtain sufficient evidence that management application of the going concern assumption was justified.
Should the auditor conclude that the assumption was not appropriate to the circumstances of the entity then he must advice the management to prepare the accounts on other than a going concern basis and should the management refuse to do so, then the auditor should consider qualifying his audit report.
The indications or risk that continuance as a going concern may be questionable could come from financial statements or from other sources

Financial indicators

- Liabilities are more than the assets of the company.
- Borrowings with fixed repayment dates approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term projects undertaken by the company.

- Adverse key financial ratios e.g. current ratio below one;
- Substantial operating losses.
- Inability to pay creditors on due dates.
- Difficulty in complying with terms of loan agreements e.g. failure to pay interest and principal on due dates.
- Change from credit to cash on delivery transactions with suppliers.

Operating indicators

- Loss of key management without replacement.
- Loss of major market or customer.
- Labor difficulties or shortage.

Other indicators

- Non compliance with capital or other statutory requirements. This could lead to the company being wound up under the law.
- Pending legal cases against the entity that may, if successful result in judgements that could not be met.
- Changes in legislation or government policy that adversely affects the client's business.

Indicators that the going concern assumption is questionable might be mitigated or countered by other factors. E.g. the effect of a company being unable to repay its loans may be countered by plans by management to dispose of some of the assets to raise money for settling the loan. The auditor should consider the effects of these steps taken by management and evaluate whether the company is a going concern or not.

Example of some of the steps management might undertake to save the company from being liquidated (mitigating factors)

1. Selling of some of the company's fixed assets with the aim of raising money to retire some of the loans falling due.
2. Borrowing money to settle some of the loans and other debts falling due. e.g. a company can obtain a loan from the bank to retire debentures falling due.
3. Restructuring debt. This may involve rescheduling the repayment date or converting debt into equity.
4. Reducing ordinary expenditure. The company can suspend planned expenditures such as the acquisition of new production plants.
5. Requesting shareholders to inject more capital into the company.

The Auditor's Procedures

When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve to the auditor's satisfaction the question regarding the entity's ability to continue in operation in the foreseeable future.

Procedures that an auditor carries out when the going concern assumption is questionable include:

- Analysing the company's cash flows, profits and other forecasts and hold discussions with management to determine how the company's future looks like.
- Reviewing events after the balance sheet date for items affecting the entity's ability to continue as a going concern e.g. If the company's year end is on 31 December and a loan was repayable on 15 January the following year, the auditor should consider whether the company has been able to repay the loan and if not what measures have been undertaken.

- Review the terms of debenture and loan agreements and determine whether they have been breached. Breach of loan contracts could lead the company to receivership or liquidation.
- Read minutes of meetings of directors and shareholders for reference to factors that could lead to the collapse of the company. If the company is facing liquidity problems this will ordinarily feature in the board meetings.
- Inquire from the company's lawyers regarding any legal suits against the company. Instances where the company's existence is threatened by the potential effects arising from legal claims against the company, the auditor should consult the client's lawyers and establish the potential effect.
- The auditor should also consider and discuss with management its plans for the future such as plans to liquidate assets borrow money or restructure debt or delay expenditures or increase capital.

When the auditor concludes that the going concern assumption is not appropriate to the circumstances of the entity he must discuss this with management and review any plans management have to keep the company as a going concern. These plans should be Specific and if dependent on third party support then the auditor should obtain written confirmation from that third party.

Letters of Support

There are occasions when an entity on the face of its balance sheet is insolvent and accordingly the going concern assumption would be inappropriate. There may however be shareholders, directors or other creditors prepared to provide support to keep the entity as a going concern. Should that be the case the auditor should obtain through the management written letters from these parties. These letters are ordinarily called letters of support.

Implications for the Auditors Report

If the auditor is satisfied that the going concern assumption was appropriate to the circumstances of the entity, there is no need to mention that fact in his audit report.

If the appropriateness of the going concern assumption is dependent on the outcome of a future event such as negotiations to obtain new financing, then the auditor may refer to this as an emphasis of matter.

When the auditor is convinced that the entity is not a going concern and management have prepared the financial statements on the going concern assumption; then the auditor should:

- Consider the materiality of the adjustments that would be necessary to bring the accounts to other than a going concern basis and if not material, then the need to mention it in his audit report.
- If the adjustments would be material, then the auditor should mention the financial effect and qualify his audit report.

PLEASE NOTE THAT: It is possible that a qualified report, (that the entity is not a going concern) could hasten the death of the company. The auditor should not refrain from qualifying his report even if it leads to the loss of a client or death of a company.

POST BALANCE SHEET EVENTS CONSIDERATIONS

Post Balance sheet events are those events both favourable and unfavourable that occur between the balance sheet date and the day the accounts are approved by the Board of Directors.

Types of Events

- Adjusting events &
- Non-adjusting events.

    - **Adjusting events** being those that provide additional evidence about conditions existing at the balance sheet date or are events.

- **Non-adjusting events** are those that are indicative of conditions that arose after the balance sheet date.

Examples of adjusting events

An enterprise should adjust the amounts recognised 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 recognised 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 recognised, or to recognise 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 realisable value at the balance sheet date. This can be used to revalue the stock to the lower of cost and net realisable value.
- The discovery of a fraud or errors that show that the financial statements were incorrect.

Examples of non-adjusting post balance sheet events

A company should not adjust the amounts recognised in its financial statements to 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 authorised 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.

- 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 transactions in progress at the balance sheet date i.e. started in the year under review and materialising/maturing in the following year. To determine the position at the balance sheet date, reference will have to be made to the maturity of 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 a past date, they are used for making decisions in the period after they become public knowledge. Consequently, should an event take place between the balance sheet date and the 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 despatching 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

1. Discuss with management whether they are of any such events and if so obtain a full listing of those events.
2. 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.
3. Review major transactions documents and primary books such as material payments, material receipts, material sales, material purchases.
4. 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 materialise.
POSSIBLE means can materialise.
REMOTE means unlikely to materialise.

The standard then says:

LOSSES

1. If a loss is probable, and it can be estimated with reasonable accuracy it should be provided for in the financial statements.
2. If a loss is probable but it cannot be estimated with reasonable accuracy it should be disclosed.
3. If a loss is possible it should be disclosed.
4. If the possibility of loss is remote, even disclosure is not necessary.

GAINS

a. If a gain is probable, do not accrue in the Financial Statement only disclose.
b. If a gain is possible or remote, disclosure is not necessary.

The information to be disclosed is:-

i. The nature of the contingency.
ii. The events likely to affect the ultimate outcome.
iii. A prudent estimate of the financial effect or a statement that it is not practicable to make such a statement.

The Auditor's Procedures

- Obtain a listing of contingencies identified by management with full management assessment as to whether the contingency is probable, possible or remote.
- Examine the evidence or documentation that management have used to identify and classify the contingencies.
- Search for any other contingencies that may not have been recognised by management.
- Communicate with the relevant third parties for their assessment of the position.
- 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 auditor 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.

REINFORCEMENT QUESTIONS

QUESTION ONE

The following methods of defalcation or fraud by employees are sometimes encountered.

a. Dummy names on payrolls (6 marks)
b. Teeming and lading (7 marks)
c. Fictitious credit notes or sales return payments for fictitious purchases. (7 marks)

(Total 20 Marks)

QUESTION TWO

What normal audit procedure would be likely to disclose each of such irregularities?
The principal objective of the verification of liabilities and commitments is to form an opinion as to their completeness, existence, valuation and presentation in the financial statements.

Required:

a. Why is it essential for the auditor to examine statements received from suppliers of goods and services? (5 marks)
b. What procedures would the auditor follow to obtain assurance that at the year-endall goods received on credit by the client are included both in inventories and creditor balances. (5 marks)
c. How would the auditor ensure that the amounts accrued for wages and salaries due but unpaid were properly compiled? (5 marks)
d. What tests would the auditor need to undertake to ensure that capital commitments at year end were fairly stated? (5 marks)

(Total 20 Marks)

QUESTION THREE

You are the auditor of Quick Meals Ltd. a company which operates a restaurant in the middle of the city. Every five years the premises are completely renovated and the company created a provision in the accounts so as to charge the expense to accounting periods in a consistent manner. You are reviewing the accounts for the year following the most recent renovation.

a. Define the words 'provision' and reserve. (6 marks)
b. Draft a paragraph for the statement of accountancy policies which would explain the provision to persons not familiar with accounting (6marks)
c. What steps would you take this year to satisfy yourself that the provision for renovation was properly stated? (8 marks)

(Total 20 Marks)

QUESTION FOUR

a) What is meant by the term verification? (4 marks)
b) Explain how you would verify the following items appearing in the balance sheet:

i. Ordinary share capital - Shs.150 million. (4 marks)
ii. Capital and revenue reserves - Shs.25 million. (4 marks)
iii. Share premium Shs.5 million . (4 marks)
iv. Long term loans from the bank- Shs.10 million. (4 marks)

(Total 20 Marks)

QUESTION FIVE

a) What are post balance sheet events? (4 marks)
b) What procedures would you carry out in order to obtain appropriate knowledge of the post balance sheet events? (10 marks)
c) State the action, if any, that an auditor is required to take regarding the post balance sheet events. (6 marks)

(Total 20 Marks)

QUESTION SIX

Going concern concept is one of the fundamental assumption underlying the preparation of financial statements. What are the procedures you would perform to ensure that the going concern is still appropriate to your clients. (10 marks)

(Total 10 Marks)

QUESTION SEVEN

a) Explain why auditors carry out circularisation of debtors. (6 marks)
b) Distinguish between positive and negative debtors circularisation procedures. (2 marks)
c) Describe in detail the work you would carry out in scrutinising the replies to the debtors circularisation and in confirming whether the debtors balance are collectible in the following situations:
   i. Where the debtor does not agree with the balance & states a difference. (2 marks)
   ii. Where the debtor reports that he cannot confirm the balance. (2 marks)
   iii. Where no reply is received from the debtor. (4 marks)
   iv. List the stages of a debtors circularisation. (4 marks)

(Total 20 Marks)

QUESTION EIGHT

a. What indications on factors might the auditor observe that would cast doubts on the appropriateness of the going concern of a client business? (8 marks)
b. List counter indications that might exist in a business to overcome the problems in a) above. (4 marks)
c. State what steps you would take to ensure that the concept of going concern was applicable to the client you are about to audit. (8 marks)

(Total 20 Marks)

QUESTION NINE

a) Define the term audit programme (2 marks)
b) Write in point form an audit programme to cover salary and wages of a small size firm. (8 marks)
c) Outline the procedures you would carry out in the verification of Creditors (10 marks)

(Total 20 Marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK.

LESSON NINE

AUDITORS REPORT AND AUDIT OPINIONS

CONTENTS

i. Auditors report to shareholders.
ii. Audit opinions.
iii. Reinforcement Questions
iv. Comprehensive Assingment

THE AUDITOR'S REPORTS TO THE SHAREHOLDERS

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 a 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 opinion as to whether the financial statements show a true and fair view of the state of affairs. The report is addressed to the shareholders.

The requirements of the Companies Act with regard to the Auditor's Report:

S.162 (1) of the Companies Act (CA): Stipulates the statements that should be expressly stated in the Auditors Report. These statements are;

- Whether they have obtained all the information and explanations, which to the best of their knowledge and belief were necessary for the purposes of their audit.
- Whether in their opinion, proper books of account have been kept by the company, so far as it appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
- Whether, the company's balance sheet and profit and loss account dealt by the report are in agreement with the books of accounts and returns.
- Whether, in their opinion and to the best of their information and according to the explanations given to them, the financial statements give the information required by the Act in the manner so required and give a true and fair view:

    - In the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and
    - In the case of the profit and loss account, of the state of the profit or loss for its financial year.
    - In the case of a holding company submitting group financial statements whether in their opinion, the group financial statements have been properly prepared in accordance with the provisions of the Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries.

Basic elements of the auditor's report

The Companies Act does not stipulate the form the auditors report should take. The auditing standard seeks 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 seeks to do this by giving to basic elements of the auditor's report.

- **Appropriate title**
  An appropriate title such as the independent auditors report distinguishes the Auditor's Report from any other reports that may be annexed to the annual report and Financial Statements.
- **The Auditor's report should be appropriately addressed**
  Usually the auditors report is addressed to the members on whose behalf the audit is carried out. For practical reasons, it also limits the users of the auditor's report.
- **Introductory paragraph**
  This identifies the Financial Statements audited. Under the Companies Act, Financial Statements or Accounts consist primarily of the Balance Sheet, Profit and Loss account and notes to the account. International Accounting Standards on Cash Flow Statements requires auditors to recognized the Cash Flows as part of the Financial Statements.
  The auditor's report relates to the above statements only. However, the published Financial Statements that are sent to the readers include other reports that may contain financial information such as the Chairman's Statement. The DirectorsReport, the detailed Profit and Loss account and other statistical information.
  Although the auditor reviews these other statement or reports, he does not report on them. It must therefore be clear in his report that he is not reporting on these other statements otherwise the financial information contained therein could have anunmerited air of authenticity.

It is felt that most readers of auditors reports and Financial Statements assume that the auditor prepared the Financial Statements. It's necessary for the auditor to clarify that the preparation of Financial Statements is the responsibility of the directors.

- **Paragraph on the scope of the audit**
  The reader requires assurance that the auditors procedures were authoritative and through. The auditor therefore needs to state that they have audited in accordance with International Standards of Auditing.
  It is felt within the profession that readers expert auditors to detect and report on material errors and frauds. It is not practicable within the constraints of auditingto detect all material misstatements be they as a result of frauds or errors. And even though an audit shouldn't be relied upon for the detection of errors and irregularities, the auditor must arrange his audit in such a manner as to have reasonable assurance that the Financial Statements are free of material misstatements.It is important to inform the reader that auditing is a limited exercise that cannot guarantee 100% completeness and accuracy. That the auditor examines items a test basis not all of them and that in valuing assets and liabilities there is subjectivity involved.
- **Opinion paragraph**
  The report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with the relevant financial reporting framework and whether they comply with the companies Act requirements.
- **Dating the audit report:**
  Clearly specifies the date the auditor committed himself to his opinion so that any subsequent developments are considered in the light of that date.
- **Auditor's address**
- **Signature in the name of the audit firm and location of the auditor i.e. office.**

AUDIT OPINIONS

Types of audit opinions

i. Unqualified opinion
ii. Qualified opinion
iii. Disclaimer of opinion
iv. Adverse opinion

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.

Emphasis of matter report:

There are occasions when the auditor has no reservations as to the financial statements but where there exists an unusual event, condition or accounting policy, he feels that unless the reader's attention was drawn to the unusual matter the reader may not reach a proper understanding of the financial position and results. In such circumstances the auditor should express an unqualified opinion but also include an extra paragraph called on 'Emphasis of matter' paragraph to draw the readers attention to the unusual matter.

