ATSWA

ACCOUNTING TECHNICIANS SCHEME WEST AFRICA

STUDY TEXT

PRINCIPLES OF AUDITING & ASSURANCE

PART III

Title page

PUBLICATION OF ASSOCIATION OF ACCOUNTANCY BODIES IN WEST AFRICA (ABWA)

ASSOCIATION OF ACCOUNTANCY BODIES IN WEST AFRICA (ABWA)
ACCOUNTING TECHNICIANS SCHEME
WEST AFRICA (ATSWA)

STUDY TEXT FOR

PRINCIPLES OF AUDITING & ASSURANCE

FOURTH EDITION

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PREFACE

INTRODUCTION

The Council of the Association of Accountancy Bodies in West Africa (ABWA) recognised the difficulty of students when preparing for the Accounting Technicians Scheme West Africa examinations. One of the major difficulties has been the non-availability of study materials purposely written for the scheme. Consequently, students relied on text books written in economic and socio-cultural environments quite different from the West African environment.

AIM OF THE STUDY TEXT

In view of the above, the quest for good study materials for the subjects of the examinations and the commitment of the ABWA Council to bridge the gap in technical accounting training in West Africa led to the production of this Study Text.

The Study Text assumes a minimum prior knowledge and every chapter reappraises basic methods and ideas in line with the syllabus.

READERSHIP

The Study Text is primarily intended to provide comprehensive study materials for students preparing to write the ATSWA examinations.

Other beneficiaries of the Study Text include candidates of other Professional Institutes, students of Universities and Polytechnics pursuing undergraduate and post graduate studies in Accounting, advanced degrees in Accounting as well as Professional Accountants who may use the Study Text as reference material.

APPROACH

The Study Text has been designed for independent study by students and as such concepts have been developed methodically or as a text to be used in conjunction with tuition at schools and colleges. The Study Text can be effectively used as a course text and for revision. It is recommended that readers have their own copies.

FOREWORD

The ABWA Council, in order to actualize its desire and ensure the success of students at the examinations of the Accounting Technicians Scheme West Africa (ATSWA), put in place a Harmonisation Committee, to among other things, facilitate the production of Study Texts for students. Hitherto, the major obstacle faced by students was the dearth of study texts which they needed to prepare for the examinations.

The Committee took up the challenge and commenced the task in earnest. To start off the process, the existing syllabus in use by some member Institutes were harmonized and reviewed. Renowned professionals in private and public sectors, the academia, as well as eminent scholars who had previously written books on the relevant subjects and distinguished themselves in the profession, were commissioned to produce Study Texts for the twelve subjects of the examination.

A minimum of two Writers and a Reviewer were tasked with the preparation of Study Text for each subject. Their output was subjected to a comprehensive review by experienced imprimaturs. The Study Texts cover the following subjects:

PART I

1 Basic Accounting
2 Economics
3 Business Law
4 Communication Skills

PART II

1 Financial Accounting
2 Public Sector Accounting
3 Quantitative Analysis
4 Information Technology

PART III

1 Principles of Auditing & Assurance
2 Cost Accounting
3 Taxation
4 Management

Although, these Study Texts have been specially designed to assist candidates preparing for the technicians examinations of ABWA, they should be used in conjunction with other materials listed in the bibliography and recommended text.

PRESIDENT, ABWA

STRUCTURE OF THE STUDY TEXT

The layout of the chapters has been standardized so as to present information in a simple form that is easy to assimilate.

The Study Text is organised into chapters. Each chapter deals with a particular area of the subject, starting with learning objective and a summary of sections contained therein.

The introduction also gives specific guidance to the reader based on the contents of the current syllabus and the current trends in examinations. The main body of the chapter is subdivided into sections to make for easy and coherent reading. However, in some chapters, the emphasis is on the principles or applications while others emphasise method and procedures.
At the end of each chapter is found the following:

- Summary
- Points to note (these are used for purposes of emphasis or clarification);
- Examination type questions; and
- Suggested answers.

HOW TO USE THE STUDY TEXT
Students are advised to read the Study Text, attempt the questions before checking the suggested answers.

ACKNOWLEDGMENTS

The ATSWA Harmonisation and Implementation Committee, on the occasion of the publication of the first edition of the ATSWA Study Texts acknowledge the contributions of the following groups of people. The ABWA Council, for their inspiration which gave birth to the whole idea of having a West African Technicians Programme. Their support and encouragement as well as financial support cannot be overemphasized. We are eternally grateful.

To The Councils of the Institute of Chartered Accountants of Nigeria (ICAN), and the Institute of Chartered Accountants, Ghana (ICAG), Institute of Chartered Accountants, Sierra Leone (ICASL), Gambia Institute of Chartered Accountants (GICA) and the Liberia Institute of Certified Public Accountants (LICPA) for their financial commitment and the release of staff at various points to work on the programme and for hosting the several meetings of the Committee, we say kudos.

We are grateful to the following copyright holders for permission to use their intellectual properties:

- The Institute of Chartered Accountants of Nigeria (ICAN) for the use of the Institute's examination materials;
- International Federation of Accountants (IFAC) for the use of her various publications;
- International Accounting Standards Board (IASB) for the use of International Accounting Standards and International Financial Reporting Standards;
- Owners of Trademarks and Trade names referred to or mentioned in this Study Text.

We have made every effort to obtain permission for use of intellectual materials in this Study Texts from the appropriate sources.

We wish to acknowledge the immense contributions of the writers and reviewers of this manual;

Our sincere appreciation also goes to various imprimaturs and workshop facilitators. Without their input, we would not have had these Study Texts. We salute them.

Chairman
ATSWA Harmonization & Implementation Committee

A new syllabus for the ATSWA Examinations has been approved by ABWA Council and the various PAOs. Following the approval of the new syllabus which becomes effective from the September 2022 diet a team was constitutes to undertake a comprehensive review of the Study Texts in line with the syllabus under the supervision of an editorial board.

The Reviewers and Editorial board members are:

REVIEWERS

This Study text was reviewed by:

Dr. Michael Oseni	-	Department of Accountancy, The Polytechnic, Ibadan
Dr. Olawale Wale-Awe	-	Wale Awe & Co. Chartered Accountant
Dr. Nathan Amadi	-	University of Maiduguri, Maiduguri, Borno State

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The Editorial Board Members are:

-	Chief (Mrs) Hilda Ofure Ozoh, FCA	Chairman, ATSWA Examinations Committee
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-	Mr. Akeem Ishola Adeniyi, FCA	ICAN, Principal Manager & HOD, ATSWA Examinations Department

Contents

PAPER 9: Principles of Auditing & Assurance

SYLLABUS AND EXAMINATION QUESTION OUTLINE

Aim

To enable candidates, understand the regulatory frameworks, ethical issues, risks and processes involved in an assurance environment.

Objectives

On completion of this paper, candidates should be able to:

a) Explain the principles and theory of assurance engagements with the applicable regulatory framework;
b) Understand how an assurance engagement is planned with verification procedures;
c) Understand the procedures of internal control and its inherent limitations;
d) Be familiar with audit and assurance services in the public sector;
e) Understand IT-based system assurance; and
f) Understand the various types of assurance reports.

Structure of the paper

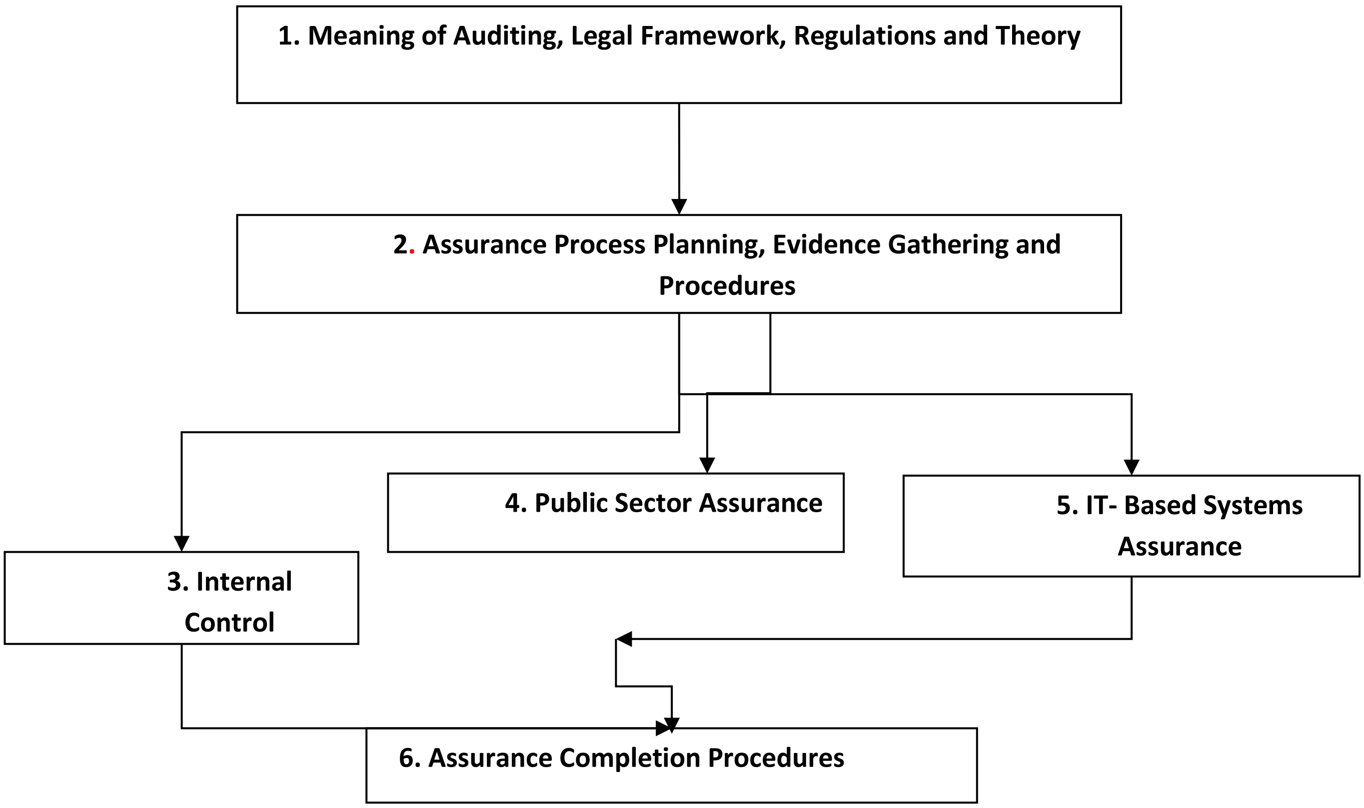
The paper is a three-hour paper, divided into two sections:

Section A: (50 Marks) - This shall consist of 50 compulsory questions made up of 30 multiple choice questions and 20 short answer questions covering the entire syllabus.

Section B: (50 Marks) - This consists of six questions of which candidates are expected to answer any four. Each of the questions attracts 12.5 marks.

Diagrammatic presentation of Principles of Auditing

The diagram summarizes the contents of Principles of Auditing.



Contents

1. Meaning of auditing, legal framework regulations and theory 20%

a. Define and explain the concepts of audit and assurance.

b. Explain the legal and regulatory framework for statutory audit and assurance in line with the provisions of:
   i. International Standards on Auditing (ISAs); and
   ii. International Standards on Assurance Engagements (ISAEs).

c. State and explain the differences between accounting and auditing.

d. State and explain the roles, rights and duties of assurance parties under company legislation in your country and other regulatory frameworks.

e. Identify and explain the liability of assurance parties for negligence under common civil and criminal laws of various countries.

f. State and explain the legal framework of external audit and assurance with respect to:
   i. Differences between statutory and non-statutory audits;

ii. The scope of internal and external audits; and
iii. Public sector audit.

g. Explain the basic steps or components of an assurance process with respect to:
    i. Fundamental principles of the professional accountancy bodies' code of ethics and conduct in your country;
    ii. True and fair view;
    iii. Materiality;
    iv. Judgement;
    v. Audit risks;
    vi. Appointment of assurance parties;
    vii. Removal of assurance parties;
    viii. Independence of assurance parties; and
    ix. Sources of liabilities of assurance parties.

2. Assurance process planning, evidence gathering and procedures 15%

a. Explain assurance planning and strategies.
b. State and discuss factors affecting evidence reliability.
c. Outline the vouching process for specific items in the financial statements.
d. State and explain the concepts of physical examination and third party evidence.
e. Explain assurance programmes, giving examples.
f. Identify and explain types of assurance tests.
g. Explain management representations, internal control reporting and assurance letters
h. Explain sampling selection methods affecting sampling size.
i. Explain the concepts of quality control and peer review.
j. Explain assurance procedures with respect to various types of intangibles assets.
k. Discuss the concepts of audit risk and risk assessment.
l. Discuss the advantages of working papers.

3. Internal control 15%

a. Explain the nature and types of internal control.
b. Explain the difference between internal control and internal audit.
c. Explain the need for internal control.
d. Identify the inherent limitations in internal control systems.
e. Explain internal control reporting and assurance control letters.
f. State and explain control procedures to gather assurance evidence.
g. Apply internal control to finance cycles.
h. Explain the role of internal audit within an organisation.
i. Discuss the effectiveness of internal audit.
j. Explain the role of the audit committee in relation to internal audit.

4. Public sector assurance **15%**

a. State the powers and functions of the Auditor-General for the federation, state and local governments or their equivalents in your country.
b. Explain financial and regulatory assurances.
c. Discuss the phases of value for money audits.
d. State the composition of the office of the Auditor- General for the federation or its equivalent in your country.
e. Explain the roles of the public accounts committee in the assurance process.
f. List the functions and objectives of Bureau of Public Procurement or a similar body in your country.
g. Explain the assurance functions of the internal auditor in the auditor general's office or in a similar office in your country.

5. IT-based system assurance **15%**

a. Explain types of information technology systems.
b. State typical control challenges faced in the assurance of small IT-based systems.
c. Explain documentation procedures used in the assurance of manual and IT-based systems.
d. Explain the approach to the audit of IT-based systems with attention to audit trail and controls.
e. Explain business systems and associated IT risks
f. Explain the concepts of IT audit activities and current trends in Information Technology relating to:
   i. Big data analytics;
   ii. Audit of electronic transactions;
   iii. Artificial intelligence; and
   iv. Machine learning.

6. Assurance completion procedures **20%**

a. State the purpose and methods of analytical procedures.
b. Discuss the "going-concern" concept.
c. Evaluate the "going-concern" of a company.
d. State the composition and functions of the audit committee.
e. Explain the importance and use of forensic audits.
f. Explain the concept of "due diligence".
g. State the form and contents of assurance report on the financial statements.
h. State the circumstances which may warrant the assurance party to issue a report with:
   i. A qualified opinion;
   ii. An adverse opinion; and
   iii. A disclaimer opinion;

i. State the methods of recording significant and material errors.
j. State the purpose of written representations.
k. State the purpose and content of an engagement letter.
l. State the need for the review of events after reporting period.
m. State the purpose and contents of a working paper file.
n. Discuss other assurance engagement services.
o. Discuss the concept of peer review.

Recommended Texts

1. ATSWA Study Pack on Principles of Auditing.
2. Aguolu Osita - Fundamentals of Auditing, Rex Charles & Patrick Ltd, Nimo, Anambra State, Nigeria.
3. Ezeribe, C. (2018). Audit Assurance Essential, Abuja; Topnotch Learning Publication.
4. Okai I.J (1966). Auditing for you: National Science and Technology press csir Accra.
5. Woolf E. - Auditing Today, Prentice- Hall International.