The addition of such an emphasis of matters paragraph does not lead to a qualification of the audit opinion but is intended to enable the reader to obtain a better understanding. To avoid this being understood as a qualification the emphasis of matter should be included after the opinion paragraph and should contain the phrase "without qualifying our opinion above"

Practical examples of emphasis of matter

1. An unusual condition would include distraction of assets after the balance sheet date but the company remains a going concern.
2. 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 the appropriateness of the going concern assumption. Unusual events could include changes in legislation that could have a material impact on the entity's business subsequent to the balance sheet date. Unusual accounting policies that may lead to an emphasis of matter would usually involve those matters not covered by any accounting standard such as accounting for agricultural produce or livestock
3. Inherent uncertainties that may call for emphasis of matter would include contingencies at the balance sheet date which have not been resolved as at the date of signing the auditor's report.
4. They could also include negotiations for financing which have not been finalized by the date of signing the auditors report.

Qualifications in audit reports

When the auditor has reservations on any matter that is considered material to the financial statements he may introduce qualifying remarks in his audit report. The auditor's reservations could arise out of the following;

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.

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.

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.

This could arise due to the following circumstances:

a. Refusal by management to allow the auditor to examine certain documents or records.
b. 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 a limitation of scope.

c. Destruction of accounting records or documents through fire or other disaster meaning that such records are not available to be examined by the auditor.
d. Being appointed auditor after the year-end with the result that certain evidence will not be collected.

Effect of a limitation in scope on the auditor's opinion

If the possible effect of a limitation on 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 a limitation on 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 on the scope of the auditor's work that requires the expression of a qualified opinion or 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.

Inherent Uncertainties

Inherent uncertainties result from circumstances in which it is not possible for the auditor to reach any objective conclusion as to the outcome of a situation due to the circumstances themselves rather than a limitation on 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 inherent uncertainty. This will involve consideration of:

- The appropriateness of any accounting policies adopted by management in treating the effect of such uncertainties.
- The reasonableness of the estimates included in the Financial Statements.
- The adequacy of disclosure.

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 be very great. In determining whether an inherent uncertainty is fundamental the auditors consider:

- The risk of the estimate included in the Balance Sheet may be 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 as fundamental when they involve a significant level of concern about the validity of the going concern basis or other matters whose potential effect on the Financial Statements is unusually great.

Disagreement

Under disagreement the auditor is able to conclude objectively. 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 management or the view given by the accounts.

Circumstances giving rise to disagreements include:

(a) Application of inappropriate accounting policies by management;
(b) They can disagree on amounts and facts included in the financial statements. E.g. the auditor might feel that the amount provided for as a contingent loss arising from a legal suit against the company is too low.
(c) They can disagree on interpretation of an accounting standard or even legislation.
(d) Disagree as to the manner or extent of disclosure of facts or amounts in the financial statements.
(e) They can disagree on the mode of the disclosure of information.

Where the auditor disagrees 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.

Effects of disagreements on the audit opinion

When the auditor concludes that the effect of the matter-giving rise to the 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

Auditors may not include qualifying remarks in their audit reports unless the matter is material. Material but not pervasive means that the reservation that the auditor has is material in the context of a segment of the financial statements but not 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 information of 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

This summarises the forms qualification issued by the auditor under different circumstances.

Nature of circumstance	Material but not significant	Fundamental
Limitationon scope/uncertainty	Qualified opinion (except for opinion)	Disclaimer of opinion
Disagreement	Qualified opinion (except for opinion)	Adverse opinion

REINFORCEMENT QUESTIONS

QUESTION ONE

a. State the prescribed circumstances in which an auditor under the Companies Act is required to qualify his report.

b. The report of the auditor on the annual accounts of a limited company contains a "except for" qualification. Comment briefly on this form of qualification.

QUESTION TWO

You are the auditor of a company whose financial year-end was 30 September 1992. A note tothe accounts states "the loan of Shs.20 million included in the balance sheet is repayable on 31 December 1992 and negotiations are currently in progress with the company's bankers for replacing the loan with a new long-term facility".

The company's cash flow projections show that no funds are available to repay the loan, but negotiations with the company's bankers are well advanced. The outcome of these negotiations however will not be known by December, the date on which you will be required to sign your audit report.

You are required to draft an audit report appropriate to the above circumstances. (22 marks)

QUESTION THREE

a. Under the provisions of CA the auditor is required to make certain disclosures in his audit report. Briefly describe these provisions. (10 marks)

b. Name 4 types of audit opinions, which the auditor may express in his report indicating the circumstances under which each can be issued. (10 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 10 OF THE STUDY PACK.

COMPREHENSIVE ASSIGNMENT NO. 4

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

Answer all the questions

QUESTION ONE

Consider the following quotations:

a. Computer systems give rise to such possibilities as lack of visible evidence and systematic errors.
b. The nature of computer based accounting systems is such that the auditor is afforded opportunities to use the client's computer to assist him in the performance of his audit work.
c. In choosing the appropriate combination of CAATs and manual procedures, the auditor will need to take into account a number of factors.
d. In performing tests on computer based accounting systems application or general controls, the auditor should obtain evidence which is relevant to the control being tested.

Required

a. Explain the meaning of the phrases- lack of visible evidence and systematic errors and state in respect of each three ways in which the auditor might attempt to overcome the problems arising from these two possibilities (9 marks)
b. State briefly two types of CAATS which the auditor can use in the audit (4 marks)
c. State and explain five factors which the auditor will need to take into account in choosing the appropriate combination of CAATs and manual procedures (7 marks)

(Total 20 Marks)

QUESTION TWO

a. What are the unique characteristics of a computerized information system that pose additional challenges to the auditor (12 marks)
b. Distinguish between application and general controls (8 marks)

(Total 20 Marks)

QUESTION THREE

a. What is a contingency? (5 marks)
b. What audit tests would you carry out in respect of an amount of KShs 4,000,000 in the notes as a contingent liability? (15 marks)

(Total 20 Marks)

QUESTION FOUR

i. Discuss the difference between substantive procedures and tests of controls (5 marks)
ii. What are cut off procedures (5 marks)
iii. What is purpose of attending a stock take by the auditor (5marks)
iv. List down the procedures you would carry out in verifying your client's bank balance. (5 marks)

(Total 20 Marks)

QUESTION FIVE

a. What are the elements of an audit report (8 marks)
b. What are post balance sheet events? Give examples of adjusting and non adjusting events (12 marks)

(Total 20 Marks)

END OF COMPREHENSIVE ASSIGNMENT NO. 4

NOW SEND YOUR ANSWERS TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON TEN

REVISION AID

CONTENTS

KASNEB SYLLABUS
MODEL ANSWERS TO REINFORCING QUESTIONS

- Lesson One
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- Lesson Seven
- Lesson Eight
- Lesson Nine

PAST CPA EXAMINATION PAPERS

- June 1997
- December 1997
- June 1998

ANSWERS TO PAST CPA EXAMINATION PAPERS

- June 1997
- December 1997
- June 1998

MOCK EXAMINATION

NOTE: ALL MODEL ANSWERS HAVE BEEN PROVIDED BY THE STAFF OF THE DISTANCE LEARNING CENTRE

KASNEB SYLLABUS

OBJECTIVE

To equip the candidate with knowledge on the nature and concept of auditing and its application to public and private organizations.

SPECIFIC OBJECTIVES

A candidate who passes this subject should be able to:

- Understand the environment under which auditing is carried out
- Understand the laws governing audit practice
- Perform the audit planning and design control processes
- Prepare various audit reports
- Understand the impact of information technology on auditing

CONTENT

The General Audit Environment

- Definition of auditing
- Distinction between auditing and accounting
- Objects of an audit
- Types of audits
- Users of audited reports
- Internal versus external audits
- Stages of an audit
- Overview of the audit process
- Background information about the client
- Audit planning, controlling, recording and evaluating

The Legal and Professional Requirement for an Auditor

- Appointment
- Letter of engagement
- Qualifications of auditors
- Rights of auditors
- Dismissal of auditors
- Duties of auditors
- Legal liability of auditor
- Negligence and the auditor
- Professional ethics
- Auditing standards and guidelines

Internal Control System

- Definition of internal control, internal check and internal audit
- Types of internal control
- Qualities of a good system of internal control
- Limitations of internal control
- Ascertainment and recording the system of internal control; internal control questionnaires, flow-charts, systems notes

- Evaluation of the system of internal controls, techniques of evaluation
- Compliance testing
- Internal controls and small businesses

Audit Evidence

- Nature of audit evidence and sources
- Methods of gathering audit evidence
- Qualities of good audit evidence; relevance, reliability and sufficiency
- Sampling in audit; reasons for sampling, methods of sampling, factors to be considered in sampling
- Qualities of a good sample

Substantive Tests and Audit of Profit and Loss Account and Balance Sheet

- Definition
- Techniques
- Audit programmes
- Tests of detail and analytical review
- Directional testing
- Techniques of analytical review of the profit and loss account
- Audit of revenues; purchases, salaries and wages
- Audit of cash, accounts receivable, stocks including work-in-progress, and fixed assets
- Audit of liabilities and owners equity

Errors, Fraud and Other Irregularities

- Types of errors
- Fraud and defalcations
- Other irregularities
- Detection, correction and prevention
- Role of the auditor in respect to detection and prevention of errors and fraud
- Auditor's duty in event of errors, fraud and other irregularities detected in the audit process

Auditor's Report

- Contents
- Types; unqualified , disclaimer and adverse reports
- Conditions requiring a report other than the standard unqualified report

Auditing in a Computerized Environment

- Impact of computers on the auditor
- Internal controls in a computerized environment
- Approaches to audit of computerized systems; auditing through the computer or round the computer

MODEL ANSWERS TO REINFORCING QUESTIONS

LESSON ONE

1.

a. Today most businesses are operated by limited companies, which are owned by the shareholders and managed by directors appointed by such shareholders. The appointed management is faced with a conflict of interest i.e. whether to act in the best interest of the company and by extension the shareholders' interest or to act in their best interest. This is what is referred to as the agency problem.

The separation that exists between the owners and management forces the absentee owners to institute control measures to ensure honesty of their company's stewards (i.e. management). The companies Act attempts to remedy this problem by requiring the management to maintain proper accounting records of all the transactions of the company and to prepare financial statements that show a true and fair view to be presented to the shareholders at the annual general meeting.

However, even with this requirement there still exists the risk that the accounting records maintained and the financial statements prepared by management might not be accurate, free from bias and reflect the true financial position and performance of the company. The companies Act therefore goes further to require that management must have the financial statements subjected to an independent examination and a report issued to the shareholders as to whether the financial statements show a true and fair view. The auditor carries out this independent examination. To ensure independence of the auditor the companies Act gives the power of appointment and removal of the auditor from office to the shareholders.

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. (Financial reporting framework refers to the international accounting standards, provisions of the companies Act and other relevant statutes and legislation). The auditor expresses an opinion as to whether the financial statements give a true and fair view of the financial position and performance of the company. An audit is intended to protect shareholders and other parties who have dealings with the company from dishonest directors and ensure that financial statements are free from bias, manipulation and are relevant to the needs of the users.

Other objectives

- To give credibility to the financial statements. This arises from the fact that the accounts have 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.

b. Directors' responsibilities in relation to the accounting function of the company

- To ensure that proper books of accounts are maintained by the company.S.147 (1) requires that every company shall maintain proper books of accounts.
- To prepare financial statements i.e. a profit and loss account and a balance sheet to be presented to the shareholders during the annual general meeting.
- To ensure that the balance sheet gives a true and fair view of the state of affairs of the company as at the end of the financial period, and every profit and loss account gives a true and fair view of the profit or loss of the company for the financial year.
- To safeguard the company's assets

- To prevent and detect errors and frauds within the company.
- To set up an internal control system. This system will assist management in meeting all the above objectives.

2. It is an independent appraisal of the performance of management in seeking to secure economy, efficiency and effectiveness in the use of resources at its disposal.

Economy: The terms and conditions under which an organisation acquires human and material resources: an economical organisation acquires these resources in the appropriate quality and quantity at the lowest prices.

Efficiency: The relationship between goods and services produced and the resources used to produce them. An efficient organisation produces the maximum outputs for any given set of resource given quality and quantity of goods or services. The underlying management objectives are increased productivity and lower unit costs.

Effectiveness: How well a programme or activity is achieving its established goals or other intended effects.

The major concern in the government bodies has been that such bodies may not be providing good value for money to their users and the public at large. The resources available to these organisations can be considered to be public funds for which the public expects accountability and the achievement of economy, efficiency and effectiveness.

The public would be interested in a report on these bodies that highlighted the following:

a. Any misconduct or frauds.
b. Weaknesses in or lack of arrangements for securing economy, efficiently and effectiveness.
c. Unnecessary expenditure or loss of income due to waste extravagance, inefficient
d. Financial administration, poor value for money, mistakes or other causes.
e. Failure to comply with statutory requirements.
f. Deficiencies in rate or country funds, sinking funds or reserve funds and other similar financial matters calling for comment.
g. Unlawful items not accounted for.

A value for money audit would therefore be expected to produce more than just an opinion on the accounts but would include investigating economy, efficiency and effectiveness and considering and reporting on matters of public interest.

LESSON TWO

i. Appointment

The Companies Act S.159 (1) provides that "every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting." This provision gives the ultimate powers of appointment of an auditor to the shareholders of the company.

Reappointment

S.159 (2)" a retiring auditor shall be deemed to be re-appointed without any resolution being passed unless: -

- He is not qualified for appointment; or
- A resolution has been passed at that meeting(i.e. annual general meeting) appointing somebody instead of him or providing expressly that he shall not be re-appointed; or
- He has given the company notice in writing of his unwillingness to be re-appointed.

According to this provision of the company's Act an appointed auditor is deemed to be automatically re-appointed come the next annual general meeting for another term in office unless any of the three mentioned situations exist.

Appointment By Registrar

S.159 (3) "Where at an annual general meeting no auditors are appointed or deemed to be appointed, the registrar may appoint a person to fill the vacancy"
The directors have the duty of informing the registrar of the failure by the company to appoint an auditor.

Appointment by the directors

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.
In default of appointment, the first auditors by the directors the company may do so. Where the directors have appointed the first auditors, the company may at a general meeting remove such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company. Notice of nomination to be given to the members at least 14 days before the date of the meeting.

Casual vacancies

S. 159 (6) "The directors may fill any casual vacancy in the office of the auditor, but while any such vacancy continues the surviving or continuing auditor(s), if any may act."
A casual vacancy may arise out of any of the following reasons;

- Death of the auditor
- Incapacitation
- Resignation

i.e. a casual vacancy arises when any of the above circumstances arise leaving the office of the auditor vacant before the expiry of the term in office under the contract.

ii. Removal of the auditor from office by shareholders

If a shareholder wishes to propose that their current auditors' be removed from office during the forth coming annual general meeting he must follow the following procedures under the provisions of the companies Act.

- He must issue a notice to the directors of the company of the intended resolution to remove the current auditors from office. The notice should be sent within such time that it is possible for the directors to serve the auditor with a 28days notice of the intended removal before the annual general meeting or such meeting where the auditor's removal will be discussed.
- Having received the notice, 28 days before the meeting, the auditor has a right to make written representations to be circulated to the members of the company before the general meeting. If the directors do not circulate such representations, the auditor has a right to read them during the general meeting.
- During the general meeting the auditor has a right to speak on any matter that concerns him as the outgoing auditor.
- During the meeting the proposed resolution to remove the current auditor will be brought for voting. Only a simple majority of over 50% of the voting shareholders will be required to remove the auditor from office.

iii. In additions to the guidelines issued by ICPAK on professional independence, suggest other steps that may be undertaken by regulators, the client and the profession to improve auditors' independence.

- Peer reviews should be made compulsory. Peer reviews involve an independent auditor or body of independent experts carrying out a review of the work carried out by another auditor. Such reviews will ensure that all audit work especially for public limited companies is carried out to the best quality possible.
- The Companies Act should be amended to include provisions on the maximum duration of time that an auditor can serve one client. Currently there is no restriction as to how long an auditor can serve a client. Compulsory rotation of auditors should be enforced.
- Strict guidelines should be issued on the provision of non-audit services such as tax consultancy and accountancy services to audit clients. This will eliminate the possibility of conflict of interest that arises when an auditor performs other work in addition to the audit. In addition the provision of these services has been known to make auditors financially dependent clients.
- The companies' Act should seek to offer more protection to the auditor from being removed from office because of reasons such as issuing a qualified opinion. Such protection would be necessary if auditors are to avoid being compromised for fear of losing a client.
- The law should penalise clients who deliberately seek to influence the outcome of the auditor's work. E.g. through undue hospitality.

LESSON THREE

1.

- Control risk; is the risk that a misstatement that could occur in an accounting balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes, would not be prevented or detected and correctly on a timely basis by the accounting or internal control system.
- Test of control: Also called compliance tests. Tests to obtain audit evidence about the effective operation of the accounting and internal control systems.

2. The control environment means the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity. The control environment encompasses the management style and corporate culture and values shared by all employees. Factors reflected in this ideal include;

- The philosophy and operating cycle of the directors and management.
- The entity's organisational structure and methods of assigning authority and responsibility.
- The directors' methods of imposing control, including the internal audit function, the function of board of directors and personnel policies and procedures.

3. Control procedures

Those policies and procedures in addition to the control environment which are established to achieve the entity's specific objectives. They include in particular procedures designed to prevent or detect and correct errors. Specific control procedures include:

- Approval and control of documents.
- Segregation of duties
- Supervisory controls
- Reconciliation of account balances

4.

Importance of an internal control system to the client

1) It enables management to carry out the business in an orderly and efficient manner. Internal controls lay out the various procedures to be followed in conducting the affairs of the organisation. E.g. there will be procedures laying out the procedures to be followed in procuring raw materials
2) It ensures that the management policies and procedures put in place in running the affairs of the organisation are adhered to.
3) Helps in safeguarding the company's assets
4) Some controls are designed specifically to ensure the assets of the company are protected from theft, destruction and that they are used in the best interest of the company.
5) This can either be directly through physical locking up or indirectly through recording. It includes assessing assets and ensuring that any access is authorised. Also ensure that accuracy and completeness of accounts is maintained.
6) ICS help in ensuring completeness and accuracy of the records maintained. The company's Act requires that a company keep proper books of accounts. These records are the basis for the preparation of the financial statements.
7) Strong internal controls help in preventing and detecting errors and frauds. The responsibility for the prevention and detection of fraud and error rests with management. This is achieved through the implementation and continuous operation of an adequate system of internal controls. Such a system reduces but does not eliminate the possibility of fraud and error.

5.

Responsibility for putting in place an internal control system

It is the responsibility of the company's management to put in place an internal control system. The Companies Act requires that the directors of the company must maintain proper accounting records and prepare financial statements, which show a true and fair view. To meet this responsibility the company must put in place a good accounting and internal control system.

6.

The auditor needs to obtain an understanding of the client's accounting and internal control system, and evaluate the system. This is to enable him to determine the level of reliance he is going to place in the internal control system as part of his audit evidence. Where management has put in place an effective internal control system that has operated well throughout the accounting period, the auditor can rely on the effective operation of such a system to ensure that complete and accurate accounting records have been maintained. Such reliance will justify a reduction in the amount of detailed testing of account balances and transactions i.e. substantive testing that would otherwise have been necessary. The rationale behind this is why spend a lot of time carrying out detailed testing while you can get the same assurance by relying on controls that have operated effectively to ensure completeness and accuracy of the account balances.

By ascertaining, recording and evaluating an internal control system the auditor is able to determine an appropriate audit approach i.e. the mix of tests of controls and substantive tests that will be carried out to meet the audit objective.

7.

- Purchasing system of a large manufacturing farm.
- The company should have a clear division of duties between the various departments. Ideally the purchasing function, stores department, factory department and the accounting department should be separated. A responsible official should be charged with the duty of overseeing the 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 re-order levels for the purchase of all materials used in production. When the re-order level is reached a purchase requisition should be raised and must be authorised by the factory manager. This should then be sent to the purchasing department.
- Upon receipt the purchase requisition, this should be checked to confirm that the transaction is authorised. Another person should prepare a purchase order and submit this together with the purchase order for authorisation by the purchasing manager.
- Orders should only be placed with authorised suppliers.
- Upon delivery an official from the stores department must inspect the goods for quality and quantity. All units received should be recorded in a suitable form say by raising a goods received note, the stores staff and the supplier's staff should sign this off.
- The goods received note and the supplier's 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 supplier the supplier's statement should be reconciled to the ledger balance.

8.

Management letters

The auditor has a professional duty to report to management on any weaknesses identified in the internal control system or any significant issues affecting the audit. This is communicated through the management letter.

Purpose of the management letter

- To enable the auditor to give his comments on the accounting records, accounting system and related controls examined during the audit. Weaknesses in the ICS that have come to his attention and might lead to material errors should be highlighted and brought to management's attention. The auditor should also give recommendations on ways of improving the system.
- To provide management with advice e.g. suggest how resources could be utilised more efficiently.
- To communicate matters that have come to the auditor's attention that might have an impact on future audits. E.g. introduction of a new accounting standard.

9.

Points to note in your answer

- Start with a brief definition of internal audit
- For part (a), you should at least have five points briefly described.
- For part (b), you should at least have five points briefly describe them.

1. Duties performed by internal audit
   Internal audit entails independent and constant appraisal of the company's activities, operations and controls so as to safeguard the company's assets, ensure reliability of the company's records and efficiency of operations all of which are aimed at assisting the management to manage the business better. It acts as a watchdog over the company's entire controls although it can be regarded as one of the controls in itself. The duties of the function include:

   a. Review of the accounting and internal control systems. Management is responsible for establishing an internal control system. These systems demand proper attention and continuous review, a function that is usually assigned to internal audit.
   b. Carrying out examination of financial and operating information. This may include detailed testing of transactions and accounting and operating procedures.
   c. Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
   d. Review of the entity's compliance with laws and regulations.
   e. Review of the entity's compliance with management policies and other internal requirements.
   f. Carrying out independent investigations into the affairs of the company as required by management

2. Criteria to consider in deciding on whether to rely on the work of internal audit
   If the external auditor wishes to place any reliance on the work of the internal audit he should evaluate the effectiveness of the function. Such evaluation will be intended at determining whether internal audit constitutes an effective control that can be relied upon to reduce the extent of audit procedures. Factors to consider include the following:

   Organization status
   Since internal audit function is part of the entity it cannot be totally independent. To boost it's independence the status of the function within the organization should be such that the internal auditor reports to the highest level of management. The internal auditor should also be free of any other operating responsibility such as performing accounting functions, which may conflict with his role as an independent watchdog of controls and operations of the entity. There should be no restrictions placed upon his work by management. Such restrictions could impair the effectiveness of the function.

   Scope of the function
   The external auditor should ascertain the nature and depth of coverage of internal audit assignments. He should also ascertain whether management considers and acts upon internal audit recommendations. Where the recommendations are not acted upon this represents a weakness in the function and hence the level of reliance should consequently be reduced.

Technical competence
The external auditor should ascertain whether internal audit work is performed by persons having adequate technical training and proficiency as auditors. Qualifications and experience of the internal audit staff should be considered.

Due professional care
The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. Exercise of due professional care is evidenced by the existence of adequate audit manuals, work programs and working papers.

Internal audit reports
The external auditor should consider the quality of the internal audit reports prepared and submitted for management action. He should ascertain whether management considers, responds to and acts upon internal audit reports and whether there is evidence to prove that action.

Level of resources available
The external auditor should consider whether internal audit has adequate resources to be able to carry out their duties effectively. Such resources would include staff and computer facilities.

3. Extent to which the external auditor can rely on the work of the internal audit function
   There are a lot of similarities between the work of the internal auditor and the external auditor. However, the internal audit function is a management function put in place to overlook the accounting and the internal control system. As a result of this the internal auditor cannot meet the prime criteria of independence required of external auditors. This in itself limits the extent to which the external auditor can rely on the work of internal audit function. Consequently regardless of the effectiveness of the internal audit function, the external auditor cannot place full and blind reliance on the work of the internal audit. The level of reliance that can be placed will be determined by the auditor's evaluation of the function. Secondly the external auditor has to consider the fact that he remains responsible for the opinion formed and he cannot escape liability by placing reliance on the work of another expert. This external auditor will therefore be guided by his judgment as to how effective the internal audit function is and how much risk hw is will to take by placing reliance on another expert.

LESSON FOUR

1.

Errors; are unintentional mistakes. They occur at any stage in a business transaction processing transaction occurrence, documentation, record of prime entry, double entry record summarising process and financial statement production. Errors can be of any kind; mathematical or clerical, or in application of accounting principles. There can also be mistakes of commission or omission or interpretation of facts.

Irregularities; may mean that proper accounting records have not been kept. They may indicate that some internal controls are not effective and that the auditor cannot place reliance of those internal controls.

Fraud; involves use of deception to obtain an unjust or illegal financial advantage. Intentional misstatements in or omissions of amounts or disclosures from, an entity's accounting records a financial statements. Illegal act is an act contrary to law. It may be committed intentionally or inadvertently.

2. In general an auditor is a watchdog not a bloodhound and tests designed specifically and uniquely to detect irregularities will be performed only when the auditor's suspicion is aroused.
3. The auditor should report to:

a. Management

The auditor should communicate factual findings to management as soon as practicable if:

- He suspects fraud may exist, even if the potential effect on the financial statements would be immaterial;
- Fraud or significant error is actually found to exist. The auditor should consider the appropriate level of management to report tom

b. To users of the auditor's report on the financial statements

If the auditor concludes that the fraud or error has significant effect on the financial statements and has not been properly reflected or corrected in the financial statements, the auditor should express a qualified or an adverse opinion. If the auditor is precluded from obtaining sufficient appropriate audit evidence to evaluate whether fraud or error that may be material to the financial statements, the auditor should express a qualified or a disclaimer of opinion on the basis of a limitation on the scope of the audit.

c. To regulatory and enforcement authorities

Rules of confidentiality preclude the auditor from disclosing fraud or error to 3rd parties. However, in certain circumstances the law gives the auditor a duty to disclose such. The auditor may need to seek legal advice in such circumstances.

d. Withdrawal from the engagement

The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action regarding fraud that the.

LESSON FIVE

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

1. Carry out a preliminary review of the client. This will involve seeking to obtain a good understanding of the nature of the clients and the client's business.
2. Hold discussions 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's accounting and internal control system.
3. 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.
4. 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.
5. Consider any accounting standards and legislation that could have an impact on the audit of this new client.
6. 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 annual general meeting, stock taking, dates when management reports are available.
7. The audit senior should also determine the number of audit staff required, experience and special skills required and the timing of the audit visits.
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.

b) How audit planning assists in the conduct of an audit

1. 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 are met.
2. 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.
3. 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.
4. It helps to ensure that audit work is completed expeditiously through more efficient use of time and proper allocation of work to audit staff.
5. Ensures proper division of work between interim and final audit to avoid repetition of work already done.
6. 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) 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 they 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, timing 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 their assigned tasks.
- Establish whether assistants understand the audit instructions
- Ensure that work is being carried out in accordance with the overall audit plan and the audit program.
- To identify and address any significant accounting and auditing questions raised during the audit.
- Resolve any differences of professional judgment between personnel

Review and co-coordinating of work

This involves a review of the audit work performed by each staff member by a person of equal or higher competence, to consider whether;

- The work has been performed in accordance with the audit program
- The work performed and the results obtained have been adequately documented.
- All significant audit matters have been resolved or are reflected in audit conclusions.
- The objectives of the audit procedures have been achieved; and
- The conclusions expressed are consistent with the results of the work performed and support the audit opinion

QUALITY CONTROLS

Quality control refers 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 the firm's own quality standards.

QUESTION TWO

Audit planning memorandum

An audit-planning memorandum is a summary of the audit strategy. This sets out;

i. The outline audit approach;
ii. How, by whom and when each item in the financial statements will be audited;
iii. Timing requirements to be met for each item;
iv. Staff usage with time budgets for each set of audit work

Contents of an audit-planning memorandum

The nature of information contained in an audit-planning memorandum will vary from one audit to the other, but generally may include;

1. A summary of the terms of engagement to lay out the nature and scope of the work;
2. Job timetable giving the provisional dates of the timing of the audit e.g. date of planned commencement of the audit.
3. Record of any changes in the client since the last audit e.g. changes in the nature of the client's business, change in management structure;
4. Details of the planning decisions such as areas identified as having weak internal controls requiring more detailed audit work, areas where the advise of an expert is needed e.t.c
5. Extent of reliance expected on internal audit;

LESSON SIX

QUESTION ONE

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.

QUESTION TWO

The ISA require that the auditor must obtain sufficient appropriate audit evidence to be able to from conclusions on which the audit opinion will be based. Sufficient implies that the evidence must be of sufficient quantity to support the opinion. Appropriate refers to the fact that the evidence must be from a credible source i.e. reliable and must relevant to the audit objective that the auditor is testing.

QUESTION THREE

Management assertions refer to the information that the management is seeking to communicate through the financial statements. This could either be explicitly stated or disclosed in the financial statements or it could be implied. The auditor therefore seeks to evaluate whether these assertions are a true and fair representation of the financial affairs of the company. Therefore the assertions become the basis of the audit objective which the auditor is trying to prove or test. These assertions are:

1. Existence- that an asset or liability exists at a given date. E.g. that closing stock physically exists.
2. Rights and obligations- an asset is a right of the entity and a liability is an obligation of the entity. E.g. land belongs to the company and the title documents are in the name of the company.
3. Occurrence- that a transaction or event took place which pertains to the entity during the period.
4. Completeness- there are no unrecorded assets, liabilities, transactions or undisclosed items.
5. Valuation- that a transaction is recorded at an appropriate carrying value. E.g. that land and buildings are carried at an appropriate value.
6. Measurement- that a transaction is recorded at the proper amount and revenue and expenses allocated to the proper period.
7. Presentation and disclosure

For example assuming that the directors have disclosed that the company was holding KShs 10 million worth of closing stock. What the directors are reporting in substance is that:

a. The stock physically exists- existence
b. The stock belongs to the company- ownership right
c. The stock is worth KShs 10 million- valuation
d. All transactions in relation to stock have been recorded- completeness
e. All transactions are recorded in the correct financial period and at the correct values- measurement.

The auditor therefore sets to prove these assertions or this information. The audit objectives will therefore be to prove:

1. The existence, ownership, valuation, completeness and measurement of stock.

QUESTION FOUR

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

this 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 occur in an account balance or class of transactions and that could be material will not be prevented or detected and corrected on a timely basis by the accounting and internal control system.