CHAPTER ONE

NATURE, PURPOSE, AND SCOPE OF AUDITING AND ASSURANCE

CHAPTER CONTENTS

a. Introduction
b. Historical Background
c. Auditing Today
d. Definition of Auditing
e. Why the need for Audit
f. Objectives and General Principles Governing an Audit of Financial Statements
g. Advantages of Audit
h. Disadvantages of Audit
i. Limitations of audit
j. The Expectation Gap
k. The Structure of an Audit Firm
l. Types of Audits
m. The meaning of Assurance
n. The Chronology of an Audit
o. Auditing and Other Assurance Services
p. The Agency Theory and Auditing
q. Audit Committees

OBJECTIVES

After the completion of this chapter, the reader should be able to:

i. explain the purpose and types of audits;
ii. understand in general terms what an audit is and put into context some basic audit techniques;
iii. recognize that there are theoretical considerations underlining audit practice
iv. outline and explain the main stages of an audit; and
v. outline the functions of audit committee;

1.1 INTRODUCTION

Managers of businesses and organizations prepare accounts to communicate how the entities have been managed within a given time period. Thus, the accounts (financial statements) are the end products of the managers' Stewardship function. In this manual, we shall be studying the audit of the accounts. An unqualified or favourable or clean audit report communicates to stakeholders that their business interests have been managed well and that they can rely on the picture that the financial statements portray.

Auditing is therefore a very onerous and demanding task and a high sense of competence, integrity, skill, experience, and technical knowledge must be brought to bear in the process of auditing. Auditors may find themselves having to gather appropriate and sufficient audit evidence to enable them make informed judgements about a whole range of business situations. This can be best achieved if auditors understand how organizations operate and the environment in which they operate. Auditing is therefore a practical and real life subject.

1.2 HISTORICAL BACKGROUND

The Evolution of auditing dates back to the medieval ages. Records have it that in ancient Egypt and Rome, people were employed to review work done by tax collectors and estate managers. It is also on record that in medieval Britain, an independent person was employed by the Feudal Barons to ensure that returns from tenant farmers accurately reflected revenues received from the estates.

In those eras, the emphasis was on detection of fraud and irregularities. Further developments in the discipline have changed the forms of auditing and made it more demanding and sophisticated.

1.3 AUDITING TODAY

It has been recognized that whenever a fiduciary relationship with financial implications exists, there is a need for a knowledgeable outsider to independently and objectively review the accounts of stewardship and to express an opinion on their integrity.

The account of stewardship, within the context of a company, refers to the records of how the directors have dealt with the investments or assets of the company on behalf of the shareholders. The summarised accounts of the stewardship are the financial statements (Statement of Profit or Loss and Other Comprehensive Income, Statement of Financial Position, Statement of Changes in Equity, Statement of Cash Flow, Statement of Value Added, and the Directors' Report). Now the services of professional accountants are being sought to take up the demanding task of the independent examination of the financial records produced by management and expression of opinion on the truth and fair viewof the underlying records.

Auditing of today is deeply rooted in the concept of separation of ownership from management in the affairs of companies. There is now the urgent need to safeguard the interests of the owners (the shareholders) who are not involved in the day-to-day decisions made by the management (the board of directors).

In Nigeria, the Companies and Allied Matters Act, 2020 has made it an obligation for every public liability company (Plc) to have its annual financial statements audited before circulating them to members. Specifically, Section 400(1) states that "Every Company shall at each general meeting appoint an auditor or auditors to audit the financial statements of the company…" Other West African countries have similar legislations which make audit of financial statements of public companies a mandatory requirement.

The appointed auditor (who should be a member of a recognized professional accountancy body and duly licensed to practice and not disqualified by any legislation) is expected to express an opinion on the truth and fairness of the Statement of Profit or Loss and other Comprehensive Income and the Statement of Financial Position, both of which should be prepared by the directors and presented to the shareholders at an annual general meeting.

1.4 DEFINITION OF AUDITING

Auditing is defined as a process, carried out by an appointed qualified person or body, whereby the records and financial statements of an entity are subjected to independent examination in such detail as will enable the auditor form an opinion as to the truth and fairness of the financial statements.

The key words and phrases in this definition are further explained below:

"**Independent Examination**" means the conduct of the audit should be carried out independent of the person who prepared the records and the financial statements. The work of the auditor should not, under any circumstance, be influenced by the client. An auditor cannot give an unbiased opinion unless he is independent of all the parties involved. Not only must the auditor be independent in fact and in attitude of mind, but he must also be seen to be independent in appearance.

Appointed qualified person means the auditor should be professionally qualified, must have completed the approved professional accountancy examinations and have the relevant skills, experience, and integrity to carry out the examination.

Records and financial Statements include written authorization to effect the transactions, the source documents, the Books of Prime Entry, the Ledgers, the Trial Balance, the Statement of Profit or Loss and Other Comprehensive Income, the Statement of Financial Position, the Statement of Changes in Equity, the Statement of Cash Flow, the Statement of Value Added, the Directors' Report and other reports issued in accordance with current corporate governance practice.

Opinion is the expression of the auditor's professional viewpoint about the financial statements after exercising his judgement about skills and based on the evidence gathered.

True and Fair (or truth and fairness) means that the financial statements are free from material misstatement; that proper books of accounts have been kept; that the financial statements are consistent with the underlying records; that the financial statements have been prepared in accordance with the acceptable accounting standards and relevant legislation; that the assets and liabilities exist, are properly valued and pertain to the entity; and that all expenses and revenues stated relate to the operations of the business for the period under consideration.

"Truth" implies that the information is factual and conforms to reality with no material errors: it is not false. In addition, it means that the information conforms to required standards and law, and that the accounts have been correctly extracted from the books and records.

"Fair" means that the information is free from discrimination and bias and are in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company's underlying transactions.

1.5 WHY THE NEED FOR AN AUDIT

The managers of the business (directors) are obliged to report to the owners (shareholders) on how their business has been managed. The owners, at this point, will like to assure themselves that the report contains no errors, it is not misleading and it discloses all relevant information.

A way out of this problem of credibility in financial accounts and reporting is to appoint an independent person, referred to as an auditor, to examine the report and express his/her opinion on it.

Modern companies have expanded; some across political boundaries. The preparation of accounts for such companies is complex since it encompasses various legislations, standards, conventions, policies and control systems. It is therefore essential that such accounts are examined by independent experts who have the skills and experience in examining financial statements.

Financial statements are required to comply with various legislations and standards. Compliance with this requirement can be assured if audit is carried out on financial statements.

There are many interested parties who use financial statements as a basis for making decisions. These are the bankers, creditors, employees, potential investors, regulators, government agencies, donors, researchers etc, and they all have interests in the state of affairs of the organisation. The independent audit requirement fulfils the need to ensure that those financial statements are objective, free from material misstatements, and are relevant to the needs of the users.

1.6 OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF FINANCIAL STATEMENTS

1.6.1 Objective 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 and that the financial statements give “a true and fair view” or “present fairly, in all material respects” the financial results and state of affairs of the client entity.

The auditor’s opinion enhances the credibility of the financial statements. Nevertheless, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

The subsidiary objectives of an audit are to:

- detect errors and fraud
- prevent errors and fraud
- help the client to improve upon his accounting and internal control systems.

It must be emphasized that audit is not designed to identify errors, detect fraud and discover significant weaknesses in the client’s systems but the audit work should be carried out in such a manner as to be able to unearth errors, frauds and weaknesses (if they exist).

1.6.2 General principles of an audit

The auditor should comply with the C*ode of Ethics for Members* issued by the International Federation of Accountants

The ethical principles governing the auditor's professional responsibilities are:

a) Independence;
b) Integrity;
c) Objectivity;
d) Professional competence and due care;
e) Confidentiality;
f) Professional behaviour or conduct and
g) Technical standards

The auditor should conduct an audit in accordance with International Standards on Auditing (ISAs). These contain basic principles and essential procedures together with related guidance in the form of explanatory and other materials.

The auditor should plan and perform an audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. An attitude of professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For examples, an attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusion on which to base the audit opinion.

1.6.3 Scope of an audit

The term "scope of an audit" refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit. The procedures required to conduct an audit in accordance with ISAs should be determined by the auditor having regard to the requirements of ISAs, relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and the reporting requirements.

1.6.4 Reasonable assurance

An audit is designed to provide reasonable assurance that the financial statements taken are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.

An auditor cannot obtain absolute assurance where there are inherent misstatements. These inherent misstatements arise because of some limitations that are unavoidable.

These limitations result from factors such as:

a. The use of testing. The auditor takes samples for testing, instead of working on the whole dataset or the total financial records of the organisation.
b. The inherent limitations of internal controls (for example, the possibility of management override or collusion).
c. The fact that most audit evidence is persuasive rather than conclusive.

Also, the work undertaken by the auditor to form an audit opinion is permeated by judgment regarding:

a. The gathering of audit evidence, for example, in deciding the nature, timing, and extent of audit procedures: and
b. The drawing of conclusions based on the audit evidence gathered, for example,
c. Assessing the reasonableness of the estimates made by management in preparing the financial statements.

Furthermore, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on assertions (for example, transactions between related parties). Accordingly, because of the factors described above, an audit is not a guarantee that the financial statements are free of material misstatements.

1.6.5 Audit risk and materiality

Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks. Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial statements. The auditor is ultimately concerned only with risks that may affect the financial statements.

The auditor obtains and evaluates audit evidence to obtain reasonable assurance whether the financial statements give a true and fair view (or a represented fairly, in all material respects) in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk that the audit opinion is in appropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as “audit risk”.

The auditor should therefore plan and perform the audit to reduce the audit risk to an acceptably low level that is consistent with the objective of an audit. The auditor reduces audit risk by designing and performing audit procedures to obtain sufficient and appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

The auditor is concerned with material misstatements and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. The auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the financial statements taken as a whole.

1.6.6 Responsibility for the financial statements

While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and fairly presenting the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity, with oversight from those charged with governance (i.e., the directors). The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. Furthermore, the directors should keep the financial statements and accounting records at the company's registered office or in any other place in the relevant country as the directors deem fit.

1.6.7 Public sector perspective

Irrespective of whether an audit is being conducted in the private or public sector, the basic principles of auditing remain the same. What may differ for audits carried out in the public sector is the audit objective and scope. These factors are often attributable to differences in the audit mandate and legal requirements or the form of reporting (for example, public sector entities may be required to prepare additional financial reports).

When carrying out audits of public sector entities, the auditor will need to consider the specific requirements of any other relevant regulations, ordinances or ministerial directives which affect the audit mandate and any special auditing requirements, including the need to have regard to issues of national security. Audit mandates may be more specific than those in the private sector, and often encompass a wider range of objectives and a broader scope than is ordinarily applicable for the audit of private sector financial statements. The mandates and requirements may also affect, for example, the extent of the auditor's discretion in establishing materiality, in reporting fraud and error, and in the form of the auditor's report. Differences of audit approach and style may also exist. However, these differences would not constitute a difference in the basic principles and essential procedures.

Audit is carried out to lend credibility to the financial statements concerned and to assure stakeholders of the truth and fairness of the statements.

Apart from the above advantages, there are inherent advantages in having accounts of companies audited. These include:

a) Disputes between partners may be largely avoided especially where complicated profit-sharing arrangements subsist. Independent examination of partnership accounts will ensure accurate assessment and division of profits.
b) Changes in ownership are facilitated by unqualified audit reports. For example, the admission of a new partner or two sole proprietors merging their businesses to form

a partnership is made easier than otherwise would have been the case, if previous audited accounts are available for examination.

c) Audited financial statements serve as reliable source of information for banks and other financial institutions when it comes to assessing the strength of loan/overdraft applicants.

d) Audited accounts of the partnership, as adjusted for tax purposes, submitted to State Internal Revenue Service carry greater authority than unaudited accounts.

e) The presence of a qualified auditor is useful because of the variety of other capacities in which he is able to assist. In the case of a company the auditor can offer taxation, information technology services, liquidation and insolvency, and other ancillary services.

1.8 DISADVANTAGES OF AN AUDIT

The disadvantages of an audit are stated as follows:

a) The payment of audit fees: Auditors' fees add extra financial burden to businesses. It is believed that, had it not been a statutory obligation, many companies would not engage the services of external auditors (despite the advantages outlined above). It is for this same reason that few partnerships and sole proprietors have their accounts audited.

b) Auditing requires the client's staff and management to provide information to the auditors which they see as additional burden that could disrupt their work plan. An external auditor should therefore plan his audit work carefully to minimize the perceived disruption to the client's work plans.

1.9 LIMITATIONS OF AN AUDIT

There are some limitations to what the auditors can do.

a. The auditors' opinion is neither a guarantee of the future viability of the entity nor an assurance of management's efficiency and effectiveness even though the auditor, during the audit work, pays attention to both matters: neither of them represents the main purpose of an audit.

b. An audit work is focused on examining financial records and statements relating to past transactions and the verification of assets and liabilities held by the client at the end of the relevant accounting period. There is no guarantee or assurance from the auditors that what happened in the past will apply to the future.

c. The primary concern of auditors is how the decisions of management affect the financial statements and to recommend ways of improving the control systems. Auditors do not conduct extensive review of efficiency.

d. Auditors express an "opinion"; they do not certify whether a set of accounts is completely correct. What is "reasonable assurance" depends largely on what a user of financial statements expects from the auditor's report. This limitation stems from the fact that:

   i. It is not practically possible for the auditor to examine all items within an account balance or class of accounts.

   ii. There is the possibility of collusion and misrepresentation for fraudulent purposes, and many audit evidence are persuasive (indicating what is probable) rather than conclusive (indicating what is definite).

1.10 THEAUDIT EXPECTATION GAP

Many people still have some misconceptions about the role of the auditor and position on what auditing is meant to achieve.

a. Some people are of the opinion that the auditor's reports are addressed to the directors of the company and not to the members (i.e., the shareholders or owners).

b. Some people think that a qualified audit report which indicates that the financial statements do not give a true and fair view of the financial position of the enterprise is more useful to those who appoint the auditors than an unqualified (or clean) report.

c. There is the misconception that it is the auditor's duty to detect fraud, (when in fact the detection of fraud is the responsibility of the directors).

These misconceptions point to the fact that an "expectation gap" still exists between what auditors do and what the law expect them to do.

1.11 THE STRUCTURE OF AN AUDIT FIRM

Audit firms have structured management. The partners generally delegate decisions of routine management to the senior partner who reports to the full partnership at regularly convened meetings.

The Partnership Secretary/Administrator reporting to the senior partner takes responsibility for administration, including preparation of agenda papers and minutes of meetings, accounting and management records, word processing, etc. The salaries paid to those involved in these activities form part of the firm's overhead.

The professional staff and partners maintain accurate time records to ensure that all the time assigned to client affairs are properly billed at the appropriate hourly rate, determined in turn by reference to salaries. In this way, the firm recovers salary cost of professional staff and overheads. The excess of audit fees over these costs represents partnership profits, to be shared among the partners in their profit sharing ratios.

The professional staff is divided into departments (taxation, audit, consultancy, information technology, accounts preparation services, liquidation, etc) and into seniority grades.

Partners are made responsible for the service given to clients which each of them is designated "engagement partner" but the detailed management of each assignment is the work of a manager, who in turn takes charge of the work teams of seniors and juniors within the broad departmental areas.

In the interest of running the firm effectively and profitably, the essential features stated below must be emphasized:

a. Regular communication of progress on audit assignment
b. Timely communication of problem areas
c. Close supervision of work of juniors by seniors
d. Proper planning of work and its allocation to appropriate staff
e. Quality control, including evidence of work completed
f. Review of work done by managers and engagement partners.

It is also essential that audit firms pay particular attention to technical training and updating of staff knowledge through in-house bulletins, seminars, provision of library and data bank.

1.12 TYPES OF AUDITS

1.12.1 Private Audit and Statutory Audit

A private audit is one undertaken at the instance of an interested party (e.g. a sole trader) or parties (partners of a partnership), even though there is no legal obligation that an audit be carried out.

In the case of private audit, the scope of the audit may be determined as narrowly or as broadly as the client wishes.

A statutory audit arises under the Company law as a result of which it is a statutory obligation for the accounts of every limited liability company to be audited annually by a professional qualified auditor. Statutory audits have their scope largely determined by the governing legislation which the client or the auditor has no authority to vary in any way. Even though the appointment of an auditor is a statutory requirement, the relationship between the company and the auditor is governed by contract.

1.12.2 External and Internal Audit

External audit is where independent persons are brought in from outside an organization to review the accounts prepared by management. The definition and objective of audit stated earlier in this chapter relate to external audit.
Internal audit is where an organization appoints a full time staff to monitor and report on the running of the company's operations as a service to the management.

1.12.3 Complete Audit, Interim Audit and Continuous Audit

Complete audit applies to smaller concerns where the volume of transactions and complexity of records do not require the auditor's attendance more than once each year. This visit normally takes place as soon as the company's financial year ends, and it continues until it has been completed and the audit report signed.

Interim Audit: In the case of larger clients, the auditor will often find it necessary to proceed with the audit on an interim basis in view of the volume of testing to be undertaken in order to reach an opinion on the reliability of the records. Interim audits, as arranged with the co-operation of the client, may be bi-annual, quarterly or even monthly, depending on the volume of audit work considered necessary. It may also be conducted any time before the year ends.

Continuous Audit: Where the system of internal control operated by a large company displays fundamental and material weaknesses, the auditor may be obliged to check a higher proportion of transactions than would otherwise be necessary, and in exceptional circumstances, members of the audit team may be required to execute checking work continuously throughout the period to which the accounts relate.

1.12.4 Systems Audit and Statement of Financial Position Audit:

Systems Audit is the review of the internal control systems through which the transactions are processed. Whereas, statement of financial position audit refers to the audit of the account balances.

The table summarizes the distinction between external auditors and internal auditors:

External Auditors	Internal Auditors
• Independent of the organisation	Responsible to Management, Managing Director, Board of Directors or Audit Committee
• Responsibilities are fixed by statute	Responsibilities are specified by Management
• Report to shareholders	Report to the Director or Audit Committee
• Perform work to enable them express an opinion on the truth and fairness of the accounts in accordance with the requirements of Company Law	Work may range over many operational and financial areas and activities as determined by Management
• Must be professionally qualified	May not be professionally qualified

It must be emphasized that some of the activities performed by internal auditors are like those performed by external auditors and the efficiency of the former largely affects the workload of the latter.

1.13 MEANING OF ASSURANCE

Assurance is a strong feeling or confidence about being right. In an assurance engagement, a firm is engaged to express opinion on the financial statements that have been prepared by the directors. The opinion is an expression of assurance about the financial statements that has been reviewed. It gives assurance to the company owners that the financial statements can be relied upon.

Assurance can be provided by:

- audit: this may be external audit, internal or a combination of the two.
- review: this is a voluntary investigation, the resulting opinion of which is usually expressed in the form of negative assurance.

Without assurance from the professional accountants, the shareholders may not accept that the financial statements give a true and fair view. The statutory audit provides assurance as to the quality of the information displayed in the financial statements.

The degree of assurance that the auditor can provide about the reliability of the financial statements will depend on the amount of work performed in carrying out the assurance process and the results of that work.

The resulting assurance falls into one of two categories:

- Reasonable Assurance – A high level of assurance provided by the practitioner's conclusion expressed in a positive form, e.g. *"in our opinion the financial statements give a true and fair view"*. The objective of a statutory audit is to provide reasonable assurance. The law does not recognise the internal auditor and as such may not be able to express an assurance opinion.
- Limited Assurance – A moderate level of assurance provided by the practitioner's conclusion expressed in a negative form, e.g. "Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view". The objective of a review engagement is often to provide limited assurance.

The higher level of assurance provided by the audit report will raise the credibility provided by the assurance process. But the audit work is likely to take more time than a review and will thus cost more than the review.

An assurance engagement performed by a professional will consist of the following five elements:

(i) A tripartite relationship consisting of the professional accountants that provided the services; the directors or responsible officers that prepared the financial statements; and the users of the assurance report e.g. shareholders, tax office and the researcher.

(ii) The subject matter: This is the financial statements or cash flow forecast prepared by the responsible officer for the professional accountants to review.

(iii) The suitable criteria: These are 'the rules' against which the subject matter is evaluated in order to reach an opinion e.g., CAMA, IFRS and ISA.

(iv) The Evidence: This refers to all material information used by the professional accountant to arrive at his/her opinion.

(v) The Assurance Report: This is the written report containing the professional accountant's opinion presented to the users.

1.14 THE CHRONOLOGY OF AN AUDIT

Auditing is a practical discipline and in detail, each audit differs from the other. However, each audit assignment follows a systematic approach as outlined below:

Stage 1

The objective of this stage is to discover the background and operational system on theoretical basis. Means of achieving the objective include the following:

- Interview selected management staff to obtain information about the system.
- Ascertain background and nature of business and the records
- Refer to procedural manual and organizational chart
- Draft own systems notes and draw systems flow charts.

Stage 2

The objective of this stage is to discover the operational system in practice. This is achieved by:

- Conducting selected walk-through test on typical transactions, and
- own observation

Stage 3
The objective is to discover the strengths and weaknesses in the control systems in detail. This is achieved by:

- completing all applicable sections of Internal Control Evaluation Questionnaire (ICEQ)
- conducting compliance tests as necessary, and
- preparing memoranda on weak areas

Stage 4
The audit objective is to evaluate the relative effect of weaknesses in each major operational area. Specific task to achieve the objective include:

- considering the effect of weak areas with reference to materiality and any compensating controls
- completing Internal Control Evaluation schedule after total effect of weaknesses is already noted
- reporting effect of major weaknesses to management

Stage 5
The objective is to confirm the reliability of the records as a basis for preparation of final accounts. Means of achieving this objective include:

- Preparation of detailed audit programme, specifying the nature of substantive tests and the extent of substantive tests of transactions and account balances.
- Executing audit programme by applying depth testing techniques

Stage 6
The objective is to ensure that the draft financial statements are in agreement with the underlying records. Means of achieving this objective include:

- Preparing detailed year-end schedules (Statement of Profit or Loss and Other Comprehensive Income schedules). Summarising individual items by cross reference to the records and Statement of Financial Position schedules;
- Reconciling the movement of each item from previous Statement of Financial Position to current Statement of Financial Position.

Stage 7
The objective is to form an opinion as to whether the accounts as presented give a true and fair view and comply with statutory and other requirements. Means of achieving the objective include:

- obtaining letter of representation from chief executive
- completing verification of assets and liabilities
- executing financial position audit programme
- executing analytical review

- considering effects of changes in accounting policy and events after the year end
- use check lists to cover all disclosure requirements
- post-audit review of files, audit programmes and accounts by independent partner.

Stage 8

The objective of this final stage is to express opinion in the audit report to members.
At this stage, the auditor:

- reviews draft contents of Directors report
- considers the need for qualification
- refers any qualification to independent partners
- draft final audit report for inclusion in the published accounts.

These steps can be summarised into five phases as follows:

a. The auditor should adequately plan, control and record his work

b. The auditor should ascertain the entity's system of recording and processing transactions and assess its adequacy as a basis for the preparation of financial statements.

c. The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions there from

d. 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.

e. The auditor should carry out such a review of the financial statements as is sufficient, in conjunction with the conclusions drawn from the other audit evidence obtained to give them a reasonable basis for his opinion on the financial statements.

1.15 AUDITING AND OTHER ASSURANCE SERVICES

Auditors have intimate knowledge of the operations of companies and some other business organisations. An auditor, acting in his capacity as a trained accountant, may be called upon by existing and prospective clients to perform a wide range of services other than auditing.
These services include:

(a) Accounting services
Providing assistance in maintenance of accounting records and preparation of financial statements for organisations especially for small firms, partnership, etc.

(b) Taxation matters
Assisting clients with the preparation and agreement of tax returns for the purpose of making claims for taxation relief and computations of capital allowances. They

attend to queries raised by the tax office in respect of client's accounts and handle objections and appeals where an assessment is disputed. They also process and procure tax clearance certificates on behalf of clients.

(c) Liquidation, receivership, and trusts.
They assist companies to realize the best returns on their assets if the company is winding up and they act in fiduciary capacity as trustee in accordance with the terms of the trust deed.

(d) Advising companies seeking quotation on the Nigerian Stock Exchange.

(e) Assisting companies to prepare feasibility reports

(f) Providing advice on establishing staff pension schemes

(g) Secretarial services.
They assist clients to perform other secretarial services like filing of annual returns, registration and incorporation of new business, etc. with the Corporate Affairs Commission (the Company Registry).

1.16 THE AGENCY THEORY AND AUDITING

a. **Agents and Principals**

Modern organizational theory views an organization as being comprised of various interest groups. The relationships between the various interested parties in the company are often described in terms of agency theory. Agency relationship occurs when one party, the principal, employs another party, the agent, to perform a service on his/her behalf.

For example, one can regard directors as the agents of the shareholders, employees as the agents of directors, and auditors as agents of shareholders.

Each principal must recognize the fact that although he is employing the agent, the agent will have interests of his own to protect and thus may not fully carry out the requirements of the principal.

b. **Agency Relationship Conflict**

The directors have a duty of stewardship of the company's assets. However, they are also interested in their level of remuneration and if this increases, the asset of the company goes down. The decision to approve the directors pay increases is effectively in the hands of the directors themselves. A conflict of interests then arises.

The auditors submit their report to the shareholders. However the auditors know the decision to reappoint is effectively in the hands of the directors. They therefore have a potential conflict in carrying out their function and also remaining on good terms with the directors

These agency relationships need to be recognized so that, perhaps steps can be taken by a principal to ensure that an agent works closer to the interests of the principal.

c. **The application of the agency theory to auditing**

Despite having recognized the conflicts of interest that may arise, agency theory predicts that matters can be organized so that, by behaving rationally, the agent would not act against the interest of the principal.

For example the theory assumes that the shareholders will only buy shares if safeguards are in place to protect their interests. The legal requirement for audited accounts is one example of necessary precondition. In addition, management will recognize the desirability of an audit. If shareholders are suspicious of quality of an audit, they will not be prepared to invest. Management will therefore arrange for a proper audit as it is in their own interest to do so.

If this is true, then the practical effect of agency theory in auditing is to conclude that statutory regulation is unnecessary. The management of large companies will pay high fees for extensive and sophisticated audits as they have the greatest need to convince shareholders of the management's honesty.

In contrast, a small company where the management and shareholders are virtually the same group will not pay high fee for an audit. It can be argued that in the latter situation, this is a reasonable result, as the shareholders have no great need for an audit. However, this conclusion does not necessarily satisfy other users of the accounting information such as lenders (who may lend based on the accounts) and the tax authorities (who assess liability to tax based on the profit reported in the accounts).

1.17 AUDIT COMMITTEE

Section 404 (2) of CAMA 2020 states that Public Limited Companies (Plc.) shall have Audit Committees. The intent is to create space between the external auditors and the directors of the Client Company.

Membership of an Audit committee

Section 404 (3) of CAMA 2020 states that the Audit Committee shall consist of five members comprising three members and two non-executive directors. It is their function to view the company's position in a detached and dispassionate manner and to liaise effectively between the main board and the external auditors.

Functions/Responsibilities of an Audit Committee Section 404 (7)

Subject to such other additional functions and powers that the company's articles may stipulate, the objectives and functions of the audit committee are to:

a. ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
b. review the scope and planning of audit requirements;

c. review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
d. keep under review the effectiveness of the company's system of accounting and internal control.
e. make recommendations to the board with regard to the appointment, removal and remuneration of the external auditors of the company; and
f. authorize the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

1.18 CHAPTER SUMMARY

i. Auditing has developed into a core business subject because of the need for credibility and transparency in stewardship accounting.
ii. Company laws of many countries have made audit of financial records and statements of corporate bodies a mandatory requirement.
iii. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements prepared was examined. The examination of the financial statement is in accordance with an identified financial reporting framework and to show that the financial statements give "a true and fair view" or "present fairly, in all material respects" the financial results and state of affairs of the client entity.
iv. The need for audit arose from the stewardship function.
v. Detection of errors and frauds in financial records are only by-products of the audit process.
vi. The role of assurance services is to give the desired confidence to various parties.

MULTIPLE-CHOICE QUESTIONS

1. Which of the following is correct concerning an auditor's responsibilities regarding financial statements?
   (A) Making suggestions that are adopted about the form and contents of an entity's financial statement
   (B) An auditor may draft an entity's financial statements based on information from the management accounting system
   (C) The fair presentation of audited financial statements in conformity with regulation is an implicit part of auditor's responsibilities.
   (D) An auditor's responsibilities for audited financial statement is contained in his letter of engagement
   (E) The auditor must include in the audited financial statements details of his letter of engagement.

2. Which of the following is not true of assurance?

(A) Assurance is a strong feeling or confidence that something is right
(B) Assurance can be provided by internal audit
(C) A review of financial statements or part thereof, as a special investigation, is an assurance service
(D) The amount of work done by the auditor is in an inverse relationship to the degree of assurance
(E) The assurance provided by the auditor is either a reasonable assurance or a limited assurance

3. In expressing an opinion on the accounts of clients, the auditor does not accept responsibility for which of the following?
(A) The consistency of the application of accounting policies
(B) The reliability of opening balances
(C) The appropriateness of the comparative figures included in the accounts
(D) The preparation of financial statements
(E) Compliance with legal requirements.

4. Which of these departments is **NOT** normally found in an audit firm?
(A) Taxation
(B) Audit/Taxation
(C) Production
(D) Management consultancy
(E) Insolvency

5. Which of the following professional services is **NOT** offered by a Chartered Accountant in addition to his service as auditor of a client?
(A) Acting as a Reporting Accountant in an initial public offer
(B) Keeping client's accounting books
(C) Attending to tax queries
(D) Recommending remedial actions to audit committee
(E) Participating in annual inventory taking

SHORT ANSWER QUESTIONS

6. Where should a company keep its accounting records as specified by CAMA 2020?
7. One of the ethical principles governing the auditor's professional responsibilities is.................................
8. The relationship between various interest parties in the company are often explained by the ……………… theory.
9. The audit that is compulsorily required by law to be carried out by an organisation is called………………………
10. Independent examination of financial statement being carried out by non-employees of an entity is called…………………………….