Detection risk

Is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance that could be material.

c. 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 reached if the entire population was subjected to the same procedure.

d. Conditions necessary to carry out sampling

1. The population must consist of items of the same nature and subject to the same level of risk i.e. the population must be homogeneous;
2. The population should cover the whole of the period under review and not just a few months;
3. The population must be large enough to allow statistical methods to be used to select and evaluate a sample;
4. The anticipated rate of error must be low. If many errors are expected compliance testing should be abandoned and the auditor should extend the level of substantive testing.

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 judgement which are difficult for the auditor to prove objectively e.g. there is no need to obtain a letter of representation on the bank balance as this can be proved objectively but there is need to obtain a representation that all contingent liabilities have been properly stated because this is difficult to prove.

Management makes various oral representations throughout the audit in response to specific inquiries. The auditor should not rely on unsupported oral representations of management as being sufficient reliable evidence when they relate to matters that are material to the financial information. The auditor should obtain written representations from management on matters material to the financial information when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

e. Factors to consider before relying on the work of an expert

The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial statements. The auditor should consider;

1. The skills and competence of the expert
2. The auditor should consider the expert's skills and competence in the particular profession. This is done by considering the expert's professional qualifications, license or membership of an appropriate professional body. The experience and reputation in the field in which the auditor is seeking evidence.
3. Objectivity and independence of the expert
4. 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, or where he is related financially with the client.
5. The sources of 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.

6. The assumptions and methods used.
7. 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.

LESSON SEVEN

1. When planning the audit in a computerised environment the following factors should be considered:

   a. Auditors need to be involved in computerised 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.
   b. Timing is more important in computerised 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.
   c. 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 clients mainframe computer to a micro computer in the auditors office enabling auditors to download data files onto their own personal computers.
   d. 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.
   e. The extent to which computer assisted audit techniques can be used. These techniques often require considerable planning in advance.

2. (a) Four areas of risk concerning a computer system are as follows.

   i. **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.
   ii. **Unauthorised access**
   If terminals are not secure it might be possible for unauthorised users to obtain or corrupt information held on file.
   iii. **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.
   iv. **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.

   i. **Physical controls**
   All hardware and files should be kept in secure locations with access only available to authorised 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.
   ii. **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 authorised 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.

3. (a) There can be no doubt that the quality of output from an EDP-based system depends greatly, although not totally, on the quality of the input. The input consists of the raw data taken from source documentation and this is what the program will process to provide the output. An example of this situation is the processing of a batch of sales despatch-notes to produce sales invoices and update a sales ledger.

There are two circumstances which could lead to inaccurate output. Firstly if the data on the despatch notes is incorrect and secondly if that data is inaccurately converted into machine-readable input. Thus it is clear that controls must be established to ensure errors do not occur at either stage. However this is not the end of the need for controls, and the auditor should be aware of the vital need to check the processing and output stages. Even if the input is completely and accurately transcribed, the output will not be correct if errors can occur at the processing stage, such as data not being processed or processed more than once. Also the quality of the output will be impaired if it is not in the format required, and does not meet the needs of the user or if the output is altered before it reaches the user.
In conclusion it may be more correct to state that the auditor must consider controls over each stage of input, process and output before he can be satisfied with the accuracy of the system.

(b) Major procedural controls which an auditor would expect to find are as follows:

i. **Input controls**

- Batch preparation and recording of batches so each document can subsequently be traced to a particular batch and so the completeness and accuracy of input can be checked by reference to totals, both real and hash.
- Authorisation procedures for input. Only batches which have been checked and approved should be input. Authorisation should be carried out by a suitably qualified member of staff.
- Division of duties should occur between those responsible for raising the documents and those responsible for input.

ii. **Output controls**

- Completeness checks should be carried out to ensure all data input and processed is output. This can be usually effected by comparing file totals before and after processing.
- Physical controls should be exercised over the distribution of output. Printouts should only be sent to authorised personnel with no opportunity for the output to be altered before reaching the user.
- Output in the form of exception reports should be recorded along with subsequent action taken on the report. This should be checked regularly by an independent official.

4. (a) Direct access by a user to master files may create the following potential control weaknesses:

i. It may be possible for an authorised user to gain access to a master file and alter certain records fraudulently.
ii. A user may alter a master file incorrectly and the erroneous alteration may not be checked by a second person.
iii. In both of the above situations, if a master file is corrupted, it will lead to inaccurate processing and faulty accounting records being generated.
iv. If alterations are keyed via the terminal there may be no hard copy of the alteration, which may also lead to the problem of loss of audit trail.

(b) In order to overcome these weaknesses it is important to establish a secure system of internal control covering users, hardware and software.

i. **Users**
Specific authority should be given to those persons entitled to alter any master file. All alterations should be detailed on special forms which carry the appropriate authorising signature. The forms should be retained by someone other than the user who input the alteration. There should be periodic checks that alterations are being input accurately. This could be done by reference to the original alteration forms.

ii. **Hardware**
Access to the terminals should be restricted to authorised users. This can be effected by use of devices such as terminal keys and passwords. These devices can also be used to restrict access to specific files so that only authorised persons can access or alter master files and then only those files which are in their area of responsibility.

Allocating specific terminals with the facility to alter master files and keeping those terminals physically secure will also improve control over access.

Terminal logging can be employed as a form of control. This can take various forms such as printing out all uses of the terminal detailing date, time, user, files accessed and type of transaction input, or logging only specific types of access such as master file amendments. The hard-copy logs can then be reviewed by an independent person to check that only appropriate users were making authorised file alterations. This method will act as a deterrent as well as a detective control.

iii. **Software**
Programs can have built-in checks on the identity of the user and the type of transaction. The check may be compatibility of user identity and type of transaction so that users cannot abuse their access to files. Another type of program check is simply on the type of transaction ensuring that amendments are within preset limits, so, for example, an alteration cannot be made to a payroll master file to adjust an employee's tax code to more than 700.

It can also be part of a file amendment program that a file update-printout is produced detailing all changes to the master file. This can be checked for completeness and accuracy against the authorised amendment forms and also provides a link in the audit trail. To be an effective control there must be a division of duties between persons inputting and checking alterations.

LESSON EIGHT

a. Dummy names on payrolls

- Compare personnel records with the wage sheets for consistency
- Check the identity cards and compare with the names of the pay list
- Compare signatures from one period to the next
- Compare wages sheet of different periods
- Surprise visits on pay day
- Compare actual wage and budgeted wages
- Test-check signatures of employees on other vouchers with those in the wage sheet for consistency

b. Teeming and lading
This can be defined as:

- Concealment of shortages of cash by the receiving cashier
- It could be manipulation of cash received by a clerk from a debtor who may be written off
- Alternatively, such a clerk may borrow such mis-appropriated cash to credit the account of the debtor whose payment he had mis-appropriated

Detection:

- Test the ICS in particular internal check for receipts which should ensure that the cashier should never have access to the debtors ledger
- Test check sales ledger of the current year with the previous year and note customers who previously paid promptly and now are paying in arrears
- Check accounts with block payments which were formerly paid in instalments
- Agree the dates in the cashbook and counterfoil of cash receipts
- Check accounts which are settled with several instalments
- Undertake circularization of debtors

NB: If the dates given by the debtor disagree with the dates in the debtors ledger it could be an indication of teeming and lading.

Audit test for Purchases

- Check the ICS and pay attention to internal check in ordering, receiving and recording
- Select a number of invoices and check their signing and note the amount on the invoice.
- Trace the invoice to goods received notes and goods returned notes.
- Ensure invoices have been entered into purchases day book and trace the posting to Purchase ledger and to control account.
- Invoices should be seen to have been authorised by user department for accountability
- Trace invoices to orders and requisition notes to ensure that purchases were bonafide
- Trace the items to the inventory
- Check the invoices with monthly reconciliation of control accounts and compare with balance on the list of purchases and investigate any differences

Audit Procedure for Credit Notes and Sales Returns

- Ensure that there are records compiled on return of goods from customer or claims in respect of short delivery or incorrectly priced goods
- Check that these records are prepared by a person who has no access to the sales and cashier's department
- Check that credit notes are numbered and issued consecutively

(a) Suppliers of goods and services

- To verify the existence of that liability shown
- To verify the corrective of money amount of such liabilities
- To verify the appropriateness of the description given in the accounts and the adequacy of the disclosure
- To verify the that all existing liabilities to the supplier are actually included in the accounts

Procedures to check inclusion of all goods received on credit by the client in inventories and

b. Creditor balances.

- The answer for this is the general procedures for liabilities
- Prepare a schedule for goods on credit which should show the make-up of the liability
- Verify cut-off
- Consider reasonableness of the liability
- Perform compliance tests on ICS
- Consider credit goods at the previous accounting date. Checking if they have been cleared.
- Authority for creating such a liability
- Description in the accounts
- Examine all relevant documents
- Check if there is security and the nature of it
- External verification with the supplier can also be undertaken
- Perform a post balance sheet event review with regard to liabilities

c. The above applies similarly to salaries but with proper adaptation of the answer to the question asked.

- Reason for lack of payment
- Confirm that the employees belong to the company.

Include the procedures for auditing of liabilities

- Authority for the commitment
- Schedule of the commitment
- Value of the commitment

3

- Definition is apparent from the text.
- This is an amount set aside for a future expense that is certain to occur or likely to be
- incurred. However, the company is not sure when the liability or loss will occur or the amount of loss eg. provision of doubtful debts. These are the company's debtors who are likely not to pay part or all their debt. The company makes the provision because it does not know when or what magnitude of loss it will occur but they are sure a loss will occur as a result of unpaid debts.
- These are the procedures for verification of provisions and accruals.

4

- Verification is proving the authenticity of a recorded balance. This is achieved through vouching the transactions that make up the balance or through direct balance testing..
- All the points have been examined in the text. Share premium should be audited like
- Ordinary share capital.

5

a. Post Balance sheet events are those events both favourable and unfavourable that occur between the balance sheet date and the day the accounts are approved by the Board of Directors.
Types of Events

- Adjusting events &
- Non-adjusting events.

Adjusting events being those that provide additional evidence about conditions existing at the balance sheet date or are events which are by convention or statutory requirement are reflected in the financial statements.
Non-adjusting events are those that don't concern conditions existing at the balance sheet date.

b. The procedures to obtain appropriate knowledge of the post balance sheet events are as explained in the text.
c. The auditor must seek evidence that:
   - All post balance events have been considered
   - Balance sheet values correctly incorporate post balance sheet events.

6 Always start with definition of key terms here it is Going concern. The procedures to ensure that the Going concern is still appropriate to your clients include:

1. Assess the adequacy of the means by which the directors have satisfied themselvesthat the adoption of the going concern basis is appropriate.
2. Examine all appropriate evidence
3. Assess the adequacy of the length of time into the future that the directors have looked.
4. Assess the systems or other means by which the directors have identified warnings of future risks and uncertainties
5. Examine budgets and other future plans and assess the reliability of such budgets by reference to past performance.
6. Examine management accounts and other reports of recent activities
7. Consider the sensitivity of budgets and cash flow forecasts variable factors both within the control of the directors (eg. capital expenditure) and outside their control (eg interest or debt collection)
8. 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.
9. Survey the existence, adequacy and terms of borrowing facilities and supplier credit
10. Appraise the key assumptions underlying the budgets, forecasts and other information used by the directors.
11. 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.

7 (a) Auditors carry out circularisation of debtors:

- To provide independent third party confirmation of the existence of the debt.
- To confirm the right to the asset debtors.
- To confirm the money amount but not the value of debtors.

- 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.

(b) **Negative Circularisation**

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 circularisation 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 satisfy themselves with regard to the purposes of circularisation 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 is the preferred method of circularisation.

c.

i. Detailed vouching of all entries in debtors accounts to confirm or refute the stated difference.

Additional vouching tests should be performed to confirm the actual debt balance because circularisations are for confirming existence not money amount of the debt.

a) Detailed vouching of all entries in debtors account.
b) Examining post balance events eg. Settlement

1. Examining the debtors remittance advice
2. Awareness of the possibility of unusual items or mis-statements
3. Reviewing correspondence if any with the debtor.

c)

1. Obtain the co-operation of the client. Only he can ask third parties to divulge information
2. Select method – positive/negative or a combination of the two
3. Select a sample. All customers can be circularised but this is unusual .

- Do not omit
  - Nil balances
  - Credit balances
  - Accounts written off in the period
- Give weight to overdue or disputed balances.
- Use stratified samples, eg all large balances and only some small ones.

1. The letter should be from the client
2. It should request a reply direct to the auditor
3. It may contain a stamped, addressed, envelope or a pre-paid reply envelope
4. It must be despatched by the auditor
5. Receive and evaluate replies
6. Follow up when replies are not received. This is the major problem.

8 (a) There are numerous possible indications that a client is no longer a going concern. A check list of some of them are:

To determine insolvency that is inability to meet debts as they fall due:

- Adverse current ratio or trend.
- Adverse acid test ratio or trend
- Overdue PAYE, VAT
- Dependence on short term finance for long term needs
- Gearing ratio, high or increasing
- Borrowing in excess of debenture trust deed agreements
- Default on loan interest or capital repayment
- Preference dividends in arrears
- Excess stocks
- Excessive debtors
- Overdrafts in excess of facilities granted
- Trade restrictions eg. cash only by suppliers
- Long term loans becoming due with no arrangements for re-finance
- Excessive reliance on high interest finance
- Credit terms taken in excess of agreed terms
- Recurrent operating losses
- Deficiency of share capital and reserves
- Necessity to seek new resources as methods of finance

To determine other possible causes of a business discontinuing.

- Loss of key management or staff
- Labour difficulties (e.g. long strikes)
- Legal proceedings
- Loss of key franchise
- Patents running out
- Loss of principal supplies/customer
- Political risks
- Increasing import penetration
- Foreign exchange movements
- Technical obsolescence
- Voluntary or imposed output restrictions
- Potential losses on long term contracts

(b) Counter-indications

Finding indications of going concern, non-applicability does not of itself justify immediate Conclusion that the entity is not a going concern. He must also seek for counter-indications or mitigating factors.

They include:

- Ability to raise cash by selling assets
- Ability to obtain new sources of finance for example leasing, factoring debts, hiring plant.
- Opportunities of rearranging debt repayment or conversion of long term debt into equity
- The possibility of a rights issue
- Support from other group companies or from associated companies
- The possibility of making alternative trading arrangements.

(c) Steps to ensure going concern is applicable to the client:

PLEASE NOTE: Points are in addition to the points for question 4 on Going concern.

- Investigate the company, its background, its plans for the future review of cash flows and financing plans;
- At every stage of the audit search for and evaluate evidence for and against the going concern applicability
- If he is in doubt, and the directors have formulated plans for the continuation of the company he should evaluate these plans ensuring that:

  a) All parts of the plan are consistent with each other;
  b) If the plans are contingent on the response of third parties then he should seek third parties written confirmations.
  c) Ascertain that the plans are specific rather than general
  d) Review the supporting evidence for the plans if available for reasonableness
  e) Seriously consider any professional advice obtained by the directors;
  f) Consider any potential support from other group companies by looking at any contractual obligations, directors intentions and the ability of the group company to give the support.

- Consider whether he has sufficient evidence to form an opinion on the applicability of the going concern assumption.

9 a)
ISA 300 Para 10 "the auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan. The audit program serves the following purposes;

- As a set of instructions to audit assistants involved in the audit;
- As a means to control and record the proper execution of the work

An audit program contains;

- The audit objectives for each area being audited;
- The audit procedures to be carried out in meeting the objective;
- A time budget in which hours are budgeted for the various audit areas or procedures

(b) Audit programme for salary and wages

Note that:
An audit programme must have the audit objectives that the auditor is aiming at testing. The audit objectives are derived from the management assertions.

Audit objective
To prove the completeness, existence and accuracy of wages and salaries.

Audit procedures

1. Analytical review procedure

   Compare the current years salary and wages expense with the budget and the previous year and obtain explanations for any significant movements/change.

Tests of details

2. Obtain the total salary and wages and agreed the balance as per the ledger to the payroll.
3. For salaries select a sample of employees and confirm the following:

   - The salary and other benefits paidagreed to the personnel file;
   - For new employees verify that all the appropriate procedures were followed in the recruitment by checking the personnel file.

- Verify that the payroll deductions such as paye are accurately computed and remitted to the tax authorities.

4. For wages select a sample of months and carry out the following:
   - That all wages payments were authorised by a senior official before being paid.
   - Select a sample of employees and verify that the correct rates, hours worked/pieces were applied in the wages computation.

c) Verification of creditors

Audit objective

To verify the completeness, accuracy and existence of creditors

Audit procedures

Analytical review procedures

- Compare the current year creditors with the previous year and obtain explanations for the significant movement/change.
  Tests of details
- Obtain a creditors listing and agreed the total balance to the general ledger.
- Select a sample of creditors statement reconciliations as at the end of the year. Confirm that the reconciliation is correctly prepared and that all reconciling items are genuine and where necessary that they have been adjusted in the ledger.
- Obtain a listing of all unpaid creditors invoices and verify that all invoices that relate to the year under review have been posted to the ledger.

LESSON NINE

1.(a) Qualify:

- If the Financial Statements have not been properly prepared in accordance with the Act.
- If the Financial Statements do not give a true and fair view.
- If proper accounting records have not been kept.
- If proper returns adequate for their audit have not been received frombranches not visited by the auditors.
- If the company individual accounts are not in agreement with the accounting records and returns.
- If the auditors have failed to obtain all the information and explanations which to the best of their knowledge and belief, are necessary for the purpose of their audit.
- If the information given in the director's report is not consistent with the Annual accounts.

(b) "Except for"
This refers to a qualified opinion issued either as a result of a limitation in the scope of an audit or a disagreement on a matter that is material but not fundamental. The auditor reports that except for the matter the financial statements show a true and fair view. E.g. if the auditor is unable to prove the existence of stock because his appointment was such that he could not observe the physical stock take and the stock balance is deemed material the auditor could report that the financial statements show a true and fair view except for the stock.

2. The report would be an Unqualified Audit Report with Emphasis of matter.
……We draw attention to note which outlines the negotiations that are currently in progress between the company and their banker for replacing the loan of Shs.20 million with a new long-term facility. These negotiations are well advanced however the company's cash flow projections show that no funds are available to repay the loan……

Apart from all the other paragraphs, which should appear in the report, this should also be included.

3. The Company's Act requires the auditor to state whether:

(a) i. Whether or not the auditor obtained all information and explanations which to the best of their knowledge and belief are necessary for the audit.

ii. Whether in their opinion proper books of accounts have been kept and proper returns adequate for their purpose of the audit have been received from branches not visited.

iii. Whether the P & L and B/Sheet are in agreement with the books of account and returns.

iv. Whether in their opinion and to the best of their knowledge and belief and according to the explanations given to their financial statements give the information required by Companies Act in the manner so required and give the true & fair view.
- In the case of balance sheet the state of capital affairs at the end of the financial year.
- In the case of P & L account of the profit & loss for financial year

v. In the case of holding company submitting group financial statements whether in their opinion group financial statements have been properly prepared in accordance with the provisions of the Act so as to give a true and fair view of the state of affairs and profit and loss of its subsidiaries.

A holding company is a company that has shares in other companies which are called subsidiaries. The holding must be substantial.

(b) Types of Audit opinions

i. Disclaimer Opinion

The auditor is unable to form an opinion as to whether the financial statements give a true and fair view. This is because of a limitation of scope i.e. he does not have enough evidence to support and are unable to express an opinion on the Financial statement.

ii. 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.

iii. Qualified 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.

iv. Unqualified Opinion

This is issued when the auditor is satisfied in all material respects that enable him to express the required opinion on the financial statements without any reservations.

Summary

Nature of circumstance	**Material but not significant**	**Fundamental**
Limitationon scope/uncertainty	Qualified opinion (except for opinion)	Disclaimer of opinion
Disagreement	Qualified opinion (except for opinion)	Adverse opinion

KASNEB PAST PAPER QUESTIONS

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART I

AUDITING

FRIDAY: 6 June 1997. **Time Allowed: 3 hours**

Answer FIVE questions. **All questions carry equal marks.**

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. (4 marks)
b) Set out the main contents of a letter of engagement. (7 marks)
c) Itemise the actions you would take in response to the non-reply by the management to your draft engagement letter. (6 marks)
d) State when it might be necessary to re-draft an engagement letter and have it re-affirmed by the client's management. (3 marks)

(Total: 20 marks)

QUESTION TWO

a) Describe the reasons for maintaining proper audit working papers. (4 marks)
b) The documents, records and related information listed below are normally maintained in 'permanent' audit file.
In each case indicate the importance of maintaining the respective document, record and information.

- Memorandum and articles of association: (2 marks)
- Principal activities and locations; (2 marks)
- Specific legislation and regulations (2 marks)
- History including summary of results; (2 marks)
- Key staff; (2 marks)
- Description of accounting systems and internal control (2 marks)
- Organisation charts; (2 marks)
- Copy of letter of engagement (2 marks)

(Total: 20 marks)

QUESTION THREE

Your firm is the auditor of Mavoko Engineering Company Ltd. and you have been asked to suggest the audit work you would carry out in verifying trade creditors at the end of the financial year. You also attended the company's annual stock take at the end of the year 31 December 1996.

Required:

Describe in detail the audit work you would carry out to verify:

a. The suppliers statements against the balances on the purchase ledger; (12 marks)
b. That purchases cut-off has been correctly carried out at the end of the year. (8 marks)

(Total: 20 marks)

QUESTION FOUR

Members of the accounting profession in common with other professions have taken steps to reduce professional risk as far as possible.

Required:

a. With reference to accounting profession, what is audit risk? (4 marks)
b. Outline the steps that the Institute of Certified Public Accountants of Kenya as taken to reduce the individual auditor's exposure to risk. (7 marks)
c. Suggest specific actions an individual auditor or audit firm could take to minimise liability arising from audit risk. (9 marks)

(Total: 20 marks)

QUESTION FIVE

a. Explain why auditors carry out circularisation of debtors (6 marks)
b. Distinguish between 'positive' and 'negative' debtors circularisation procedures (2 marks)
c. Describe in detail the work you would carry out in scrutinising the replies tothedebtors circularisation and in confirming whether the debtors balances are collectable in the following situations:

- Where the debtor does not agree with the balance and states a difference; (6 marks)
- Where the debtor reports that he cannot confirm the balance; (2 marks)
- Where no reply is received from the debtor (4 marks)

(Total: 20 marks)

QUESTION SIX

During the final stages of the first audit of Nairobi National Bank Ltd. you request the client to provide you with a letter of representation. The client reads the representations you are requesting and refuses to furnish the letter. The client states its position to be as follows:

"You are asking us to tell you all manner of things which we appointed you to find out. You are requesting us to say such things as 'all the transactions undertaken by the bank have been properly reflected in the accounting records' and yet we pay you to carry out the audit. You should know whether these statements are true or not."

Required:

a. Explain to the client the purpose of the letter of representation (6 marks)
b. Describe the nature of the content of a letter of representation. Your answer should be illustrated
c. With specific examples of items which may appear in a letter of representation (6 marks)
d. Explain the reliability of a letter of representation as audit evidence and the extent to which the
e. auditors could rely on this evidence. (5 marks)
f. (d) Explain the consequence of your client's refusal to furnish a letter of representation. (3 marks)

(Total: 20 marks)

QUESTION SEVEN

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? (3 marks)
b. Explain the meaning of the following terms;

- Relevant audit evidence (2 marks)
- Reliable audit evidence (3 marks)
- Sufficient audit evidence. (3 marks)

c. Explain whether the following types of audit evidence meets the standards of relevancy, reliability and sufficiency as required by the auditors operational standard with regard to:

- Written confirmation of a trade debtor circularised at year end; (3 marks)
- Work-in-progress stocks identified during the annual physical stock count; (3 marks)
- Solicitor's letter confirming pending legal action; (3 marks)

(20 marks)

QUESTION EIGHT

a. Explain the meaning of the following phrases:-

- Qualified audit report (5 marks)
- Fundamental uncertainty (5 marks)

b. State the matters that the Companies Act requires to be contained in an audit report (5 marks)
c. What types of audit opinion would normally follow from a limitation in the scope of the audit? (5 marks)

(20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART I

AUDITING

TUESDAY: 2 December 1997. **Time Allowed: 3 hours**

Answer FIVE questions. **ALL questions carry equal marks.**

QUESTION ONE

Restmount Kenya Ltd. was formed on 1 October 1997 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 (6 marks)
b. Procedures for the appointment of an auditor of a public company under the Companies Act. (5 marks)
c. Directors responsibilities in relation to the accounting function of the Company (4 marks)
d. Auditors' statutory responsibilities in relation to the audit of the company's financial statements (5 marks)

(Total: 20 marks)

QUESTION TWO

a. Briefly explain two practical circumstances when the auditor may be liable for damages arising from material misstatements in published financial statements on which the auditors have expressed an audit opinion. (6 marks)
b. List the classes of persons who may make a successful legal action against the auditors negligence. (4 marks)
c. Explain how an audit firm can minimise its potential legal liability for professional negligence. (10 marks)

(Total: 20 marks)

QUESTION THREE

Tamu Tamu Limited is a general trading company. It has presented its annual accounts for audit for the year ended 31 December 1996.

Required:

a) State how you would verify the following assets:
- Short term deposit with the bank: (4 marks)
- Motor vehicles; (4 marks)
- Disposal of plant; (3 marks)
- Loans given to employees; (3 marks)

b) With reference to the annual general meeting of the company, list the items that you would expect to be recorded in the resolutions of the shareholders. (6 marks)

(Total: 20 marks)

QUESTION FOUR

You are the auditor of a manufacturing company which makes and sells ladies clothing. While checking the accounts at the date of the balance sheet you receive from management a certificate showing the value of stock and work in progress. You feel that additional work is necessary to confirm the correctness of the figures.

Required:

a. Describe the procedure you would carry out when checking the stock sheets. (10 marks)
b. Indicate the additional work that must be carried out on the work in progress. (4 marks)
c. State three factors that could affect the accuracy of the figures given by the management. (6 marks)

(Total: 20 marks)

QUESTION FIVE

a. Describe the principal purpose of a management letter. (5 marks)
b. Your audit firm has acted for many years as auditors of Western Fishing Products Ltd. In the course of your audit, you have come across the following matters, which you believe should bebrought to the attention of the directors through a management letter.

- The company banks all its cheques and cash once a week; usually on a Friday afternoon.
- Unbanked cash is held in a petty cash box which is kept in the drawer of a desk in the general office. Only the financial controller and the general manager have access to the keys for the drawer and petty cash box.
- Suppliers statements once received are passed on to the purchases ledger clerk for checking against creditors account and subsequent filing. No further controls are implemented after the filing.
- The company's stock taking instructions require that pre-numbered stock sheets be issued by and returned to the financial controller. During the stock take attendance you noted that the stock sheets in use were not pre-numbered as required.

Required.

Draft a management letter to the managing director highlighting the above weakness, their implications and suitable recommendations to overcome them. (15 marks)

(Total: 20 marks)

QUESTION SIX

Explain the following terms:

a. Materiality; (4 marks)
b. The duty of confidentiality; (5 marks)
c. Professional idemnity insurance; (3 marks)
d. Peer review; (3 marks)
e. Quality Control; (5 marks)

(Total: 20marks)

QUESTION SEVEN

Petty Shops Ltd. operates a large number of small retail outlets selling newspapers, sweets, cigarettes and sundry items. The internal control system provides for all books to be kept at head office with a branch stock account at selling price. Each outlet is required to bank receipts daily and intact; and to make a weekly stock report. All stock other than newspapers and magazines required by an outlet must be ordered from the company's central warehouse and is delivered twice weekly. Each outlet receives daily deliveries of newspapers and magazines direct from the supplier.

There are usually two members of staff on duty at each outlet at any one time with a considerable number of the staff being employed on a part-time basis. Petty Shops Ltd. employs a small internal audit department who visit each outlet at least twice each year.

Required:

a) State and explain four criteria which should be employed in assessing the effectiveness and the relevance of an internal audit function. (8 marks)
b) Identify three types of fraud to which Petty Shops Ltd. may be particularly vulnerable in operating a large number of small outlets. (3 marks)
c) In circumstances where the auditors have identified high risk areas within an audit, give five keyelements which should exist in the general audit approach to these areas. (5 marks)
d) State with reasons whether the external auditors would be expected to visit outlets every year. (4 marks)

(Total: 20 marks)

QUESTION EIGHT

During the course of the audit, the auditor may need to consider audit evidence in the form of reports, opinions, valuations or statements from specialists.

Required:

a) List four examples of situations where an auditor may wish to rely upon the report of a specialist. (8 marks)
b) Describe the principles or factors which the auditor should consider when placing reliance on audit evidence provided by specialists. (12 marks)

(**Total: 20 marks)**

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL BOARD

CPA PART I

AUDITING

MONDAY: 8 June 1998 **Time Allowed: 3 hours**

Answer any FIVE questions **ALL questions carry equal marks.**

QUESTION ONE

Write brief notes on the following:

a. Final or completed audit: (5 marks)
b. Interim audit (5 marks)
c. Continuous audit; (5 marks)
d. Balance Sheet audit (5 marks)

(Total: 20 marks)

QUESTION TWO

Integrated Consulting Engineers Ltd. has undergone a period of substantial growth since its establishment ten years ago. Due to lack of accounting expertise within the company, it has traditionally instructed its auditors, Shah & Company (CPA) to perform the two functions of accountancy and auditing. Shah & Company have also provided consultancy services to the company.
Arising from these responsibilities, Shah & Company earn 20% of their gross fees from Integrated Consulting Engineers Ltd.

Required:

a) Discuss the acceptability and desirability of Shah & Company continuing to act as accountants, auditors and consultants for the company. (10 marks)
b) If, despite having been re-elected as the company's auditors, Shah & Company decide to resign during the year, state the procedures they should follow. (5 marks)
c) What action should Integrated Consulting Engineers Ltd. take on receipt of the letter of resignation from Shah & Company? (5 marks)

(Total: 20 marks)

QUESTION THREE

Three important aspects of an audit which must be planned for well in advance are:

a. Audit staffing requirements;
b. The timing of the audit field visits;
c. Clients use of computerised systems.