MULTIPLE-CHOICE QUESTIONS

1. B
2. B

3. D
4. C
5. A

SHORT ANSWER QUESTION SOLUTION

6. Its registered office or such other place in the country as the Directors think fit
7. Any one of the following:
   a. Independence;
   b. Integrity;
   c. Objectivity;
   d. Professional competence and due care;
   e. Confidentiality;
   f. Professional behaviour or conduct and
   g. Technical standards
8. Agency
9. Statutory audit
10. External audit

CHAPTER TWO

REGULATORY FRAMEWORK OF AUDITING

CHAPTER CONTENTS

a. Keeping Proper Books of Accounts
b. Mandatory Requirement to have Accounts Audited
c. Appointment and Remuneration of Auditors
d. Removal and Resignation of Auditors
e. Rights and Responsibilities of Auditors
f. Requirements for competence and integrity
g. Requirements for objectivity and independence
h. Procedure for the appointment of Auditors
i. Auditors' Responsibility to consider Fraud and Error
j. Auditors' Responsibility to Consider Non-compliance with Laws and Regulations
k. Impact of laws and Accounting Standards on Audit
l. Scope of Audit functions under CAMA, BOFIA and INSURANCE ACT

OBJECTIVES

At the end of this unit, the reader should be able to:
a) outline the statutory provisions as to keeping proper books of accounts;
b) outline the qualifications of an external auditor;
c) state the powers, duties and statutory rights of an auditor;
d) appreciate professional ethical requirements of an audit;
e) describe the ethical requirements relating to the appointment and removal of auditors;
f) outline the purpose and content of client screening process;
g) detail the steps to be taken on a new client engagement;
h) outline the purpose and contents of an engagement letter;
i) understand the impact of Laws and Accounting Standards on Audit; and
j) know the scope of Audit functions under the CAMA, BOFIA and Insurance Act.

2.1 KEEPING PROPER BOOKS OF ACCOUNTS

The keeping of proper books of accounts by every company is made obligatory by statute (S.374 of CAMA). Proper books of accounts are not deemed to have been kept unless they portray a true and fair view of the state of the company's affairs, explain transactions and enable the preparation of the Statement of Comprehensive Income and the Statement of Financial Position.

The books of accounts must be always open to inspection by the directors, secretary and auditors of the company.

The books must generally contain a proper record of the financial affairs of the company, changes in the financial position and with respect to the control of and accounting for all assets acquired. In particular, the books must show details of:

a. all sums received and expended, and matters in respect of which the receipts and expenditure took place.

b. all sales and purchases of property, goods and services; and

c. the company's assets and liabilities and the interest of shareholders.

Each public company shall host its audited accounts on its website.

2.2 MANDATORY REQUIREMENTS TO HAVE ACCOUNTS AUDITED

It is a mandatory requirement that the auditor's report must be attached to every company's financial statements before they can be circulated to its members. It therefore implies that every company should have an auditor. Section 377 of CAMA made it mandatory for financial statements to be prepared and audited.

2.3 APPOINTMENT AND REMUNERATION OF AUDITORS

2.3.1 Who qualifies to be an Auditor? S 403 of CAMA

For a person to qualify for appointment as an auditor of a public company, he must be a member of a recognized professional accountancy body who has been duly licensed to practice by the professional accountancy body of the home/host country, and who must not have been disqualified by means of legislative instrument issued at the instance of the Registrar/Commissioner.

None of the following persons is entitled to act as auditor to either a private or a public company:

a. An officer of the company or of any associated company;
A person who is a partner or in the employment of an officer of the company, or of any associated company; save that partnership with a person acting as a Secretary or Registration Officer of the company or any associated company shall not constitute a disqualification;
b. An infant;
c. A person found by a competent court to be of unsound mind;
d. A body corporate except that members of an incorporated partnership may be appointed;
e. An undischarged bankrupt, unless he shall have been granted leave to act as an auditor of the company concerned by the court which adjudged him bankrupt.

2.3.2 Who Appoints the Auditors? (S 401 of CAMA)

Auditors are generally appointed by the shareholders (members) of a company in a general meeting by ordinary resolution and to hold office from the conclusion of that, until the conclusion of the next annual general meeting. It is however permissible for the directors to appoint the first auditors of the company and fill any casual vacancy in the office of the auditor (where at an annual general meeting, no auditors are appointed or re-appointed, the directors may appoint a person to fill the vacancy);

The written consent of a person is necessary before he can be appointed as an auditor.

2.3.3 Who Fixes the Auditors' Remuneration? (S 408 of CAMA)

Generally, the auditors' remuneration is fixed by the members of the company in a general meeting by an ordinary resolution or in such manner as the company may determine.

However, in the case of an auditor appointed by directors of the company, the remuneration may be fixed by the directors, for the period expiring at the conclusion of the next annual general meeting of the company.

2.4 REMOVAL AND RESIGNATION OF AUDITORS

2.4.1 Resignation of an Auditor

Section 412 of CAMA (Companies and Allied Matters Act of Nigeria 2020 provides for the resignation of the Auditor as follows:

a) An auditor of a company may resign his office by depositing a notice in writing to that effect at the company's registered office and such notice shall operate to bring his term of office to an end on the day on which the notice is deposited or on such later date as may be specified in it;

b) An auditor's notice of resignation shall not be effective unless it contains either a statement to the effect that there are no circumstances connected with his resignation which he considers should be brought to the notice of the members or creditors of the company, or a statement of any circumstances as are mentioned above;

c) Where a notice is deposited at a company's registered office, the company shall, within 14 days, send a copy of the notice to the Commission and if the notice contained a statement as prescribed in (b) above, it shall be sent to all persons entitled to receive copies of the company's financial statements (principally the shareholders).

d) The company or any person claiming to be aggrieved may, within 14 days of the receipt by the company of a notice, apply to the court for an order;

e) If on such an application the court is satisfied that the auditor is using the notice to secure needless publicity for defamatory matter, it may, by order, direct that copies of the notice need not be sent out; and the court may further order the company's costs on the application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application; and

f) The company shall, within 14 days of the court's decision, send to the Commission, shareholders and debenture holders a statement setting out the effect of the order (if the court makes an order), or a copy of the notice containing the statement (if the court makes no order).

Virtually, the same provisions as stated above are made in the Ghana Companies Code as follows:

i) If auditors wish to resign partway through their term of office, they must carry out the following procedures; and

ii) The auditors must deposit written notice of their resignation at the registered office of the company. Resignation is effective on the day the notice is received, unless the auditors have specified some later date.

They must accompany such notice with a statement that either:

- There were no circumstances connected with their resignation which they consider should be brought to the notice of the members or creditors of the company; or

- A statement detailing any such surrounding circumstances.

iii) The company must send a copy of the auditors' resignation notification and the statement of circumstances to the Registrar of Companies.

a) Should the Statement of Circumstance so dictate, further copies must be sent to all members and all debenture holders of the company, and anyone else entitled to receive notice of general meetings.

b) The auditors may attach a signed requisition for the directors to convene an extraordinary general meeting, in order that the circumstances surrounding the resignation can be brought to the attention of the members.

c) Before the general meeting is convened, the auditors may request the company to circulate to its members a written statement of circumstances of reasonable length. The company must circulate this statement to all members to whom notice of the meeting is being sent. If for any reason, this fails to happen, the statement can be read out at the meeting.

d) The auditors who have resigned may also exercise their other rights. They are entitled to receive all notices relating to the general meeting at which their term of office would have expired and any general meeting at which it is proposed to fill the casual vacancy caused by their resignation. They are entitled to attend such meetings and speak at them on any part of the business which concerns them as former auditors.

2.4.2 Removal of an Auditor

According to Section 409 of the Companies and Allied Matters Act of Nigeria, the removal of auditors can be effected in the following manner:

a. A company may by an ordinary resolution remove an auditor before the expiration of his term of office, notwithstanding anything in any agreement between the company and the auditor

b) Where a resolution removing an auditor is passed at a general meeting of a company, the company shall within 14 days give notice of that fact in the prescribed form to the Commission;

c) The removal provisions shall not deprive the auditor of compensation or damages payable to him.

Similar provisions are made in Ghana Companies Code as follows:

For the removal of an auditor to have effect, the following conditions must be observed:

a) There must be a resolution to remove the auditor or to appoint another person in his place.
b) The resolution must be passed at an annual general meeting of the company.
c) Written notice of the intention to move the resolution must have been given to the company not less than 35 days before the annual general meeting at which it is to be moved (14 days in the case of a resolution affecting the removal or replacement of an auditor appointed by the directors).
d) On its receipt, the company shall forthwith arrange for a copy thereof to be sent to the auditor concerned.
e) Notice of such resolution must be given by the company to its members at the same time, and in the same manner as it gives notice of the meeting, or if that

is not practicable, notice must be given to the members in the same manner as notices of meetings are required to be given not less than 21 days before the meeting (7 days where the notice relates to a resolution to remove or replace an auditor appointed by directors).

f) The right of the auditor concerned to be heard on the resolution at the meeting must not be withheld.

g) The company should send with every notice of the annual general meeting, copies of any written statement submitted by the auditor, as he is entitled to do. If the statement is received too late, the company, has to circulate copies forthwith to every person entitled to notice of the meeting, in the same manner as notices of meetings are required to be given.

h) The court, may, on application by the company or some other aggrieved person, decide against the circulation of the auditors' statement because it is considered to be unreasonably long or amounts to an abuse of the right or an attempt to secure needless publicity of defamatory matter. This is without prejudice to the auditor's right to be heard orally at the company meeting and to have his written statement read to the meeting if so required by him.

i) If the resolution is duly passed, it takes effect only after the conclusion of the annual general meeting.

The objects of these statutory removal provisions are to preserve the right of the shareholders to appoint the auditors of their choice and to preserve the auditors' independence of the directors by not permitting directors, who may be in disagreement with the auditors, to dismiss them.

2.4.3 Other Types of Departure from Office

Auditors may be removed from office by a resolution at the annual general meeting to appoint new auditors. Special notice is required of such a resolution, and the auditors may, prior to the annual general meeting, make representations as to why they think they should stay in office.

Alternatively, auditors decline to offer themselves for re-election at the Annual General Meeting. In these circumstances, they can make representations about the resolution to appoint new auditors prior to the general meeting at which that resolution is discussed.

2.5 RIGHTS AND RESPONSIBILITIES OF AUDITORS

2.5.1 Duties of the Auditor

The statutory duties of the auditor are as follow:

a. To make a report to the members of the company on all accounts and financial statements laid before the members in Annual General Meeting;

b. To state whether the financial statements of the company (or group of companies) show a true and fair view and have been properly prepared in accordance with the provisions of the code;

c. To consider if any information in the Directors' Report is consistent with the accounts and to report the facts if there are any of such instances;

d. To form an opinion as to whether proper accounting records have been kept by the company; proper returns adequate for their audit have been received from branches not visited by them; the company's Statement of Financial Position and its Statement of Comprehensive Income are in agreement with the accounting records and returns, and such information and explanations as he thinks necessary for the company's officers. (these matters are reported on by "exception only" and that where the auditor is not satisfied, no mention is made in the report);

e. To outline in his report, details of directors' remuneration, loans to officers, transactions involving directors and other connected persons (if not disclosed in the financial statements themselves);

f. To make other special reports in various circumstances; and

g. To make a "statement of circumstances" when he ceases to hold the office for any reason.

2.5.2 The Rights of the Auditor

The statutory rights of auditors are as follows:

i. Right of access at all times to books of accounts and vouchers of the company;

b. Right to inquire from the officers, including the directors of the company, such information and explanations as are deemed necessary for the performance of the auditors' duties;

c. The right to attend any general meeting of the company and to receive notices of, and other communications relating to any general meeting on any part of the business of the meeting which concerns them as auditors;

d. The right to apply to the court for directions in relation to any matter arising in connection with the performance of their functions under the - Companies and Allied Matters Act and to have the costs of any such application met by the company, unless directed by the court;

e) The right to be notified in writing in the event of an intended resolution to remove them or appoint some other persons in their stead, to submit a written statement which must be circulated to members and be read, if so required, at the general meeting;

f. The right, before accepting appointment as auditor of a company, to communicate with a retiring auditor, if any; and

g. The right to contract with a company, in addition to their statutory duties to the members of the company, expressly or by implication, to undertake obligations to the company in relation to the detection of defalcations, and advice on accounting, taxation, raising of finance and other matters.

2.6 REQUIREMENTS FOR COMPETENCE AND INTEGRITY

2.61 The Principles of Due Skill, Care and Competence

a) Auditors should carry out their professional work with the skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of them.

b) All auditors in public practice are obliged to provide quality services to their clients.

c) The degree of skill and care depend on the work. A higher degree of skill is required for work of a specialized nature (e.g. due diligence investigations) or where negligence is likely to cause substantial loss.

d) The duty of skillful act and care is not absolute; opinion and advice do not give rise to claims just because they can be subsequently proved wrong.

e) Auditors must exercise reasonable care in whatever they do. They are particularly expected to apply generally accepted auditing techniques when performing their tasks as auditors.

f) If auditors come across any matter which puts them upon enquiry, they have a duty to investigate such a matter to a reasonable and satisfactory conclusion. Auditors should not accept any explanation unless they have carried out such investigations and tests as will enable them draw their own conclusion and form their own judgment.

2.6.2 The Principle of Integrity

a) Auditors should behave with integrity in all professional, business and personal financial relationships. Integrity implies not merely honesty, but fair dealing and truthfulness.

b) Auditors should strive for objectivity in all professional and business judgments. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand. It is bound up with intellectual honesty.

c) Auditors must not accept or perform work which they are not competent to undertake unless they obtain such advice and assistance as will enable them competently carry out the work.

d) Auditors must carry out their professional work with due skill, care, diligence and expedition and with proper regard for the technical professional standards expected of them.

e) Auditors should behave with courtesy and consideration towards all with whom they come into contact with during the course of performing their work.

2.6.3 Professional Duty of Confidence

a) Clients expect their business affairs to be kept confidential by their auditors. Maintaining client and hence confidentiality may mean that auditors cannot "blow the whistle" on malpractices of the client, and hence such malpractices will be allowed to continue.

b) It is recommended that information acquired in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper source, or where there is a public duty to disclose or where there is a legal or professional right or duty to disclose.

c) An auditor who acquires 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.

d) In general, where there is a right to disclose information, an auditor should only make disclosure in pursuit of a public duty or professional obligation.

e) Where an auditor agrees to serve a client in a professional capacity, both the auditor and the client should be aware that it is an implied term of that agreement that the auditor will not disclose the client's affairs to any other person except the consent of the client is given within the terms of certain recognized exceptions.

The recognized exceptions are as follow:

(i) If the auditor knows or suspects his client has committed the offence of treason, he is obliged to disclose all information at his disposal to a competent authority. Suspicion of terrorism or drug, money laundering also gives rise to a duty to report. The auditor should consider whether non-compliance with laws and regulations affects the financial statements. An auditor should include in his report a statement that non-compliance has led to significant uncertainties or non-compliance means that the auditors disagree with the way certain items have been treated in the accounts.

(ii) Where there is a public duty to disclose, e.g. where an offence has been committed which is contrary to the public interest.

(iii) Where disclosure is compelled by law, for example, where in an action a member is required to give evidence or delivery of documents.

(iv) If an auditor is requested to assist the police, the State Internal Revenue Service, Federal Inland Revenue Service or other authority by providing information about a client's affairs in connection with enquiries being made, he should be satisfied that such information is demanded. Unless he is satisfied that such statutory authority exists, he should decline to give any information until he has obtained his client's authority. If the client's authority is not forthcoming and the demand for information is pressed, the member should not accede unless so advised by his solicitor.

(v) If an auditor knows or suspects that a client has committed a wrongful act, he must ensure that he has not prejudiced himself by, for example relying on given by the client which subsequently, proves to be incorrect.