Required:

a. Explain the importance of each of the above matters for the successful conduct and completion of the audit. (11 marks)
b. Identify and list in point form the inputs to the planning process in respect of each of the three items stated above. (9 marks)

(Total: 20 marks)

QUESTION FOUR

a. The external auditor of a company uses the system of internal control to determine the nature, extent and timing of his audit tests.

Required:

- Whose responsibility is it to ensure the existence of a strong system of internal controls? (4 marks)
- What value does a client obtain from the external auditor with respect to internal controls? Explain how the auditor provides that value. (6 marks)

b.

- What is the main role of the internal auditor with respect to internal controls? (4marks)
- How does the external auditor assure himself that internal audit is effective? (6 marks)

(Total: 20 marks)

QUESTION FIVE

The auditing guideline on 'planning, controlling and recording' contains the following statement with regard to working papers: 'audit working papers should always be sufficiently complete and detailed to enable an experience auditor with no previous connection with the audit subsequently to ascertain from them what work was performed and to support the conclusions reached.'

Required:

a) Describe four benefits that the auditor will obtain from working papers that meet the above requirement. (8 marks)
b) If the auditor has discovered that a claim for damages is a significant item requiring exercise of judgement in the financial statements, show what type of evidence on the matter the auditor must record in the current file. Give reasons for the inclusion of such evidence in the current file. (6 marks)
c) List three types of information which is normally retained in the audit file and state why such information should be available for reference in the course of an audit. (3 marks)
d) Comment on the desirability of using standardised working papers and give an example of such working paper and its use. (3 marks)

(Total: 20 marks)

QUESTION SIX

The principle objective of the verification of liabilities, commitments and contingencies is to form an opinion as to their completeness, existence, valuation and presentation in the financial statements.

Required:

a. Why does the auditor examine statements received from suppliers of goods and services? (8marks)
b. How would the auditor ensure that at the year end all goods received by a client were included in both inventories and creditor balances? (4 marks)
c. How would the auditor ensure that the amounts accrued for wages and salaries due but unpaid were properly calculated and recorded in the books? (4 marks)
d. What tests would the auditor need to undertake in order to ensure that capital commitments at the year end were fairly stated in the books? (4 marks)

(Total 20 marks)

QUESTION SEVEN

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. (8 marks)
b. State two circumstances in which the auditors may qualify their report owing to inherent uncertainty. (4 marks)
c. State four types of circumstances in which the auditors may qualify their report as a result of disagreement with the directors (8 marks)

(Total: 20 marks)

QUESTION EIGHT

"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:

1. The safety of unclaimed wages
2. The receipt of cash from customers.
3. The company's cheque books
4. Issue of credit notes to debtors.

Required:

a. For each of the above, explain how a fraud can occur in the area. (12 marks)
b. What controls should be in place to prevent the occurrence of each of the frauds described in (a) above? (8 marks)

(Total: 20 marks)

MODEL ANSWERS TO CPA PAST PAPERS

MODEL ANSWERS TO CPA I EXAMINATION SET 6th JUNE 1997

Q1.

a. Why the letter of engagement is sent before any new audit appointment is accepted.
Meaning and importance of the letter of engagement.
It is the purpose of a letter of engagement to clearly define the extent of the auditor's responsibilities and so minimise 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 clear 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's 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.

Q2. **a) Reasons for maintaining proper audit working papers.**

(i). To control the current year's work. A record of work done is essential for:
- The audit clerk to see that he has done all that he should.
- His supervisor, manager, the partner to whom he is responsible and other persons who will review the work he had done.
- Enabling evidence to be available in the final overall review stage of an audit so as to consider if accounts show a true and fair view.

- Working papers collected in investigation of one part of an enterprise may be used in the verification process for another part.
- The audit of one part of an enterprise is not to be conducted in isolation.

(ii) To form a basis for the plan of audit in the next year clearly a starting point for a year's audit is the review of the previous year's work. Rigidly following the same procedures year after year could lead to:

- Client staff getting to know the procedures.
- They could design frauds which the procedures will not uncover.

(iii) Evidence of work carried out.
Audit clerk need to provide evidence to their superiors that they have carried out the work. Evidence of the work carried out may be needed in a court of law.

b) The importance of maintaining the respective document, record and information of the following documents in the permanent file.

- Memorandum and articles of association: show the rules governing the conduct of business.
- Principal activities and locations: to ensure easy accessibility by the auditor during the audit.
- Specific legislation and regulations: show the rules that govern the conduct and activities of the enterprise.
- History including summary of results: to show the history of reserves, provisions, share capital acquisition and records of important account records.
- Key staff: to show their line of responsibility and explain their roles in the business.
- Description of accounting systems and internal control: so as to reveal areas with weaknesses and also to explain the various departments in the business.
- Organisation charts: show the principal departments and subdivisions in the business. It is a clear display of the number of people involved.
- Copy of letter of engagement: it explains the scope of the auditor's assignment.

Q3. a) The auditor should examine the books in which the purchase invoices are recorded and the file of purchase invoices. Each invoice will be examined and the following details looked for:

- the invoice should be addressed to the firm
- it should at least appear to be an authentic invoice from the supplier
- the goods should be of a nature relating to the business carried on.
- The invoice should bear the signature or initials of the clerk deputed to check them.
- The invoice should have attached to it a docket signed by the gate-keeper acknowledging receipt of the goods or bear reference to a goods inwards book or some other evidence that the goods have actually been received.
- The entry should be extended into the correct column in the purchase day book or be otherwise correctly coded so that it ends up in the right place in the final accounts. Particular attention should be paid to goods of a capital nature.
- The details relating to VAT and discounts should also be checked.
- Calculations and extensions should be checked.
- The date should fall in the accounting period
- If the invoice date and the date of supply of the goods or services fall in different periods, the auditor must see that the correct treatment has been given to the item in the final accounts.

b. Cut-off test

This is a test aimed at ensuring that transactions have been recorded in the financial period to which they relate so as to avoid over-lap of transactions where some may be recorded in a wrong financial period.

Procedure:

- Check the item concerned at least two weeks (15days) before the end of the financial period.
- Check the same item two weeks (15days) after the end of the financial period i.e. respective entries of the previous period.
- Check the reasonableness of the entries in both periods with the respective entries of the previous period.

Q4.

a) Audit risk: Generally refers to the possibility of the auditor reaching a wrong conclusion e.g. conclusion that creditors are fairly stated and they are not. This means the chance of damage to the audit firm as a result of giving an audit opinion that is wrong in some particular.
Damage to the audit firm may be in the form of monetary damages paid to a client or third party as compensation for loss caused by the conduct of the audit firm or simply loss of reputation with the client or business community.

b) These steps are adequately covered under the chapter on independence and qualities of an auditor whereby we considered steps taken by the profession to secure the qualities of competence, judgement objectivity and integrity in an auditor.

c) Specific actions by an audit firm to minimise liability arising from audit risk.

- Proper recruitment and training of all personnel.
- Allocation of staff with appropriate ability to particular audits.
- Planning the work of the firm in such a way that each audit can be approached in a relaxed but disciplined way and timing problems may be accommodated.
- Two way communication with staff on matters of general concern and in connection with special audit.
- Use of audit manuals which conform to the audit standards and guidelines.
- Use of audit documentation which is comprehensive and yet allows for special situations.
- Use of budgeting and other techniques to ensure that audits are remunerative and yet risk minimising.
- Use of precise and frequently updated letters of engagement.
- Use of review techniques for all audits.
- Existence of a technical section so that all new developments accounting law and audit procedures are rapidly incorporated into the firm's actions.

Q5.

a) The easiest way to know whether a debtor exists is to ask him this is called circularisation.
Reasons for carrying out circularisation of debtors.

- To obtain confirmatory direct external evidence of the existence and beneficial ownership of the asset debtors.
- To give evidence that the figure in the accounts for debtors is a true and fair one.
- To provide confirmatory evidence that the system of recording and documenting sales and debtors and the controls there on can be relied upon to produce an accurate figure for debtors. Normally, tests which are designed to obtain evidence of the reliability of the systems are called compliance test. Circularisation therefore is useful both for substantive and compliance tests.

- To provide evidence as to the correctness of cut-off. Cut-off is the technical term used to ensure that in computing profits sales are accurately compared with the costs of the goods sold. Cut-off tests can be substantive i.e. examining last numbers of documents or compliance that is, if control exists their application can be tested.
- To provide evidence on the existence of disputed items. It is a direct confirmation.

b) Positive:

The customer is asked to reply whether he agrees to the balance or not; or is asked to supply the balance himself. This method is used where there is weak internal controls, suspicion of irregularities or items in dispute and numerous book-keeping errors.

Negative:
The customer is asked to communicate only if he does not agree with the balance. Effectively the customer is told that if no reply is received from them then the auditor will conclude that the debtor is in agreement with all the terms in the circular.
The major drawback in this method is that if the debtor does not receive the circular, he will not respond.
This method therefore is unreliable and should only be used when there is strong internal control.

c) (i) Determine the system of internal control over sales and debtors. The system should ensure that**:**

- Only bona fide sales bring debtors into being.
- All such sales are approved.
- Check if all sales are recorded
- Check that once they were recorded the debts are only eliminated by receipt of cash or on the authority of a responsible official.
- Check balances are regularly reviewed and aged and a proper follow up exists and if necessary there is provision for bad and doubtful debts.

(ii) A circularisation is very effective in confirming the existence of the debtor and the title to the asset debtor, but is not designed for establishing the value of debtors. It is therefore up to the auditor to confirm the balance and not the debtor.

(iii) If there is no reply send a reminder. Still no response, then the following alternative auditing procedures should be adopted:

- Detailed vouching of all entries in the debtors accounts
- Examining the debtors remittance advice.
- Awareness of the possibility of unusual items or misstatements
- Reviewing correspondence if any with the debtor.
- Examining the post balance sheet events e.g. settlements

Q6. a) Purpose of the letter of engagement.

Paragraph four of the auditors operational standards state that the auditor should obtain relevant and reliable audit evidence sufficient to enable him to arrive at conclusions necessary for his opinion. The guideline recognises management as a valid source of audit evidence. However the same guideline considers internal evidence to be less reliable including representations by management. If representations are made by management their reliability is enhanced if they are written. The guideline on "representations by management" classifies oral and implied representations by management as;

- Not material to financial statements.
- Material to financial statements but capable of independent corroboration.
- Material but knowledge of facts is restricted to by management or it is a matter of subjective judgement or opinion.

(b) Audrey M Kinyua
Certified Public Accountant of Kenya
P O Box 85088
NAIROBI

6th March 2000

Managing Director
Nairobi National Bank Ltd
P O Box 53
NAIROBI

Dear Sir,

Re: **Letters of Representation**

Following your reluctance to sign a suggested draft of the letter of representation which we sent to you, we have considered it prudent and necessary to explain to you purposes and advantages of the aforesaid letter. Firstly it reduces to writing oral statements by the directors. Without the letter of representation, a meeting will have to been called every time we need to get some information. But when the letter of representation is made available time is saved and operations in the company do not come to a standstill so as to answer questions.

Secondly, it provides evidence necessary to carry out an effective and sufficient audit. Audit evidence is vital for our work. Evidence that management has been or is responsible for the fair presentation of accounts in accordance with the necessary accounting and auditing standards and guidelines. The management is also made aware of existing circumstances, events and conditions.

Thirdly the letter is a requirement of the companies Act cap 486. Since all the laws apply to companies then your company should all adhere to the law.

Fourthly, the letter may be used in court or to settle any dispute as a source of evidence. For example your firm may use the letter to prove the auditors' negligence. Also bearing in mind the same facts are not obtainable from evidential sources for example contingent liabilities and also some matters of opinion have no evidence for example life of a plant.

Finally, it acts as a reminder to the management of areas in the accounts and in the internal control system at large that it must take care of in particular.

Yours faithfully
(signature)
Audrey Mwendwa Kinyua. CPA (K).

c) The auditor should adopt these steps with regard to this type of representation that is type of representation where it is material but management restricts knowledge of facts, therefore the auditor cannot verify them independently.

- Ensure through appropriate testing that there is no conflicting evidence contradicting management representations.
- Consider whether representations made by management appear reasonable and consistent with other audit evidence obtained including other representations.
- Consider if individuals making representations can be expected to be well informed on the matter.
- If representations by management are contradicted by other evidence the auditor should investigate the circumstances and when necessary reconsider the reliability of other representations by management. When management representations are the only source of evidence and the tests have been satisfactory and management confirm representations in writing then the auditor can use these representations as audit evidence.

  He should not rely on management representations rashly but must consider these representation with other evidence obtained before reaching a conclusion on whether he has obtained relevant audit evidence. Management representations are just an additional piece of audit evidence and should not be viewed in isolation.

d) If the auditor is unable to obtain all the information and explanations he considers necessary for the purpose of the audit he may consider it a limitation of scope as it will prevent him from obtaining sufficient evidence to express an unqualified opinion. This however depends on whether the matter is material or immaterial.

Q7.

a) Audit evidence; it will constitute or consist 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) (i.) 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.

(ii) 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 analysing 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.

iii) Sufficient audit evidence

- The auditor's judgement is influenced by:
- His knowledge of the business and its industry.

- The degree of audit risk. Assessment of this is helped by considering:
- Nature and materiality of items of account.
- The auditor's experience of the reliability of the management and the staff and records.
- The financial position of the enterprise.
- Possible management bias but also the management may wish to "even out" profits for stock market image or taxationpurposes.
- The persuasiveness of the evidence.
- The nature of the accounting and internal control system and the control environment.

(c) i) Written confirmation of a trade debtor circularised at year end.

Evidence from outside the enterprise is more reliable than that secured solely from within the enterprise. Though debtor circularisations may not be sufficient evidence depending on the case in question.

ii) Work in progress stocks identified during annual physical stock count. If the auditor was present during the stock taking process 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 statement so as to collect sufficient evidence.

(iii) 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 with the ease.

Q8. a)

a) **Qualified audit report;** A qualified report is one where the auditor does not state the auditor's opinion that the accounts have been properly prepared in accordance with the Act. A qualified report has legal consequences and may lead to accounts being seen as less reliable by contact groups.

Types of qualifications
These can be summarised as:

Nature of Circumstances	Very Material and Persuasive	Less Material
Limitation of scope	Disclaimer	Possible adjustment
Disagreement	Adverse	Except for

Each of the above should be explained briefly this has been done in the study pack.

b) **Fundamental uncertainty;** Inherent uncertainties are inevitable in accounting. Suppose that the company is engaged in litigation and the case will not be heard for many months and the verdict cannot be predicted. The only way to determine the uncertainty is to wait on the outcome of the trial but the financial statements must be produced to accord with companies Act time limits and because shareholders need the accounts.
These are uncertainty where the degree of uncertainty and its potential impact on the view given by the financial statements may be very great. In determining whether an inherent uncertainty is fundamental, the auditors consider:-

- The risk that the estimate included in the financial statement may be subject to change.
- The range of possible outcomes
- The consequences of those outcomes on the view given by the financial statement.

Inherent uncertainties are regarded as fundamental when they involve a significant level of concern about the validity of the going concern basis or other matters whose potential effect on the financial statements is unusually great.

What to do about the auditors report:

	Not Fundamental	Fundamental
Uncertainty is adequately accounted for and disclosed	Do nothing	Explanatory paragraph
uncertainty is mistated or inadequately disclosed	'Except for' qualified opinion	Adverse qualified opinion

An explanatory paragraph is one which is included in the section of the auditor's report which sets out the basis of the opinion. It is not a qualification.

b. The Companies Act requirements:
Whether in the auditor's opinion the financial statements:

- Have been properly prepared in accordance with the Act.
- Give a true and fair view
- The auditor must state these matters in his report
- If in the auditor's opinion proper accounting records have not been kept.
- If in the auditor's opinion returns adequate for their audit have not been received from branches not visited by them.
- If in the auditor's opinion the company individual accounts are not in agreement with the accounting records and returns .
- If in the auditor's opinion they have failed to obtain all the information and explanation which to the best of their knowledge and belief are necessary for the purpose of their audit.
- If in the auditor's opinion the information given in the directors' report is not consistent with the annual accounts.

c. Limitations of scope means a limitation of scope of the auditor's work that prevents them from obtaining sufficient evidence to express an unqualified opinion.
The qualification if the limitation is:

- Very material and pervasive – the qualification is a Disclaimer
- Less material and not pervasive – qualification is possible adjustments in the accounts.

MODEL ANSWERS TO CPA I EXAMINATION SET 2nd DECEMBER 1997

Q1. 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.
    - He has not given in writing a notice to resign.
    - He has not committed any 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.
    - He is incapacitated.
    - He resigns.
- Directors duties with regard to accounting function:
    - They should ensure that proper books of accounts are kept to aid in the decision making process.
    - They should also oversee that it is continuous i.e. done through-out the financial period.
- These are outlined in s.162 of Cap 486.
    - 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 P & L Account and Balance Sheet are in agreement with the books of account and returns.
    - 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 state of affairs at the end of its financial year.
        - In the P & L a/c the profit or loss for the year.

- In case of a holding company submitting group financial statements, whether in their opinion group financial statements have been properly prepared in accordance with the provisions of the Act so as to give a true and fair view of the state of affair and profit and loss of its subsidiaries.

Q2.

a) Circumstances under which the auditors may be liable for damages arising from mater misstatements in published financial statements on which the auditors have expressed an audit opinion.

The auditor is expected to exercise reasonable care and skill while carrying out an assignment. Failure to exercise that reasonable care and skill constitutes professional negligence on the accountants part therefore negligence is said to be the;

- Failure to detect material misstatements which, reasonably competent auditor or accountant would have be expected to detect. It follows therefore that failure to detect immaterial misstatements would not constitute negligence on the accountants part. Similarly failure to detect material misstatement which involve an ingenious scheme of fraud would also not be considered negligence on the accountants part.
- Performing an audit and failing to comply with approved auditing standards and guidelines or generally accepted accounting principles and practice e.g. attendance during stock take, bank letters, debtors circularisation and lawyers letters.

An accountant will be judged to be negligent and can suffer loss of reputation or be required to make good the loss suffered by the complainant. But to suffer those damages and to make good the loss the complainant must prove that theaccountant was negligent and two more conditions must be met;

- The auditor must have owed a duty of care to the plaintiff.
- The plaintiff must have suffered a loss as a result of the auditor's negligence.

b) The parties to which the auditor may be liable.

- Any person/institution with whom the auditor has contractual relations.
- Client (individuals, companies or partnerships.
- Persons who may rely on the work of the auditor (providing the audit knew or ought to have known that the person would rely on the work.

c) Ways to minimise liability.

- By not being negligent.
- By following the precepts of auditing standards.
- By agreeing duties and responsibilities in an engagement letter. This should specify
- the specific asks to be undertaken. It should also define the responsibilities to be undertake by the client and specify any limitations to the work to be undertaken.
- By defining in his report the precise work undertaken, work not undertaken and any limitations to the work.
- By 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.
- By stating in any report the purpose of that report and that it may not be relied on for any other purpose.
- Authorising persons who can be recipients of reports in the engagement letter and in the report.
- By limiting or extending liability by a term in the engagement letter or third parties by a disclaimer in the report.

- Obtaining an indemnity from the client on third party.
- Defining the scope of professional competence to include only matters with auditor's competence. Do not take work which you are not proficient at.

Q3.

a) (i) Short term deposit from the bank.

- The main concern in this area is to establish the existence of the balances and more recently due to failures in banks in Kenya, valuation of these balances.
- Check the cashbook and bank statement reconciliation statement paying particular attention to the reconciling items. These should be genuine reconciling items.
- Unpresented cheques and uncleared lodgements should appear in the bank statements early in the new year say within 2 weeks of the year end. If they do not appear this should be investigated as manipulation fraud could be indicated.
- Uncleared lodgements present more fraud or distortion. Banks normally clear lodgements within a week, therefore if after a week we have uncleared lodgements the position may probably be fictitious.
- The creditor should obtain direct confirmation from the bank confirming the balances at that time. The main purpose is to confirm that the bank statement is not fraudulent.
- The client will write to the bank requesting them to provide the auditor with any information the that auditor would require. So the confirmation is sent directly to the auditor.
- The auditor must carry out a further test to establish that the balances are maintained in a reputable bank that is still a going concern.

(ii) Motor vehicle

The only issue of concern here is existence and ownership. Motor vehicles being mobile may not be available for the auditor to physically verify when he pays his visit.

Existence: related evidence can suffice however to prove existence for example if we own the motor vehicle we expect that if it is being used, it will incur costs such as insurance, repairs, fuel and maintenance. The engine and chassis numbers should be checked against the log books to ensure that it is the same vehicle that we are looking at as clients have been known to change the registration number plates from one vehicle to another.
Ownership: ensure that the log book is in your clients name.
Cost and Authorisation: motor vehicles are vouched to the supporting documentation such as invoices, cash books, approved budgets, etc.
Valuation: valued at depreciated historic costs. Auditors responsibility is to ensure that the accounting policy for depreciation is appropriate.

(iii) Disposal of Plant

The issue here is authorisation for disposal and the elimination of the costs concerned from the records. The auditor also tries to ensure that the value obtained was reasonable either by looking at valuations obtained independently from professional valuers before the disposal and looking at the book value of the asset and related values for assets of that nature. Ensure that this plant is removed from the records that is both the residual value and the depreciation. Check the recording of the profit/loss in the profit and loss account.

(iv) Loans given to employees

These are not usually material assets to the company if it is not in the business of giving loans. The verification work will involve:

- Determining, evaluating and testing the systems of internal control. Particular attention being paid to authorisation.
- Obtaining a schedule of the debtors and testing it for accuracy and completeness.
- Obtaining certificates direct from the debtors concerned.
- Preview of agreements and ensuring that the terms are being followed.
- The debt maybe secured in which case, the security is examined and consideration given to its value and realisability.
- The loan may be guaranteed in which case the status of the guarantor must be examined.
- Provision for bad and doubtful debts must be reviewed for adequacy. Where loans have been made to employees they usually become bad if the employee leaves the company before repayment is completed.

c) Items to be recorded in the resolutions of the shareholders are:

- The appointment of auditors
- The election of directors
- Acceptance of accounts and auditors' reports
- Approval of payment of dividends
- Approval of investments proposed.
- Approval of increase in share capital.

Q4. a) Auditors duties with regard to stock.

- Ascertaining the accounting policies adopted by the entity for valuing stocks.
- Auditor must consider suitability of accounting policy adopted for valuation of stock by the organisation.
- The auditor should test check the stock sheets or the continuous stock records with relevant documents such as invoices and costing records to determining cost has been correctly arrived at.
- The auditor must examine and test the treatment of overheads
- The auditor must test the treatment and examine the available evidence for items valued at net realisable value.
- The auditor must check the arithmetical accuracy of the calculations made and the disclosure of the accounting policies adopted.
- The auditor must consider the adequacy of the description used in the accounts and the disclosure of the accounting policies adopted.

Review Tests

- Quantity reconciliation of changes in stocks at successive periods ends with records of movements i.e. receipt and issues.
- Comparison of quantities of every kind of stock held at one year end with those held at a previous year end and the related receipts and issues.
- The gross profit ratio is compared to that of the previous year, other companies and budget.
- Review of rate of stock turnover with previous year.
- Comparison of stock figures and budgets sales and particulars
- Consideration of standard costing records, the treatment of variances in the valuation of stocks and work in progress.

Work-in-progress

- Enquiry into the costing system from which work in progress is ascertained
- Enquiry into how reliable the costing system is. A costing system integrated with the financial system will be more reliable because of the discipline of double entity and the inherent checks imposed by external data such as creditors statements.
- Enquiry into checks that are made as part of the system or statistical data concerning inputs of materials and outputs of products and expectations.
- Enquiry into the system of inspecting and reporting on work done so that allowance is made for scrapping and rectification of work.
- Determining the basis in which overheads are included in costs and ensuring that this is based on international accounting standards.
- Making enquiry into the basis on which any profit elements are dealt with. Profits should be eliminated from work in progress.
- Where the organisation constructs internally some of its own fixed assets, the auditor must make sure that such items as are under construction at the year end are not accounted for twice i.e. in fixed assets and in work in progress.

Factors affecting accuracy of figures given by management.

- Incompetent staff
- Wastage/consumption without proper recording
- Possibility of management bias
- Loss or pilferage of stock
- Change of the stock valuation method.

Q5. a) Principal purposes of a management letter.

- To enable the auditor to give his comments on the accounting records, systems and controls.
- To enable the auditor to bring to attention of management areas of weakness that might lead to material errors.
- In some audit engagements there is a requirement to make a report to directors. These include local authorities, stock exchange firms, housing associations and financial service sector.
- To enable the director to communicate matters they have an impact on future audits.
- To enable the management to put matters that may have otherwise led to audit report qualification.
- To enable the auditor to point out areas where management could be more efficient or more effective or where economies of scale could be made or resources used more effectively.

b)

23rd April 2000

Mary Muthoni
Managing Director
Western Fishing Products Ltd
KANGEMA.

Dear Madam

Internal Control
During our audit we examined the accounting records of your company and the system of internal control over those records established in your company. This system was designed to ensure accurate and reliable records to safeguard the company's assets. We have set out below the principal weaknesses in the system in which we found together with our recommendation for improvement.

Banking of cheques and cash
The company banks all its cheques and cash once a week. Unbanked cash and cheques are held in the petty cash box and only the financial controller and general manager have access to the drawer and petty cash box. If cash and cheques are banked only once a week there is a greater likelihood that cash can be lost or be stolen. If cash is banked everyday then little or no cash will be put in the petty cash box. The financial controller and general manager may collude and end up misappropriating cash.

Suppliers
Statements from suppliers are passed on to the purchases ledger clerk for checking against creditors account and then filed. This can lead to errors and frauds as the clerk is not very competent to carry out all the necessary checks for the creditors.

The clerk should be accompanied by someone else and check the invoices from suppliers and check them against the suppliers statements. Rubber stamps should be extended for invoices already checked.

Stocktaking
The stock sheets were not prenumbered.
This means that all the stocks may not be accounted for. Frauds could be perpetrated by having stock sheets which are not bona fide being used in the organisation by stock managers.

We recommend that:

- Stock sheets be prenumbered.
- Rubber stamps be extended on checked invoices.
- A reconciliation between invoices and suppliers statement be done.
- More rigorous control be kept over the key to the petty cash holding.

Please tell us in due course what action you have taken on these matters.

Yours faithfully,
A MWENDWA KINYUA AND CO.

Q6. a) 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.

b) 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 clients employer or other proper source 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.

c) Professional indemnity insurance; There is a tendency to sue the auditor knowing that he will not 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 filed 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.

d) 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 work products such as financial statements.

e) Quality control; Audits should be extremely well done and yet be completed expeditiously and economically. The auditor should ensure that audits are carried out:

i. In accordance with international accounting standards.
ii. In conformity with statutory and contractual requirements.
iii. In accordance with ethical standards.
iv. In agreement with any professional standards set out by the firm and by other professional bodies.
v. Economically and to time schedules with minimum risk.

Q7. a) Criteria for assessing effectiveness and relevance of an internal audit function.

- Independence.
- Competence.
- Due professional care.
- Staffing.
- Evidence.
- Reporting.

b) Three types of frauds.

- Sabotage of goods/stock during delivery to the outlets.
- Collusion between the suppliers manager and the supplier to overstate the value of newspapers and magazines.
- Misappropriation of cash receipts.

c) Five key elements which should exist in the general audit approach of high risk areas.

- Sceptical.
- Use high calibre audit staff.
- Collection of wide range of audit evidence in each area.
- Meticulous preparation of audit working papers.
- Extreme care in drafting audit report.

The external auditor does not have to visit outlets every year. For example if he does not to do a stock take he must certify himself on the stock take by:

- Using rotational verification methods.
- Intensifying other verification methods
- Using perpetual inventory records more thoroughly
- Appointing agents.

Q8. a.) Examples of situations when an auditor may wish to rely on the report of a specialist.

- Valuations of certain types of assets for example land and buildings, plant and machinery, works of art and precious stones.
- Determination of quantities of physical condition of assets for example mineral stored in stock piles, underground minerals and petroleum reserves and remaining useful life of plant and machinery.
- Determination of amounts using specialised techniques or method for example actuarial valuation.
- The measurement of work completed and to be completed on contracts in progress for the purpose of value recognition.
- Legal opinion concerning interpretations of agreements, laws and regulations.

b) Factors to consider when placing reliance on specialists work.

- The materiality of the item being examined in relation to the financial information as a whole.
- Nature and complexity of the item including the risk of error therein.
- Professional qualification, licence or membership of an appropriate professional body.
- Experience and reputation in the field in which the auditor is seeking advice.
- The objectivity of the expert. This may be impaired if he is employed by the client or is related in some manner to the client.
- The source data used by the expert whether it is appropriate in the circumstances in question.

MODEL ANSWERS TO CPA I EXAMINATION SET 8th JUNE 1998

Q1. a) Final or completed audit;

Usually done at the end of the year on the balance sheet and the profit and loss account. A report is written to the shareholders regarding the true and fair view.

Advantages

- Eliminates note taking during the process.
- It is flexible.
- Ideal for small businesses.
- It does not disrupt work.
- Plan used can be recycled as in every year the same details are checked.

Disadvantages

- Errors and frauds are discovered too late.
- The auditor has to schedule many companies at around the same time.
- Takes a long time.

b) Interim Audit;

It is usually done mid-way the year. It is important to companies that usually declare interim dividends. The balance sheet transactions are left out and only profit and loss account is dealt with.

Advantages

- It is ideal for dynamic businesses.
- Compared to continuous audits it is cheaper.
- It facilitates final audits.
- Up to date accounts are kept.
- Errors and frauds are prevented and detected at an early stage compared to final audits.
- Essential in a partnership in which some partners are retiring or when a new partner is being admitted into the business.
- Essential when mergers and take-overs are being contemplated.
- Facilitates the calculation of interim dividends.

Disadvantages

- Errors are at an advanced stages compared to continuos audits.
- Managers may manipulate accounts so as to conceal profit if they do not want to pay interim dividends.
- Over dependence on audit staff to solve accounting problem.
- Figures already checked can be altered by audit staff or management.

c) Continuous Audit;

Done at intervals of one, two or three months. They are ideal for:

- Banking businesses whose transactions must be up to date to prevent errors and frauds.
- Manufacturing or trading concerns with numerous transactions.
- Businesses without strong internal control system.
- Businesses operating in risky areas.