It would be a criminal offence for an auditor to act positively, without lawful authority or reasonable excuse, in such a manner as to impede with intent the arrest or prosecution of a client whom he knows or believes to have committed an offence calling for arrest.

2.7 REQUIREMENTS FOR OBJECTIVITY AND INDEPENDENCE

i. Objectivity and Independence

An auditor's objectivity must be beyond question. That objectivity can only be assured if the auditor is and seen to be independent. The threat to independence may be reduced by the nature and extent of the precautions taken by the practice to guard against loss of objectivity. The following circumstances may pose threat to objectivity and independence:

ii. Undue Dependence on an Audit Client

Objectivity may be threatened or appear to be threatened by undue dependence on any audit client or group of connected audit clients.

It is recommended that in general, the recurring work paid by one client or group of connected clients should not exceed 15% of the gross practice income. In the case of listed and other public interest companies, the figure should be 10% of the gross practice income.

In the case of a new practice where such criterion may not be satisfied, extra care may be necessary to safeguard independence.

iii. Overdue Fees

The existence of significant overdue fees from an audit client or group of associated clients can be a threat or appear to be threat to objectivity akin to that of a loan.

Firms must therefore ensure that overdue fees along with fees from current work could not be constructed as a loan.

iv. Actual or Threatened Litigation

A firm's objectivity may be threatened or appear to be threatened when it is involved in, or even threatened with litigation in relation to a client.

Litigation of certain sorts will represent a breakdown of the relationship of trust between auditor and client. This will impair the independence of the auditor or cause the directors of the client to become unwilling to disclose information to the auditor. A dispute which is only in relation to audit fees may not cause such problems.

v. Associated Firms: Influences Outside the Practice

A firm's objectivity may be threatened or appear to be threatened as a result of pressures arising from associated practices or organizations or from other external sources, such as bankers, solicitors, government or those introducing business.

The problems of independence in relation to large and prestigious clients may arise in connection with the activities of an associated practice or organization of the client.

Factors to be considered by the firm include the closeness of the association and the strength of the associates' interest in the firm retaining the client.

vi. Family and Other Personal Relationships

An auditor's objectivity may be threatened or appear to be threatened as a result of family or other close personal or business relationships.

Problems arise if an officer or senior employee of an audit client is closely connected with the partner or senior staff member responsible for the conduct of the audit. In this context, closely connected people include auditor's children and their spouses, siblings and their spouses, any relative to whom regular financial assistance is given or who is indebted to the staff member or partner.

Proximity needs to be taken into account, including whether the partner or staff member is involved in the audit and the position of the person in the client's office (the more the junior, the less the risk).

The Companies Code prevents an officer or employee of a company (or their partner) from becoming an auditor of that company. The statement extends this prohibition for its members to two years after ceasing to be an officer or employee of the company.

vii. Beneficial Interests in Shares and other Investments

A member's objectivity may be threatened or appear to be threatened where he or she holds a beneficial interest in the shares or other forms of investment in a company upon which the practice reports.

Staff and partners should not have shareholdings in client businesses (this includes beneficial shareholdings held by a spouse or minor child). If shares are acquired involuntarily (by marriage or inheritance) then they should be disposed of at their earliest opportunity.

Where the Regulations of the client company require the auditor to be a shareholder, then the auditor should hold only the minimum number of shares and the holding should be disclosed in the accounts of the client company.

viii. Beneficial Interest in Trusts

The objectivity of a practice may be threatened or appear to be threatened where a partner or a person closely connected with the partner has a beneficial interest in a trust, having a shareholding in an audit client company.

The following cases apply:

a. Where a trust, in which a partner or a person closely connected with a partner is a beneficiary, holds or acquires shares in a company audited by the practice.

b. Where the partner is and wishes to remain a trustee, the shareholding should be regarded as equivalent to a beneficial shareholding, and the practice should cease to report.

c. Where the partner is not a trustee, he should cease personally to report as soon as he becomes aware of the shareholding.

ix. Trustee Investments

An auditor's objectivity may be threatened or appear to be threatened by the trustee shareholdings and other trustee investments.

An audit firm should not have a public company as an audit client if a partner (or the spouse of a partner) is a trustee of a trust holding shares in that company and the holding is in excess of 10 percent of the stated capital of the company or total assets comprised in the trust.

A trust holding of 10 percent or more (as described above) of any company will indicate problems with independence.

x. Voting on Audit Appointments

Where a partner or staff member holds shares in any capacity in a company which is an audit client of the practice, they should not vote or be voted for at any general meeting of the company in relation to the appointment, removal or remuneration of auditors.

xi. Loans

Objectivity may be threatened or appear to be threatened by a loan to or from an audit client. No loans or guarantees should be undertaken unless they are with client financial institutions in the normal course of business.

xii. Goods and Services or Hospitality

Objectivity may be threatened or appear to be threatened by acceptance of goods, services or hospitality from an audit client.

Acceptance on normal commercial terms, or with only a modest benefit, is acceptable.

xiii. Provision of Other Services

There are occasions where objectivity may be threatened or appear to be threatened by the provision to an audit client of services other than the audit.

If auditors provide other services (like accountancy, taxation, consultancy, etc.) their independence may be threatened in a number of ways, for example, auditors can end up making management decisions for the company and this will definitely harm their independence.

Some critics have suggested that auditors will be unwilling to qualify audit reports if as a result they risk not just losing the audit, but also lucrative non-audit work.

Many small audit firms aim to provide a complete service for their client (accountancy, taxation and general advice as well as audits). With these clients, it would be difficult to demonstrate that the firm has carried out an objective audit of accounts it has prepared.

One way of countering the problem is to have different staff preparing the accounts and carrying out the audit.

If the same staff member prepares the accounts and carries out the audit, the audit work done must be carefully planned and recorded. In particular, the file should show what audit assurance has been obtained through accountancy work.

An important rule affecting large firms is that auditors should not provide accountancy services for public companies. However, large firms can provide consultancy services, corporate finance and taxation. Many large firms have countered the threat to independence by the use of separate departments for each service (consultancy, audit, taxation, etc.) with no information passing between them.

2.7.1 Integrity, Objectivity and Independence-Review Procedures:

Every auditing firm should establish review procedures (including annual review) in order to guard against loss of independence. These procedures should enable a firm to satisfy itself that each engagement may be properly accepted or be continued, and to identify situations where independence may be at risk. Such safeguard might include:

a. the inclusion of a manager or other qualified employee in the audit team rotation of the engagement partner

b. rotation of senior members of staff

The content of the next chapter covers the practical and ethical issues involved in the appointment of an auditor.

2.8 PROCEDURE FOR THE AUDIT APPOINTMENT OF AUDITORS

After knowing who qualifies to be an auditor, his rights and responsibilities and what the profession requires of him as to skills, competence, integrity and independence, it is appropriate that we look at the procedure of appointing external auditors.

The import of this session is to deal with the professional requirements governing the appointment of new auditors. One key issue is for the prospective auditor to communicate with the retiring auditor with the aim of discussing issues relating to the client. If the client refuses to give approval for the incoming auditor to communicate with the outgoing auditor, the incoming auditor should refuse to accept the audit assignment.

There is also the professional requirement for the potential auditor to seek reference about the prospective client. Some potential auditors go straight through client screening process before accepting offer of appointment. This is to safeguard against suffering considerable adverse publicity and/or possible legal action for associating with not-doing-well or dubious client. Client screening process therefore aims at identifying risks associated with accepting the offer of a particular client and to assess the levels of controls.

The terminal point of the screening process is to decide on whether to accept the offer of appointment or not. If the offer is accepted, it then becomes necessary for the terms of the engagement to be formalized and confirmed through the letter of engagement.

2.8.1 Pre-Accepting Conditions

Prior to acceptance of an offer of appointment, the auditors must ensure that the principles of integrity, objectivity, independence and other ethical requirements are not compromised. In addition, new auditors should ensure that they have been appointed in a proper manner, with particular reference to taking over from a retiring auditor.

2.8.2 Ethical Consideration

a. If the fees from this appointment would exceed 15% of the gross fees of practice (other than new practice) then the appointment should not be accepted.

b. Any personal relationship with an officer or employee of the company would be considered unethical.

   Any financial involvement with the company such as a shareholding or a loan to or from the company would also be regarded as unethical.

   Any conflict of interest should be avoided, such as advising two clients who are in dispute with each other.

2.8.3 Legal Consideration

The Companies Code prohibits officers or servants of the company or partners or employees of an officer or servant of the company from accepting the position of auditor to the company.

The auditor must be a member of The Institute of Chartered Accountants of Nigeria or other professional Accountancy bodies recognised by the law in the country of practice and must not have been disqualified by any statute.

2.8.4 Practical Consideration

The auditors must ensure that the firm's existing resources (material, manpower, equipment, etc.) are adequate to service the needs of the new client. This raises questions of staff and time availability and technical expertise.

It may be impossible for the appointment to be accepted because the auditing firm is not sufficiently large (in terms of staff and logistics) to audit the client company or is heavily engaged in other audits at the time the client would need his audit to be carried out.

Also, the firm may not have the necessary expertise, for example, in computing, etc. to provide a satisfactory service to the client.

The auditor may also consider the level of audit fees vis-à-vis the risks associated with the engagement. The auditor may decline to accept the offer if the fees cannot match with the associated risks.

2.8.5 Seeking Reference about the Client

It is important that the auditors obtain knowledge of the client's business sufficiently enough to enable them identify and appreciate issues that impact on the business of the client. Independent enquiries should be made concerning the status of the company.

The knowledge covers areas such as:

a. general economic factors;

b. industry conditions affecting the client's business;

c. the entity itself, covering such aspects as composition of board of directors, management profile, etc.;

d. the entity's products, market, supplies, expenses and operations;

e. the entity's financial performance and condition; and

f. the reporting environment.

Sources of Information About New Clients Include the Following:

a. previous auditors,

b. confidential enquiries from prospective client's bankers, solicitors, underwriters, registrar, etc.,

c. prior-year financial statements,

d. professional rules, regulations and standards,

e. specific rules and regulations pertaining to the industry,

f. the regulations of the client’s company; and

g. the directories of incorporated companies.

2.8.6 Communicating with the Present Auditors

One of the ethical requirements prior to the acceptance of an audit engagement is to obtain client’s permission to write to the retiring auditors, enquiring if there is any professional reason why the appointment should not be accepted. The essence of this ethical requirement is to protect the shareholders and as a means of professional courtesy.

The auditors should request the prospective client’s permission to communicate with previous auditors. If such permission is refused, they should decline the nomination.

If the permission is granted, the auditor should write to the previous auditors to request relevant information which will enable them take decision as to whether they should accept the nomination.

When the previous auditor receives the request from the prospective auditor, the previous auditor should request the client’s permission to discuss the client’s affairs freely with the prospective auditor. If the request is refused, the retiring auditors should report that fact to the prospective auditors. The offer may then be declined.

If the request is granted, they should frankly and freely discuss with the prospective auditor all issues relevant to the appointment of which the latter should be aware, and disclose fully all information which appears to them to be relevant to the client’s affairs.

2.8.7 Post-Acceptance Procedures

After going through the pre-acceptance procedure as outlined above, the prospective auditors will be in a position to accept the nomination or otherwise.

The following procedures should be carried out after accepting the nomination:

a) The new auditor should ensure that the outgoing auditor’s removal, retirement or resignation has been properly concluded and is in consonance with provisions of the Companies and Allied Matters Act 2020

b) The new auditor should ensure that his appointment is valid and formalized. It is essential that he obtains a copy of the resolution passed at the general meeting appointing him as the company's auditor.

c) Where a portion of the outgoing auditor's fees is still outstanding, the new auditor should join hands with the outgoing auditor to secure payment.

d) The new auditor should submit a letter of engagement to the directors of the client's company.

e) On taking up the appointment, the new auditors should make arrangements to collect all books, documents and papers that belong to the client from the outgoing auditors. The outgoing auditors are expected to co-operate in that regard and transfer al such documents unless they have lien over the records as a result of outstanding fees.

2.9 LETTER OF ENGAGEMENT

Prior to the commencement of any audit work, the auditor should agree in writing, the precise scope and nature of the audit work to be undertaken. The letter of engagement serves this purpose.

The letter of engagement is therefore a letter sent by the auditors to a client at the beginning of any audit. It sets out the terms of the engagement and forms the basis of the contract.

2.9.1 Purposes of Letter of Engagement

a) To define clearly the extent of the auditors' and directors' responsibilities.

b) By formalizing the terms of the engagement, it helps to minimize the possibilities of any misunderstanding between the auditors and the client.

c) It provides written confirmation of the auditors' acceptance of the appointment.

d) It confirms in writing verbal arrangements in respect of scope of the audit, the form of their report and the scope of any non-audit service.

2.9.2 Contents of Letter of Engagement

The main emphasis of this letter is on the relevant responsibilities of the directors and the auditors and the scope of the audit. It should also identify any report which the auditor must submit in addition to the statutory audit report.

Specific contents are outlined hereafter:

a) The board of directors' responsibilities in respect of the proper books of accounts and financial statements.

b) The auditors’ responsibilities to report on the financial statements; the scope and basis of the audit work to be undertaken.

c) Fees and billing arrangement (it does not state the fees payable)

d) Where appropriate, arrangement concerning the involvement of other auditors and experts in some aspect of the audit.

e) Any agreement for the auditor to provide taxation services.

f) Arrangements, if any, to be made with the predecessor auditors.

g) Any restriction of the auditors’ liabilities to the client (this is not possible with limited companies).

h) A reference to any further agreements between the auditors and the clients.

i) A proposed time-table for the agreement.

j) A request for written acknowledgement of the letter.

2.9.3 Issuing and Revising Engagement Letters

(a) The letter should be issued to any new client before audit work begins.

The letter should be reviewed every year to ensure that it is up to date.

b) Whenever there is a change of circumstances (e.g. extra duties, new auditing guidelines) or change in the nature of services provided or other terms and conditions, a new letter of engagement must be issued to an existing client.

c) The following specific factors may necessitate the agreement of a new letter of engagement:

   i. An indication that the client misunderstands the objective and scope of the audit;

   ii. A recent change of management, board of directors or audit committee;

   iii. A significant change in ownership, such as a new holding company;

   iv. Any relevant change in the nature and size of the client’s business; and

   v. Any relevant change in legal or professional requirements.

(d) In any particular year where the issue of a new letter is deemed unnecessary, it may be appropriate for the auditors to remind the client of the original letter.

(e) The letter is addressed to the board of directors or audit committee of the client company.

2.9.4 Public Sector Perspective

The purpose of the engagement letter is to inform the auditee of the nature of the engagement and to clarify the responsibilities of the parties involved. The legislation and regulations governing the operations of public sector audits generally mandate the appointment of a public sector auditor and the use of audit engagement letters may not be a widespread practice. Nevertheless, a letter setting out the nature of the engagement or recognizing an engagement not indicated in the legislative mandate may be useful to both parties. Public sector auditors have to give serious consideration to issuing audit engagements letter when undertaking an audit.

In the public sector, specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the public if management (including the department head) attempts to limit the scope of the audit.

2.9.5 Example of Letter of Engagement

Babatunde &Co. (Chartered Accountants)
26 Prime Street
Victoria Island Lagos

30th April, 2022

The Board of
Directors,
Primetime Plc,
Lagos.

Dear Sir,

Letter of Engagement

The purpose of this is to set out the basis on which we are to act as auditors of your company and the respective areas of our responsibility and that of the directors.