Advantages

- They facilitate interim audits.
- Accounts are usually kept up to date.
- Errors and frauds are discovered at an early stage.
- The auditor gathers sufficient knowledge of the business as a result of his frequent visits.
- Saves time during final audits.
- Better report is developed as time spent is more.

Disadvantages

- It is expensive to have a continuos audit system.
- Frequent disruptions of the clients work during the audit.
- Tendency to over depend on auditing staff to solve accounting problems.
- Consumes a lot of time.
- Interference of work which has already been audited by the client's staff.

d) Balance sheet audits

Tests the strength of the internal control system by working backwards to get the initial transactions. It is based on verification of assets by checking;

- Description: Mainly of recording entries.
- Ownership: Prove of ownership either by use of logbooks for cars or title deeds for land.
- Value: Cost and method of depreciation.
- Existence: Is the asset really there?

Advantages

- It is cheap compared to other audits.
- A balanced opinion can be reached.

Disadvantages

- It is a partial audit.
- Applied only to business with strong internal control system.

Q2. a) Acceptability and desirability of Shah & Co. continuing to act as accountants, auditors and consultants for the company.

- Shah and Co. are earning 20% of their gross income from one client. This could easily jeopardise the independence of the auditor. The auditor should not earn more than 15% of gross practise income from any one client or a group of connected clients. This is good ground for auditors to resign.
- The auditors are also providing other services like consultancy. It is customary for auditors in many cases to provide other services as well as the audit. This is acceptable providing that the auditor does not perform executive functions or make executive decisions. For example discussing annual dividends with the board would be an executive action and hence unacceptable.
- Preparation of accounting records and accountancy services. Care should be taken that the client takes responsibility for the work done and that objectivity in auditing is not impaired. The accounting records on a public company should not be prepared by the auditors.

b) Procedures to take during resignation

- Depositing a notice in writing to that effect to the client Integrated Consulting Engineers. This notice is not effective unless accompanies by a statement of circumstances.
- The statement of circumstances should contain any circumstances which he considers to be important to members or creditors and if he considers to be none that is no such circumstances then a statement that there are none.

c) Action of the client on receipt of resignation letter.

- The company must send a copy of the notice of resignation to the Registrar of resignation.
- The directors call such Extra-ordinary meeting within 21 days on pain of a fine and must send out copies of the statement and if they fail to do so the auditor can require that the statement be read at the meeting.

Q3. a) 1. Audit staffing requirements;
It is important because:

- The auditor can determine the nature, timing and extent of audit procedures
- It also helps in co-ordinating work to be performed.
- Established degree of internal control
- The client budget limit should not be exceeded
- He may require to involve experts.

2. The timing of audit field visits;

- So as to organise discussions with client's management and staff
- He should also organise to have access to the premises and the plants
- Special skills needed to possess and the timing of their audit visits.

3. Clients use of computerised systems.

It is important because there are several differences in auditing manual and a computerised system. The basic approach to an audit is the same for all audits. However there are some features of computerised systems which make it necessary to change some to the audit approach. Methods used by companies range from the use of giant mainframe computers to desktop machines, from centralised computer departments to the use of outside bureau, to the use of electronic invoicing systems. The auditor has to adapt himself to this resolution. However, the auditor's duties remain the same whatever the data processing systems used.

b) 1. Inputs to the planning process in respect of audit staffing requirements:

- How many staff members are needed for the work?
- The duties and responsibilities of each of them.
- The use of experts
- Experience of audit assistants required.

2. Inputs to the planning process in respect of timing of audit field visit

- Timing for visits to various branches
- Personnel to be sent to the branches
- Information to be gathered from them.

3. Inputs to the planning process in respect of clients use of computerised systems.
All audits must be planned. In a computer environment the following matters may need to be borne in mind.

- Auditors need to be involved computerised systems at the planning development and implementation stages. Knowledge of the system gained at these stages will enable the auditor to plan his audit with an understanding of the system.
- Timing is more important in computerised environments than in manual ones. The auditor will need to be present when data and files are available. More frequent visits to the client are usually required.
- Recording methods may be different. A recent development is the use of portable micro computers to make the audit working 'papers' on floppy discs instead of paper.
- The allocation of suitably skilled staff to the audit. It may be necessary to use the computer audit department for some parts of the audit and for general audit staff to have had some computer experience.
- The extent to which CAAT (Computer Assisted Audit Tests) can be used. These techniques often require considerable planning in advance.

Q4. a) (i) It is the responsibility of the management to ensure the existence of a strong system of internal control. The auditor's responsibility is to oversee the efficiency of the internal control system.

(ii) Value of external auditing to client.

- The external auditor's work is laid down by the statutes and professional requirements of the institute therefore he is likely to be more objective.
- He is primarily interested in the truth and fairness of the accounts.
- The auditor is responsible to shareholders and the public at large therefore he tends to take more care of his work.

b) (i) Role of the Internal auditor in respect to internal controls:

- He acts as a consulting department to other departments in matters to do with internal controls.
- He serves as a check for errors and frauds in the company.
- He should implement and control all activities in the business to ensure that it is effectively run.

ii) How does he assure himself that the internal audit is effective? He can do this by checking the internal auditor's:

- Degree of independence
- Scope and objectives of internal audit functions
- Due professional care
- Technical competence
- Internal audit reports

Q5. a) Benefits

i.To control the current year's work. A record of work done is essential for:

- The audit clerk to see that he has done all that he should.
- His supervisor, manager, the partner to whom he is responsible and other persons who will review the work he had done.

- Enabling evidence to be available in the final overall review stage of an audit so as to consider if accounts show a true and fair view.
- Working papers collected in investigation of one part of an enterprise may be used in the verification process for another part.
- The audit of one part of an enterprise is not to be conducted in isolation.

ii. To form a basis for the plan of audit in the next year clearly a starting point for a year's audit is the review year could lead to:

a. Client staff getting to know the procedures.
b. They could design frauds, which the procedures will not uncover.

iii. Evidence of work carried out.
Audit clerk need to provide evidence to their superiors that they have carried out the work. Evidence of the work carried out may be needed in a court of law.

b) Claim for damages. Matters to record in the current file.

- Document of external verification e.g. a court statement showing the event causing the Details showing the estimated amounts of the claim.
- Copy of explanations by management about the law suit as this will give evidence to the auditor on the probability of receiving the claim.
- Written confirmation by the defendant that he will pay the amount in question.
- The company's follow up on the matter. To determine how soon the claim will be received.

c) Write 3 types of information into the permanent file.

- An outline history of the organisation.
- List of accounting matters of importance.
- Addresses of the registered office and all other premises with a short description of the work carried on at each.

d) Standardisation of working papers.
Most firms adopt a system of standard working papers which can be used on all audits. This has many advantages including:

- Efficiency.
- Staff become familiar with them.
- Matters are not overlooked.
- They assist to instruct staff.
- Work can be delegated to lower level staff.
- Work can more easily be controlled and reviewed.

Disadvantages are;

- Work becomes mechanical.
- Work becomes standard.
- Client staff may become familiar with the method.
- Initiative may be stifled.
- The exercise of necessary professional judgement is reduced.

Q6. a) Examination of statements received from suppliers of goods and services:

- To ensure that all the liabilities are included for both services and goods
- To ensure that where a service or a good has been received before the year end the corresponding liability has been set up. This is called checking the cut-off.
- It also helps in establishing the reasonableness of the liability which may put him upon enquiry
- It also gives him the chance to compare the current liabilities with previous years liabilities
- He examines the statements to establish the terms and conditions when accepting a liability between the client and his creditor.
- The auditor also wants to ensure that the description in the accounts is adequate.
- This statements will show the materiality of the supplies which has to be taken into consideration.
- The auditor will examine the statements in order to match the physical goods to the statement.

Ensuring that all goods and received by a client were included in both inventories and credit balances:

- Checking they use pre-numbered goods received notes and if they match the goods received notes with suppliers statements and invoices.
- The use of pre-numbered purchase orders and their subsequent matching with goods received notes.
- The auditor should investigate the matched goods received notes.
- Regular reconciliation between the creditors ledger and the suppliers statements, having a list of approved suppliers.

Ensuring that the amounts accrued for wages and salaries due but unpaid were properly calculated and recorded in the books.

- Check if a proper independent record of employees is maintained so as to find out dummy employees on the payroll. Fictitious names may be invented or employees who have left or retired may be retained on the payroll. This is usually done by the wages officer.
- Improper calculation of pay can occur when there is collusion between employees and wages officer so this should be directed as well.
- Check if they cast the payroll at the time of approval.

Tests undertaken in order to ensure that capital commitments at the year end were fairly stated in the books.

- Check authorisation of capital commitments this should be prepared by very senior level management and those responsible should have no connection with cash or the custody of title.
- Maintenance of investment register; check if it is done by a clerk with no access to documents of title and responsibility for authorisation of purchase or sales .
- Ensure that an independent clerk should be given the duty of comparing contract notes with purchase and sales authorisation and for ensuring that charges have been correctly calculated.
- Adequate custody procedures must be maintained for documents of title and two senior officials should have responsibility for them.

Q7. (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: this was described earlier in the study pack.
Uncertainty of 2 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. In this situation the auditor 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.

(c) Four circumstances in which the auditors may qualify their report as a result of disagreement with directors.
Departure from accepted accounting practices where:

- There has been failure to comply with the relevant IAS and the auditor does not concur.
- An accounting policy not the subject of a IAS is adopted which auditor's opinion is not appropriate to the circumstances of the business or;
- Exceptionally an IAS has been followed with the result that financial statements do not present a true and fair view.
- Disagreement as to the facts or amounts included in the financial statements
- Disagreements as to the manner or extent of disclosure of facts or amounts in the financial statements
- Failure to comply with the relevant legislation or other requirements.

Disagreements is material but not fundamental

Indicate that the auditor indicates that he has exceptions against reservations noted under uncertainty and he will mention in his report that to the extent of the exception the accounts do not give a true and fair view.

Disagreement is material and fundamental.

Its impact on financial statements is to make them misleading as a whole. In this situation the auditor will state that the accounts taken as a whole do not give a true and fair view.

Q8. 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 authorised.
- 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 debtors 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.

b) Controls

- Have serially numbered wages claim form.
- Document all payments made.
- Reconciliation of payroll, paid wages, cashbook and unclaimed wages by an independent clerk.
- Mechanisation of cash collection points.
- Immediate document of the purpose of payment.
- Custody of cheque books by an officer with integrity.
- Bank reconciliation's should be regular.
- Confirm goods returned are by the debtor in question.

MOCK EXAMINATION

Answer any SIX questions **Time: 3 Hours**
To be carried out under examination conditions. Marks allocated to each question are shown at the end of the question. Show all your workings.

QUESTION ONE

Jujenga Ltd. is a construction company which builds houses and factories for its clients. During the year ended 31 December 1998, the company's own staff constructed an extension to its building on a piece of land immediately beside their existing offices. The new building was required because of expansion which had taken place during the last two years. The costs incurred were:

	Shs
Land- purchased from neighbour	18,000,000
Materials- bricks, cement, etc	6,000,000
Labour- wages paid to employees while engaged upon the office project	14,000,000
Depreciation on construction machinery	2,000,000
Cost of resurfacing existing car park adjoining offices.	1,000,000
	41,000,000

As the audit senior in charge of the audit, explain how you will audit each of the above items of expenditure. (20 marks)
(Total 20 Marks)

QUESTION TWO

a. Describe the procedures which should be followed by the directors of a company wishing to appoint a new auditor to replace the present auditor under the following circumstances:

   1. The auditor has resigned and he does not wish to be re-appointed. (6 marks)
   2. The auditor has disagreed with the directors because he has issued a qualified report on the accounts. (8 marks)

b. What are the rights of an outgoing auditor? (6 marks)
(Total 20 Marks)

QUESTION THREE

a. The auditor is required to keep detailed working papers which document all aspects of the planning and completion of the audit work and also of the conclusions formed during the audit. The working papers should also record all matters of judgement in some detail. Why should the audit work be recorded in this level of detail? (12 marks)

b. The directors of a company are of the opinion that their auditors current files might contain a great deal of useful management information. They write to the auditor after the conclusion of the audit and ask for access to the files. How should the auditor respond to the request? (8 marks)
(Total 20 Marks)

QUESTION FOUR

i. A large company which manufactures pharmaceutical products has recently opened a chain of chemists' shops across the country. This was to enable the company to sell its own brands of medicines to the public and also to diversify into the retailing industry. Other manufacturers products are also sold through the shops.
The board of the company is concerned that gross margins are not as good as had been budgeted. All purchasing is done centrally and the cost of goods is roughly in line with expectations. It has been suggested that fraud by staff is having an effect on recorded income, particularly as the shops have been designed to deter shoplifters.

ii. State why it may be difficult to prevent fraud by staff in a major retail organisation. (5 marks)

iii. Explain in detail some of the controls which could be put in place within the shops to minimise or prevent fraud by staff. (15 marks)

(Total 20 Marks)

QUESTION FIVE

a. List three purposes of a debtors circularisation. (3 marks)

b. List the stages of a debtors circularisation. (4 marks)

c. When no replies are received from debtors in a debtors circularisation exercise, the auditor normally performs alternative procedures before he can conclude on whether the objectives of the circularisation have been met. List and explain alternative procedures. (6 marks)

d. Explain the meaning and importance of the letter of engagement. What are the usual contents of the letter of engagement? (7 marks)

(Total 20 Marks)

QUESTION SIX

Kenya Auditing Guideline – Operational No. 6 states that "if the auditor wishes to place reliance on any internal controls, he or she should ascertain and evaluate controls and perform compliance tests on their operation."

Required:

a. Explain the circumstances when it is not appropriate for auditors to check the internal control system. (3 marks)

b. Explain the circumstances when auditors should check internal controls and the reasons why they perform these checks. (4 marks)

c. Describe the audit work you will carry out at each of the stages shown below in relation to internal control system over purchases:

i. Ascertaining the system; (4 marks)
ii. Recording the system; (4 marks)
iii. Confirming the system; (3 marks)
iv. Evaluation of the controls. (2 marks)

(Total 20 Marks)

QUESTION SEVEN

Kenya Auditing Guideline 7 on Review of Financial Statements states " The auditor should consider whether his review has disclosed any new factors which affect the presentation or accounting policies adopted. For example, it may become apparent as a result of his review of the financial statements as a whole, that the entity has liquidity problems and the auditor should consider whether or not the financial statements should have been prepared on a going concern basis."

Required:

a. Explain the meaning of 'going concern' concept. (4 marks)
b. List eight factors which might cast doubt on the going-concern status of a company. (8 marks)
c. Describe the audit procedures necessary in order to obtain sufficient audit evidence to be able to form an opinion on the going-concern status of a company. (8 marks)

(Total 20 Marks)

QUESTION EIGHT

a. Outline the benefits that can be derived by an auditor from the successful employment of statistical sampling techniques as opposed to non-statistical sampling. (10 marks)
b. Under what conditions is statistical sampling likely to prove most successful in an audit? (10 marks)

(Total 20 Marks)

END OF MOCK EXAMINATION

NOW SEND TO THE DISTANCE LEARNING CENTRE FOR MARKING