Responsibility of Directors

As Directors of Primetime Plc, you are responsible for ensuring that the company maintains proper accounting records for preparing financial statements which give a true and fair view of the financial statements. You are also responsible for making available to us, as and when required, all the company’s accounting records and all other records and related information, including minutes of all management and shareholders‟ meetings.

Responsibility of Auditors

As auditors, we have a statutory responsibility to report to the members whether in our opinion the financial statements give the true and fair view of the state of the company’s affairs and of the profit or loss for the year and whether they have been properly prepared in accordance with the Companies and Allied Matters Act / Companies Code. In arriving at our opinion, we are required to consider the following matters, and report on any in respect of which we are not satisfied.

We are required to report:

- Whether proper accounting records have been kept by the company and proper returns have been received from branches not visited by us,
- Whether the company’s Statement of Financial Position and Statement of Profit or Loss and Other Comprehensive Income are in agreement with the accounting records and returns,
- Whether we have obtained all information and explanations which we think are necessary for the purpose of our audit; and
- Whether the information in the directors’ report is consistent with the financial statements.

In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in our report. For example, where the financial statements do not give full details of directors’ remuneration or their transactions with the company, the Companies Act/Code requires us to disclose such matters.

We have professional responsibility to report if the financial statements do not comply (in any material respect) with applicable accounting standards, unless in our opinion, the non-compliance is justified in the circumstance. In determining whether the departure is required, we consider:

Whether the departure is required in order for the financial statements to give a true and fair view; and whether adequate disclosure has been made concerning the departure.

Our professional responsibilities also include:

a. Including in our report, a description of the directors’ responsibilities for the financial statements where the financial statements and accompanying information do not include such a description; and

b. Considering whether other information in documents containing audited financial statements is consistent with those financial statements.

Scope and Basis of Audit

Our audit will be conducted in accordance with approved auditing standards and will include such tests of transactions and of existence, ownership and valuation of assets and liabilities, as we consider necessary. We shall obtain an understanding of accounting and internal control systems in order to assess their adequacy as a basis for the preparation of the financial statements and to establish whether proper accounting records have been maintained by the company. We shall expect to obtain such appropriate evidence, as we consider sufficient to enable us draw reasonable conclusions therefrom.

The nature and extent of our procedures will vary according to our assessment of the company's accounting system and where we wish to place reliance on it, the internal control system and may cover any aspect of the business operations. Our audit is not designed to identify all significant weaknesses in the company's system but, if such weakness come to our notice during the course of our audit which we think should be brought to your attention, we shall report them to you. Any such report would not be provided to third parties without your prior written consent. Such consent will be granted only on the basis that such reports are not prepared in the interest of anyone other than the company in mind.

As part of our normal audit procedures, we may request you to provide written confirmation of oral representations which we have received from you during the course of the audit on matters having a material effect on the financial statements. In connection with representation and supply of information to us generally, we draw your attention to the provisions in the Companies Act/Code under which it is an offence for an officer of the company to mislead the auditors.

In order to assist us in the examination of your financial statements, we shall request sighting of all documents or statements, including the chairman's statement; operating and financial review and the directors' report, which are due to be used with the financial statements. We are also entitled to attend all general meetings and receive notices of all such meetings.

The responsibility for safeguarding the assets of the company and prevention and detection of fraud, error and non-compliance with laws or regulations rests with yourselves. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or accounting records (including those resulting from fraud, error or non-compliance with law or regulation), but our examination should not be relied upon to disclose all such material misstatements or fraud, errors, or instances of non-compliance as may exist.

Once we have issued our report, we have no further responsibility in relation to the financial statements for the financial year. However, we expect that you will inform us of any material event occurring between the date of our report and that of the Annual General Meeting which may affect the financial statements.

Other Services
You have requested that we provide other services in respect of taxation. The terms under which we provide these other services are dealt with in a separate letter. We will also agree in a separate letter, the provision of any services relating to investment business advice.

Our fees are computed on the basis of the time spent on your affairs by the partners and our staff and on levels of skill and responsibility involved. Unless otherwise agreed, our fees will be billed at appropriate intervals during the course of the year and will be due on presentation.

Applicable Law
The engagement letter shall be governed by, and construed in accordance with the laws of West African Countries. The courts of countries in West Africa shall have exclusive jurisdiction relating to any claim, dispute or differences concerning the engagement letter and any matter arising from it.

Once it has been agreed, this letter shall remain effective from one audit appointment to another, until it is replaced. We shall be grateful if you could confirm in writing your agreement to these terms by signing and returning the enclosed copy of this letter or letting us know if they are not in accordance with your understanding of our terms of engagement.

Yours faithfully,

Babatunde & Co. (Chartered Accountants)

2.10 AUDITORS' RESPONSIBILITY TO CONSIDER FRAUD AND ERROR

When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditors should consider the risk of material misstatements in the financial statements, including those resulting from fraud or error.

"Fraud" refers to the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations affecting the financial statements by one or more individuals among management, employees or third parties. Fraud involves:

a. Manipulation, falsification or alteration of records or documents;

b. Misappropriation of assets or theft;

c. Suppression or omission of the effects of transactions from records or documents;

d. Recording of transactions without substance; or

e. Intentional misapplication of accounting policies.

“Error” refers to unintentional mistakes in financial statements such as:

a. Mathematical or clerical mistakes in the underlying records and accounting data;

b. Inadvertent omission or misinterpretation of accounting policies; and

c. Unintentional misapplication of accounting policies.

Responsibility of the Directors

The responsibility for the prevention and detection of fraud and errors rests with directors through the implementation and continued operation of adequate accounting and internal control systems. Such systems reduce but do not eliminate the possibility of fraud and error.

2.10.1 Responsibility of the Auditors

a. **Prevention**

It is not the auditor’s function to prevent fraud and error. The fact that an annual audit is carried out may, however, act as a deterrent.

b. **Risk Assessment**

When planning the audit, the auditors should assess the risk that fraud or error may cause the financial statements to contain material misstatements.

In addition to weaknesses in the design of the accounting and internal control systems and non-compliance with identified internal controls, conditions or events which increase the risk of fraud and error include:

i) questions with respect to the integrity or competence of management;

ii) unusual pressures within an entity;

iii) unusual transactions; and

iv) problems in obtaining sufficient appropriate audit evidence.

c. **Detection**

Based on their risk assessment, the auditors should design audit procedures so as to have a reasonable expectation of detecting statements arising from fraud or error which are material to the financial statements.

The auditors should seek sufficient appropriate audit evidence that fraud and error which may be material to the financial statements have not occurred or that, if they have occurred, the effect of fraud is properly reflected in the financial statements or the error is corrected. The likelihood of detecting errors is ordinarily higher than that of detecting the concealment of its existence, such as collusion between employees or falsification of accounting records.

Due to the inherent limitations of an audit, there is an unavoidable risk that material misstatements in the financial statements resulting from fraud and to a lesser extent, error may not be detected. The subsequent discovery of material misstatement on the financial statement after the auditor's report does not in itself, indicate that the auditors have failed to adhere to the basic principles and essential procedures of an audit.

Unless the audit reveals evidence to the contrary, the auditors are entitled to accept representations as truthful and records and documents as genuine. However, the auditors plan and perform the audit with an attitude of professional skepticism, recognizing that conditions or events may be found that indicate that fraud or error may exist.

While the existence of effective accounting and internal control systems reduces the probability of misstatement of financial statements resulting from fraud and error, there is always some risk of internal controls failing to operate as designed. Furthermore, any accounting and internal control system may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls that would prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them, or by suppressing information relating to transactions.

2.10.2 Procedures When There is an Indication that Fraud or Error May Exist

When the application of audit procedures indicates that fraud or error may exist, the auditors should consider the potential effect on the financial statements. If the auditors believe that the indicated fraud or error could have a material effect on the financial statements, they should perform appropriate modified or additional procedures.

The extent of such modified or additional procedures depends on the auditors' judgment as to:

a. the types of fraud or error indicated;

b. the likelihood of their occurrence; and

c. the likelihood that a particular type of fraud or error could have a material effect on the financial statements.

Unless circumstances clearly indicate otherwise, the auditors cannot assume that an instance of fraud or error is an isolated occurrence. If necessary, the auditor~~s~~ should adjust the nature, timing and extent of their substantive procedures.

To the extent that suspicion of fraud or error is not dispelled by the results of modified or additional procedures, the auditors should discuss the matter with management, the directors or audit committee and consider whether the matter has been properly reflected or corrected in the financial statements. They should also consider the implications in relation to other aspects of the audit, particularly, the reliability of management representations.

If the performance of the modified or additional procedures supports their suspicion of fraud or error, the auditors need to consider the legal consequences. This involves considering whether it is appropriate to contact the entity's lawyers or whether to seek their own legal advice and what future action they need to take.

2.10.3 Reporting Fraud and Error to Management

The auditors should communicate factual findings to management, the board of directors or the audit committee as soon as practicable if:

a. they suspect fraud may exist, even if the potential effect on the financial statement is immaterial; or

b. material error is actually found to exist.

In determining an appropriate representative of the entity to whom to report the occurrences of apparent fraud or material error, the auditors need to consider all the circumstances. With respect to apparent fraud, the auditors should report the matter to the next higher level of authority within the entity that they do not suspect anybody of involvement in the fraud. For example, if the auditor suspects that members of senior management, including members of the board of directors are involved, it may be appropriate to report the matter to the audit committee. Where no higher authority exists, or the auditors are precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether fraud or error which is material to the financial statement has, or is likely to have occurred, or if the auditors believe that the report may not be acted upon or are unsure as to the person to whom to report, they may wish to have legal advice.

2.10.4 Reporting Fraud and Error to Members of the Company

Auditors should consider the implications of their report if:

a. they conclude that a suspected instance of fraud or error has a material effect on the financial statements and they disagree with the accounting treatment or with the extent, or the lack of any disclosure in the financial statements of the instance or of its consequences, or

b. they are unable to determine whether fraud or error has occurred. They should not refrain from qualifying their opinion on the grounds that the position has been corrected since the statement of financial position date or because of the possible consequences of qualification.

2.10.5 Reporting Fraud and Error to Third Parties

When the auditors become aware of a suspected instance of fraud (or in particular cases, error) which is supported by strong evidence, and considering the fact that the matter may be one that ought to be reported to a proper authority in the public interest, they should ensure that the matter is drawn to the attention of the directors, including any audit committee. If, having considered any views expressed on behalf of the entity and in the light of any legal advice obtained, they concluded that the matter should be so reported; they should report it themselves if:

a. they are under statutory duty to do so; or

b. the entity does not do so itself or is unable to provide evidence that the matter has been reported.

In extreme cases, auditors should report a matter directly to a proper authority in the public interest and without discussing the matter with the entity if they conclude that the suspected instance of fraud (or, in particular cases, error) should be so reported and it has caused loss of confidence in the integrity of the directors.

Confidentiality is an implied term of the auditor's contract. The duty of confidentiality, however, is not absolute. In certain exceptional circumstances, auditors are not bound by the duty of confidentiality and have the right to report matter to a proper authority in the public interest. Auditors need to weigh the public interest in maintaining confidential client's relationships against the public interest in disclosure to a proper authority.

Auditors whose suspicions have been aroused need to use their professional judgment to determine whether their misgivings justify them in carrying the matter further or are too insubstantial to deserve report.

Examples of circumstances which may cause the auditors not to have confidence in the integrity of the directors include situations:

i. where they suspect or have evidence of the involvement or intended involvement of the directors in possible fraud which could have a material effect on the financial statements; or

ii. where they are aware that the directors are aware of such fraud, and contrary to regulatory requirements or the public interest, have not reported it to a proper authority within a reasonable period.

Auditors are protected from the risk of liability for breach of confidence or defamation, provided that in the case of breach of confidence:

- disclosure is made in public interest;
- such disclosure is made to an appropriate body or person;
- there is no malice motivating the disclosure, and

In the case of defamation:

- disclosure is made in their capacity as auditors of the entity concerned, and
- there is no malice motivating the disclosure.

In addition, auditors are protected from such risks where they are expressly permitted or required by legislation to disclose information.

Matters to be taken into account when considering whether disclosure is justified in the public interest may include:

a. the extent to which the suspected fraud is likely to affect members of the public;

b. whether the directors have rectified the matter or are taking, or are likely to take, effective corrective action;

c. the extent to which non-disclosure is likely to enable the suspected fraud to recur with impunity;

d. the gravity of the matter; and

e. the weight of evidence and the degree of the auditors' suspicion that there has been an instance of fraud.

When reporting to proper authorities in the public interest, it is important that, in order to retain the protection of qualified privilege, auditors only report to one who has a proper interest to receive the information. Which body or person is the proper authority in a particular instance depends on the nature of the fraud. Proper authorities could include Serious Fraud Office, the Police Service, Bureau of National Investigations (BNI), recognized Professional Bodies, the Stock Exchange, the Central Bank, the Inland/Internal Revenue Service, the VAT Office, the Customs, and Excise& Preventive Service (CEPS) etc.

Auditors who can demonstrate that they have acted reasonably and in good faith in informing an authority of an instance of fraud which they think has been committed would not be held by the court to be in breach of duty to the client even if, an investigation or prosecution proves that there had not been any offence.

Auditors need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.

Auditors need to remember that their decision as to whether to report, and if so to whom, may be called into question at a future date, for example, on the basis of:

a. what they knew at the time;

b. what they ought to have known in the course of their audit;

c. what they ought to have concluded; and

d. what they ought to have done.

Auditors may also wish to consider the possible consequences if financial loss is occasioned as a result of fraud which they suspect (or ought to suspect) has occurred but decide not to report.

2.10.6 Withdrawal from the Engagement

The auditors may conclude that withdrawal from the engagement is necessary in certain circumstances, for example, if they consider that the shareholders have not been given the information they require and see no opportunity for reporting such information to the shareholders whilst continuing as auditors. Factors that may affect the auditors' conclusion include the implications of the involvement in the fraud of the highest authority within the entity, which may affect the reliability of management representations, and the effects on the auditors of continuing association with the entity. In reaching such conclusion, the auditors may need to seek legal advice.

Resignation by auditors is a step of last resort. It is normally preferable for the auditors to remain in place to fulfil their statutory duties, particularly, where minority interests are involved. However, there are circumstances where there may be no alternative to resignation, e.g. where the directors of a client company refuse to issue its financial statements or the auditors wish to inform the shareholders or creditors of the company of their concerns and there is no immediate occasion to do so.

2.11 AUDITORS' RESPONSIBILITY TO CONSIDER NON-COMPLIANCE WITH LAWS AND REGULATIONS

Auditors should plan and perform their audit procedures and evaluate and report on the results thereof, recognizing that non-compliance by the entity with law or regulations may materially affect the financial statements.

Whether an act constitutes non-compliance with law or regulations is a legal determination that is ordinarily beyond the auditors' professional competence. However, auditors' training, experience and understanding of the entity and its industry may enable them to recognize that some acts coming to their attention may constitute non-compliance with law or regulations. The determination as to whether a particular act constitutes or is likely to constitute non-compliance with law or regulations is generally based on the advice of an informed expert qualified to practice law, but ultimately can be determined only by a court of law.

Laws and regulations vary considerably in their relation to the financial statements. Some laws and regulations relate directly to the preparation of, or the inclusion or disclosure of specific items in the financial statements. Other laws and regulations provide a legal framework within which the entity conducts its business.

Non-compliance with law or regulations may result in financial consequences for the entity, such as fires or litigations.

2.11.1 Responsibilities of the Directors

It is the responsibility of the directors to ensure that the entity complies with law and regulations applicable to its activities and to establish effective arrangements for preventing any non-compliance with laws or regulations and detecting any that occurs. Neither the assignment of particular responsibilities to management nor the audit process relieves the directors of these fundamental responsibilities.

The following policies and procedures, among others, may assist the directors in discharging their responsibilities for the prevention and detection of non-compliance with laws or regulations.

a. Maintaining an up-to-date register of significant laws and regulations with which the entity has to comply within its particular industry;

b. Monitoring legal requirements and any changes therein and ensuring that operating procedures are designed to meet these requirements;

c. Instituting and operating appropriate systems of internal control;

d. Developing, publicizing and following a code of conduct;

e. Ensuring employees are properly trained and understand the code of conduct;

f. Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it;

g. Engaging legal advisers to assist in monitoring legal requirements; and

h. Maintaining a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to:

a. an internal audit function;

b. a legal department;

c. a compliance function; and

d. an audit committee.

In certain sectors or activities (for example financial services), there are detailed laws and regulations that specifically require directors to have systems to ensure compliance. These laws and regulations could, if breached, have a material effect on the financial statements. In addition, the directors are required to report certain instances of non-compliance to the proper authorities on a timely basis.

Directors are also responsible for preparing financial statements that give a true and fair view of the state of affairs of the entity. In order for the financial statement to give the required true and fair view, it is necessary, where possible non-compliance with laws or regulations has occurred which may result in a material misstatement in the financial statements, for the matter to be reflected appropriately in those financial statements.

2.11.2 Responsibilities of the Auditors

a. **Prevention**
It is not the auditors' function to prevent non-compliance with law or regulations. The fact that an annual audit is carried out, may however act as a deterrent.

b**.** **Detection**
Auditors plan, perform and evaluate their audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements. When doing so, they recognize that material misstatement may arise from non-compliance with law or regulations. However, an audit cannot be expected to detect all possible non-compliance with laws and regulations.

An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with Auditing Standards. This risk is higher with regard to misstatements resulting from non-compliance with laws and regulations due to such factors as the following:

i. There are many laws and regulations, relating to the operating aspects of the entity, that typically do not have a material effect on the financial statements and where the consequences of any non-compliance are not captured by the accounting and internal financial control systems;

ii. The effectiveness of audit procedures is affected by the inherent limitations of the accounting and internal control systems and by the use of testing;

iii. Much of the evidence obtained by the auditors is persuasive rather than conclusive in nature; and

iv. Non-compliance with laws or regulations may involve conduct designed to concede it, such as collusion, forgery, override of controls or intentional misrepresentations being made to the auditors.

2.11.3 Auditors in the Public Sector

Auditors of entities in the public sector may have duties that go beyond those of auditors of limited companies and other entities in the private sector. For example, auditors of local authorities are required to keep under review the legality of an authority's transactions and a specific requirement to take action in cases of prospective unlawful expenditure or courses of action. Auditors of central government accounts have a statutory duty to satisfy themselves that grants have been applied to the purposes for which the grants made by parliament were intended and that the expenditure conforms to the authority which governs it.

2.11.4 The auditors' Consideration of Compliance with Laws and Regulations

The auditors plan and perform the audit with an attitude of professional skepticism. They recognize that the audit may reveal conditions or events that could lead to questioning whether an entity is complying with laws and regulations. For audit purposes, laws and regulations relevant to the audit can be regarded as falling into two main categories:

a. those which relate directly to the preparation of, or the inclusion of disclosure of specific items, in the financial statements of the entity; and

b. those which provide a legal framework within which the entity conducts its business and where non-compliance may reasonably be expected to have a fundamental effect on the operations of the entity and hence on its financial statements.

The auditors should obtain sufficient appropriate audit evidence about compliance with those laws and regulations which relate directly to the preparation of, or the inclusion or disclosure of specific items in the financial statements.

The auditors should perform procedures to help identify possible instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and where non-compliance may reasonably be expected to have a fundamental effect on the operations of the entity and hence on its financial statements, by:

a. obtaining a general understanding of the legal and regulatory framework applicable to the entity and the industry, and of how the entity is complying with that framework;

b. inspecting correspondence with relevant licensing or regulatory authorities;

c. enquiring of the directors as to whether they are on notice of any such possible instances of non-compliance with law or regulations; and

d. obtaining written confirmation from the directors that they have disclosed to the auditors all those events of which they are aware which involve possible non-compliance, together with the actual or contingent consequence which may arise there from.

The auditors need to obtain a general understanding of those laws and regulations which provide a general framework within which the entity conducts its business. This includes a general understanding of those laws and regulations which are specific to an industry and to activities that are fundamental to a company, such as:

a. in a company in which a major activity is the development of a single property, the planning regulations or consents;

b. in a waste disposal company, the terms of licenses held by the company under which it is allowed to dispose of hazardous waste; and

c. those laws and regulations in relation to which the company is required to provide financial information to regulatory or other authorities and where non-compliance may affect the company's ability to continue trading.

Non-compliance with such laws and regulations may result in the entity ceasing operations, or call into question the entity's continuance as a going concern.

To obtain the general understanding, the auditors use their existing knowledge of the entity's industry and business and of its regulatory environment to:

i. enquire of management as to the laws or regulations (and any changes therein) that may be expected to have a fundamental effect on the operations of the entity

ii. enquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations, in particular, those which may be expected to have a fundamental effect on the operations of the entity and hence on its financial statements;

iii. discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation, claims and assessments; and

iv. discuss the legal and regulatory framework with auditors of subsidiaries in other countries, (for example, if the subsidiary is required to adhere to the securities regulations of the parent company).

Other than as described above, the auditors are not required to plan and perform other procedures to identify possible instances of non-compliance with law or regulations, because to do so is outside the scope of an audit of financial statements.

When carrying out their procedures for the purposes of forming an opinion on the financial statements, the auditors should in addition be alert for instances of possible non-compliance with law or regulations which might affect the financial statements.

Procedures that may bring such non-compliance to the auditors' attention include:

i. reading minutes of Board and Management Meetings;

ii. enquiring of the entity's directors and legal counsel concerning litigation, claims and assessments, and

iii. performing substantive tests of details of transactions or balances.

2.11.5 Procedure when Possible Non-Compliance with Law or Regulations is Discovered

When the auditors become aware of information concerning a possible instance of non-compliance with law or regulations, they should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and other sufficient information to evaluate the possible effect on the financial statements.

Indications that non-compliance may have occurred

Examples of the type of information that may come to the auditors' attention and may indicate that non-compliance with law or regulations that has occurred are listed below:

a. Investigations by government department or payment of fines or penalties;

b. Payments for unspecified services or loans to consultants, related parties, employees and government employees;

c. Sales commissions or agents' fees that appear excessive in relation to those normally paid by the entity or in its industry or to the services actually received;

d. Purchasing at prices significantly above or below market price;

e. Unusual transactions with companies not registered with the tax authorities;

f. Payments for goods or services made other than to the country from which the goods or services originated;

g. Existence of an accounting system that fails, whether by design or by accident to provide adequate audit trail or sufficient evidence;

h. Unauthorized transactions or improperly recorded transactions; and

i. Media comment.

When evaluating the possible effects of non-compliance on the financial statements, the auditors consider:

a. the potential financial consequences, such as fines, damages, threat of expropriation of assets, enforced discontinuance of operations and litigation;

b. whether the potential financial consequences require disclosure; and

c. whether the potential financial consequences are as serious as to call into question the view given by the financial statements.

When the auditors believe there may be non-compliance with law or regulations, they should document their findings and, subject to any requirements to report them direct to a third party, discuss them with directors.

Depending on the circumstances, the methods which auditors may decide to adopt to document their findings include taking copies of records and documents and making minutes of conversations.

If the directors do not provide sufficient information about the suspected non-compliance to show that the entity is in fact in compliance, the auditors may consider it prudent to obtain legal advice about the application of law or regulations to the circumstances and the possible effects on the financial statements.

The auditors normally, with the entity's permission, consult the entity's lawyers as to know whether non-compliance with a law or regulation is involved and the possible legal consequences. However, where it is not possible to consult the entity's own lawyer, or it is not appropriate to rely on the entity's lawyer's opinion, or where the auditors so wish, or it is not clear what further action if any, the auditors ought to take, they may obtain their own legal advice.

When adequate information about the suspected non-compliance with law or regulations cannot be obtained, the auditors consider the implications of the lack of audit evidence for their report.

The auditors should consider the implications of suspected non-compliance with law or regulations in relation to other aspects of the audit, particularly, the reliability of management representations.

If the auditors consider that non-compliance with law or regulations may have or has occurred, they have to reconsider their assessment of audit risk and the validity of management representations. Factors affecting the auditors' risk assessment or discovering a possible instance of non-compliance with law or regulations include:

a. any apparent failure of specific control procedures;

b. the level of management or employees involved; and

c. the concealment, if any, of the act.

For example, a series of suspected instances of non-compliance with law or regulations which are financially immaterial may be symptomatic of management's general disregard for the law and hence may throw doubt on the integrity of the financial statements and perhaps even the future prospects of the entity.

2.11.6 Reporting Non-Compliance with Law or Regulations to Management

The auditors should, as soon as practicable, either

a. communicate with management, the board of directors or the audit committee, or
b. obtain non-compliance with law or regulations that comes to the auditors' attention.

If in the auditor's judgment, the non-compliance with law or regulations is material or is believed to be intentional, the auditors should communicate the finding without delay.

If the auditors suspect that there has been an instance of possible non-compliance with law or regulations, the auditors may report the matter to the next higher level

of authority within the entity which they do not suspect of involvement in the non-compliance. For example, if the auditors suspect that members of senior management, including members of the board of directors are involved, it may be appropriate to report the matter to the audit committee. Where no higher authority exists, or if the auditors believe that the report may not be acted upon or are unsure as to the person to whom to report, they may wish to obtain legal advice.

2.11.7 Reporting Non-Compliance with Laws or regulations to Shareholders

Auditors may consider the implications of their report if:

They conclude that a suspected instance of non-compliance with laws or regulations has a material effect on the financial statements and they disagree with the accounting treatment or with the extent, or the lack, of any disclosure in the financial statements of the instance or of its consequences, or they are unable to determine whether non-compliance with law or regulations has occurred.

They should not refrain from qualifying their opinion on the grounds that the position has been regularized since the statement of financial position date or because of the possible consequences of qualification.

When determining whether a possible instance of non-compliance with law or regulations requires disclosure in the financial statements, auditors have regard to whether shareholders require the information to enable them to assess the stewardship of the directors, and any potential implications for the future operations or standing of the entity.

Suspected non-compliance with laws or regulations may require disclosure in the financial statements because, although the immediate financial effect on the entity may not be material, there could be future material consequences such as fines or litigations. For example, an illegal payment may not itself be material but may result in criminal proceedings against the entity or loss of business which could have a material effect on the true and fair view given by the financial statements.

2.11.8 Reporting Non-Compliance with Laws or Regulations to Third Parties

Where the auditors become aware of a suspected instance of non-compliance with laws or regulations and consider that the matter may be one that ought to be reported to a proper authority in the public interest, they should ensure that the matter is brought to the attention of the directors, including any audit committee.

In extreme cases, auditors should report a matter direct to a proper authority in the public interest and without discussing the matter with the entity if they conclude that the suspected instance of non-compliance should be so reported and it has caused them no longer to have confidence in the integrity of the directors.

Confidentiality is an implied term in the auditors' contract. The duty of confidentiality, however, is not absolute. In certain exceptional circumstances, auditors are not bound by the duty of confidentiality and have the right to report matters to a proper authority in the public interest. Auditors need to weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to a proper authority. Determination of where the balance of public interest lies requires careful consideration. Auditors whose suspicions have been aroused need to use their professional judgment to determine whether their misgivings justify them in carrying the matter further or are too insubstantial to deserve report.

Examples of circumstances which may cause the auditors no longer to have confidence in the integrity of the directors include situations:

a. where they suspect or have evidence of the involvement or intended involvement of the directors in possible non-compliance with laws or regulations which could have a material effect on the financial statements;

or

b. where they are aware that the directors are aware of such non-compliance and, contrary to regulatory requirements or the public interest, have not reported it to the proper authority within a reasonable period.

Auditors are protected from the risk of liability for defamation provided that:

i) disclosure is made in the public interest, and

ii) such disclosure is made to an appropriate body or person; and

iii) there is no malice motivating the disclosure.

iv) disclosure is made in their capacity as auditors of the entity concerned.

Public interest is a concept that is not capable of general definition. Each situation must be considered individually. Matters to be taken into account when considering whether disclosure is justified in the public interest may include:

- the extent to which the suspected non-compliance with law or regulations is likely to affect members of the public;
- whether the directors have rectified the matter or are taking, or are likely to take, effective corrective action;
- the extent to which non-disclosure is likely to enable the suspected non-compliance with law or regulations to recur with impunity;
- the gravity of the matter;
- whether there is a general management ethos within the entity of disregarding law or regulations; and
- the weight of evidence and the degree of the auditors' suspicion that there has been an instance of non-compliance with law or regulations.

When reporting to proper authorities in the public interest, it is important that in order to retain the protection of qualified privilege, auditors report only to one who has a proper interest to receive the information. Which body or person is the proper authority in a particular instance depends on the nature of the suspected non-compliance. Proper authorities could include the Serious Fraud Office, Police Service, the Securities Commission, the recognized Professional Bodies, the Stock Exchange, the Central Bank, Local Authorities, the Internal Revenue Service, the Customs, Excise & Preventive Service, the Ministry of Trade and Industry etc. Auditors may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.

Auditors need to remember that their decision as to whether to report and if so, to whom, may be called into question at a future date, for example, on the basis of:

- what they know at the time;
- they ought to have known in the course of their audit;
- what they ought to have concluded; and
- what they ought to have done.

Auditors may also wish to consider the possible consequences if financial loss is occasioned by non-compliance with law or regulations which they suspect (or ought to suspect) has occurred but decide not to report.

2.12 IMPACT OF LAWS AND ACCOUNTING STANDARDS ON AUDIT

Companies & Allied Matters Act (CAMA)

The statutory audit carried out in Nigeria is regulated by the Companies and Allied Matters Act 2020, Banks and Other Financial Institutions Act 2020 and Insurance Act 2003. These acts contain detailed regulations on the conduct of an audit, the accounting records on which the auditor will work, the financial statements on which he will report and on the auditor's relationship with the company. Schedule 2 of CAMA specifically stated that every company shall keep accounting records which shall sufficiently show and explain the transactions of the company such as to:

a. disclose with reasonable accuracy at any time the financial position of the company and

b. enable the Directors to ensure that any financial statement prepared under this part comply with the requirements of the CAMA as to the form and contents of the company's financial statements. The accounting records shall, in particular contain day to day entries of all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place and record of the assets and liabilities of the company.

If the business of the company involves dealing in goods, the accounting records shall contain:

a. statement of inventories held by the company at the end of the year of the company

b. all statement of stocking from which any such statements of stock as is mentioned in the above of this subsection has been or is to be prepared and

c. except in the case of goods sold by ways of ordinary retail trade, statement of all goods sold and purchased showing the goods and the buyers and sellers in sufficient details to enable all these to be identified.

Financial Reporting Council

The Financial Reporting Council (FRCN) is charged with the responsibility for developing and publishing accounting standards to be observed in the preparation of financial statements in Nigeria. The Companies and Allied Matters Act makes it mandatory for auditors to ensure that financial statements prepared in Nigeria comply with accounting standards issued. Section 64 (1)of the Financial Reporting Council Act states “that any person who fails to comply with the prescribed statement of accounting and reporting standards developed by the Council to the effect that a public interest entity has failed to comply with any of its pronouncements under the Act, and with such other accounting and financial reporting standards as may be specified under the relevant enactments, commits an offence and is liable on conviction to a fine by not exceeding ₦10,000,000 or imprisonment for a term not exceeding two years or both, provided that the Council shall bring such non-compliance to the notice of the preparers of such financial statements”. It further seeks to promote and enforce compliance with the accounting standards to be observed in the preparation of financial statements. The FRC Act 2011 prescribes stiff penalties for non-compliance with accounting standards issued by it.

The penalties include:

Fines at the discretion of the board

(a) ₦5 million fine

(b) One year imprisonment or both on conviction

(c) Proscription or de-listing of the firms of accountants

The Council from time to time issues Statements of Accounting Standards (SAS) which seek to provide a guide for accounting policies and accounting methods that should be followed by companies in the preparation of their financial statements relative to income recognition, loss recognition, statement of financial position classification and many other provisions. The Council since inauguration has issued many SASs.

Main Functions of Financial Reporting Council

The Board shall

a) Develop and publish in the public interest accounting standards to be observed in the preparation of financial statements;

b) Promote the general acceptance and adoption of such standards by preparers and users of financial statements;

c) Promote and enforce compliance with the accounting standards developed or reviewed by the Council; and

d) Review from time to time the accounting standards developed in line with the prevalence social, economic and political environment.

2.13 SCOPE OF AUDIT FUNCTIONS UNDER CAMA, BOFIA AND THE INSURANCE ACT

The Companies and Allied Matters Act (CAMA) 2020 is the principal law which set the tone for the incorporation and conduct of business in Nigeria. The Banks and Other Financial Institutions Act 2020 (BOFIA) regulates the operations of banks and other financial institutions in Nigeria while the Insurance Act 2003 regulates the operations of Insurance Companies in Nigeria.

2.13.1 COMPANIES AND ALLIED MATTERS ACT

Section 404 (1) of Companies and Allied Matters Act states that the auditors of a company shall make a report to its members on the accounts examined by them and on every Statement of Financial Position and the Statement of Comprehensive Income and on all group financial statements copies of which are to be laid before the company in a general meeting during the auditors' tenure of office.

In addition to the above report, the auditor shall in the case of a public company also make a report to an audit committee which shall be established by the public company. The audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum of six members) and shall examine the auditor's report and make recommendations thereon to the annual general meeting as it may think fit.

Subject to such other additional functions and powers that the company's articles of association may stipulate, the objectives and functions of the audit committee shall be to:

(a) ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;

(b) review the scope and planning of audit requirements;

(c) review the findings on management matters in conjunction with the external auditor and departmental responses thereon;

(d) keep under review the effectiveness of the company's system of accounting and internal control;

(e) make recommendations to the board with regard to the appointment, removal and remuneration of the external auditors of the company; and

(f) authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

Section 407(1) states that it shall be the duty of the company's auditor, in preparing their report to carry out such investigations as may enable them to form an opinion as to the following matters whether:

i. Proper accounting records have been kept by the company and proper returns adequate for their audit have been recalled from branches not visited by them.

ii. The company's Statement of Financial Position and (if not consolidated) its Statement of Comprehensive Income are in agreement with the accounting records and returns.

Section 407(2) states that if the auditors are of opinion that proper accounting records have not been received from branches not visited by them, or if the Statement of Financial Position and (if not consolidated) the Statement of Comprehensive Income are not in agreement with the accounting records and returns, they shall state the fact in their report.

Section 407(3) states that every auditor of a company shall have a right of access at all time to the company's book, accounts and vouchers and entitled to require from the company office such information and explanations as s/he thinks necessary for the performance of the auditor's duties.

Section 407 (4) states that it shall be the auditors' duty to consider whether the information given in the director's report for the year for which the accounts are prepared in consistent with those accounts and if they are of opinion that it is not, they shall state the fact in their report.

2.13.2 Banks and Other Financial Institutions Act 2020 (BOFIA)

The BOFIA Act 2020 regulates the operations of banks and other financial institutions in Nigeria. The CBN (Central Bank of Nigeria) is charged with the responsibility of administering the BOFIA, as amended which aims at ensuring high standards of banking practice and sustaining financial stability. There are various provisions in BOFIA (as amended) which govern the operations of banks and the publication of their annual accounts in Nigeria.

Publication of Annual Accounts of Banks

(a) Subject to the prior approval in writing of the Central Bank, a bank, shall not later than four months after the end of its financial year:

  (i) Cause to be published in a daily newspaper printed in and circulating in Nigeria and approved by the Central Bank

  (ii) Exhibit in a conspicuous position in each of its offices and branches in Nigeria, and

  (iii) Forward to the Central Bank, CBN, copies of the bank's Statement of Financial Position and Statement of Comprehensive Income duly signed and containing the full and correct names of the directors of the bank.

(b) Every published account of a bank shall disclose in detail, penalties paid as a result of contravention of the provisions of this Act and provision of any policy guidelines in force during the financial year in question and the auditor's report shall reflect such contravention.

(c) The Statement of Financial Position and the Statement of Comprehensive Income of the bank shall bear on their face the report of approved auditors and shall contain statements as such matters as may be specified by the bank from time to time.

(d) For the purpose of sub-section (3) of this section, an "approved auditor" shall be an auditor approved for the purpose of section 28 of this Act.

(e) Any bank which fails to comply with any of the requirements of this section is in respect of each such failure guilty of an offence and liable to penalty of not less than ₦5,000,000 and an additional penalty of ₦100,000 for each day the contravention continues.

Contents and Form of Accounts

(a) Every Statement of Financial Position and Statement of Comprehensive Income of a bank shall give a true and fair view of the state of affairs of the bank as at the end of the reporting period.

(b) Every Statement of Financial Position and Statement of Comprehensive Income of a bank forwarded to the Central Bank shall comply with the requirements of any circular which has been issued by the central bank thereon.

(c) Any person being a director of any bank who fails to take all reasonable steps to secure compliance with any of the prescribed provisions in respect of any account is guilty of any offence and liable to pay to the bank a fine of ₦2,000,000.

Appointment, Power and Report of Approved Auditor

a) Every bank shall appoint annually a person approved by the Central Bank referred to as "approved auditor", whose duties shall be to make to the shareholders a report upon the annual Statement of Financial Position and Statement of Comprehensive Income of the bank and every such report shall contain statements as to the matters and such other information as may be prescribed from time to time by the Central Bank.

b) For the purpose of this section, the approved auditor shall be an auditor who is:

   i. a member of one of the professional bodies recognised in Nigeria;

   ii. approved by the Central Bank;

   iii. resident in Nigeria; and

   iv. carrying on in Nigeria professional practice as accountant and auditor.

c) Any person:

   i. having any interest in a bank otherwise as a depositor;

   ii. who is a director, officer or agent of a bank;

   iii. which is a firm in which a director of a bank has any interest as partner or director;

   iv. who is indebted to a bank, shall not be eligible for appointment as the approved auditor for that bank;

   v. a person appointed as such auditor who subsequently:

      - acquires such interest; or
      - becomes a director, officer or agent of the bank
      - becomes indebted to a partner in a form in which a director of a bank is interested as partner or director, shall cease to be such auditor

d) If any bank fails to appoint an approved auditor, the Central Bank shall appoint a suitable person for that purpose and shall fix the remuneration to be paid by the bank to such auditor.

e) Any approved auditor who acts in contravention of or fails deliberately or negligently to comply with any of the required provisions is guilty of an offence and liable on conviction to pay to the Central Bank a fine of not less than ₦200,000 and not exceeding ₦500,000.

f) The report of the approved auditor shall be read together with the report of the board of directors at the annual general meeting of the shareholders of the bank and two copies of each report with the auditors analysis of bad and doubtful advances in a form specified from time to time by the Central bank shall be sent to the Central Bank.

g) If an auditor appointed under this section, in the course of his duties as an auditor of a bank, is satisfied that:

  i) there has been a contraventions of this Act, or that an offence under any other law had been committed by the bank or any other person or

  ii) losses have been incurred by the bank which substantially reduces its capital funds; or

  iii) any irregularity which jeopardizes the interest of depositors or creditors of the bank or any other irregularity has accrued or

  iv) he is unable to confirm that claims of depositors or creditors are covered by the assets of the bank, he shall immediately report the matter to the Central Bank.

  v) The approved auditor shall forward to the Central Bank two copies of the domestic report on the bank's activities not later than three months after the end of the bank's financial year.

  vi) Any approved auditor who acts in contravention of or fails deliberately or negligently to comply with any of the required provisions is guilty of an offence and liable on conviction to a fine of not less than ₦2,000,000and where the approved auditor is a firm, the individual partner or partners are in addition liable on conviction to imprisonment for a term not less than three years or a fine of not less than ₦2,000,0000 or both.

  vii) The appointment of an approved auditor shall not be determined by a bank without prior approval of the Central Bank (Section 28).

2.13.3 INSURANCE ACT, 2020

In a similar way to the accounts of banks, the accounts of insurance companies have some peculiarities arising from the fact that insurance business is a special type of business. It involves provision of economic protections from identifiable risks that may occur during a specific period. Hence, there are legal and regulatory requirements that must be met by each insurance company. These include the following:

a. Insurance Act, 2020

b. Companies and Allied Matters Act, 2020;

c. IFRS 4 replaced by IFRS 17 which is effective January, 2023

d) Relevant circulars issued by the National Insurance Commission (NAICOM). Some sections of the Insurance Act provide that insurance business shall be classified into two main classes as follows:

   i. Life insurance business; and

   ii. General insurance business

In the case of life insurance, there shall be three categories namely:

- Individual life insurance business
- Group life insurance and pension business and
- Health insurance business

In the case of general insurance, there shall be eight categories:

- Fire insurance business
- General accident insurance business
- Motor vehicle insurance business
- Marine and aviation insurance business
- Oil and gas insurance business
- Engineering insurance business
- Bonds credit guarantee and surety ship insurance business
- Miscellaneous insurance business

In addition to the two broad classes above is an advanced type of insurance business referred to as "Re-insurance business". Re-insurance business in respect of any of the two broad classes mentioned above is a practice where by insurance companies buy their own insurance against losses that might result from claims made against them by those insured by them.

PAID UP CAPITAL

Section 10 of the Insurance Act as amended by NAICOM circular – NAICOM/DPR/CIR/25/2019 provides for the minimum paid-up share capital as follows:-

a) Life insurance business not less than ₦8 billion;

b) General insurance business less than ₦10 billion;

c) Composite insurance business, not less than ₦ 18 billion; and

d) Re- insurance business, not less than ₦20 billion.

Records of Insurance Companies

Sections 17 and 18 - Provide for the various records which an insurance and/or re-insurance company should keep in its principal office while section 19 provides that where an insurance company carries on the two classes of insurance business, separate and distinct account should be kept and shall be carried to and form a separate insurance fund with appropriate name.

Each insurance fund shall represent the liabilities in respect of all contracts of insurance of that particular class and shall consist of certain reserves/provision as specified in section 19(2) (a) and (b)

Records Maintained at Principal Office

The Records to be Kept and Maintained by an Insurer at its Principal Office are as follow:-

a) (i) The memorandum and articles of association or other evidence of the constitution of the insurer; and

(ii) A record containing the names and addresses of the owner of the insurance business whether known as or called shareholder or otherwise;

b) The minutes of any meeting of the owners and of the policy making executive; (whether known as or called the board of directors or otherwise)

c) A register of all policies in which shall be entered in respect of every policy issued, the names and address of the policy holder, the date when the policy was effected and a record or any transfer, assignment or nomination of which the insurer has notice;

d) A register of claims in which shall be entered every claim made together with the date of claim, the name and address of the claimant and the date on which the claim was settled, or in the case of a claim which is repudiated, the date of repudiation and the grounds for the rejection or in the case of litigation, the particulars of the litigation and the decision of the court in the matter;

e) A register of investment showing those which are attributable to the insurance funds and those which are not, and also any alteration in their values from time to time;

f) A register of its assets;

g) A register of reinsurance ceded in showing separately those ceded in Nigeria and those ceded outside Nigeria;

h) A Cash book;

i) A Current account book;

j) A register of open policies in respect of marine insurance transactions;

k) Management report by external auditors; and

l) An insurer shall in respect of its life insurance business maintain and keep the following additional record:-

    i. A register of assured under group policies;

    ii. A register of loans on policies;

    iii. A register of cash surrendered values; and

    iv. A register of lapsed and expired policies

Provisions and Reserves

Sections 20-23 provide for various provisions and reserves which must be established and maintained by all insurance companies. The reserves include:

a) Provision for unexpired risk;

b) Provision for outstanding claims;

c) Contingency reserves; and

d) Contingency reserve fund

The specific rates and conditions applicable for the calculations and determination of each of the above provisions and reserve are indicated in the appropriate reactions.

Investment in Assets
Section25 provides for the various guidelines on how an insurance company shall

invest and hold investment in the Nigerian assets, which are equivalent to and not less than the amount of policy holders' funds. The type of property and securities in which policy holders' funds can be invested are also stated.

Returns to NAICOM

Section26 Provides that an insurance company shall not later than 30th June each year submit to the National Insurance Commission the following:

a) A Statement of Financial Position as at the end of the last financial year plus the relevant profit and loss account meant for presentation to the shareholders at its annual general meeting;

b) A revenue account applicable to each class of insurance business for which the insurance company is registered to keep separate account of receipts and payments; and

c) A statement of investments representing the insurance funds.

The section provides further that an insurance company shall in each year after receipt of the approval of the commission; publish its general Statement of Financial Position together with its Statement of Profit or Loss and Other Comprehensive Income in at least one newspaper having wide circulation in Nigeria covering insurance business, life assurance business, and composite business as detailed below:

General Insurance Business:

a) Premium recognition;

b) Expenses;

c) Unexpired risk;

d) Financial statement; and

e) Disclosures in the revenue account, statement of comprehensive income and statement of financial position.

Life Assurance Business:

a) Premium recognition;

b) Claims;

c) Expenses;

d) Policy liabilities;

e) Valuation surplus / Deficiency;

f) Financial statements; and

g) Disclosure in the revenue account, statement of comprehensive income and statement of financial position.

Composite Business (Life and General)

An insurance company carrying on both life and general business should follow the same disclosure requirements set out above. In addition, its financial statements should include a separate Statement of Financial Position. As with the case of banks, the auditor should take all the above issues into consideration in approaching the audit of an insurance company, right from the planning stage, the auditor should consider the peculiarities of an insurance company and throughout the audit. The auditor's report should also make reference to compliance not only to CAMA but also with the Insurance Act 2003.and relevant circulars

2.14 CHAPTER SUMMARY

a. Every company, by law should have its financial statements audited before circulation to members and other stakeholders;

b. The appointed auditor should be a professionally qualified accountant who has been duly licensed to practise;

c. Generally, the auditor is appointed at the annual general meeting by members. Where casual vacancy exists, the directors of the company may appoint an auditor;

d. The auditor's remuneration is determined by the appointing authority, i.e. the members or the directors as the case may be;

e. An auditor can resign before he completes his term of office; in which case, notice of resignation should be given to the client company;

f. An auditor can, on the other hand be removed from office by ordinary resolution before the expiration of his term of office;

g. The auditor, by virtue of his appointment, has statutory responsibilities and rights which cannot be compromised in any way;

h. The auditor, by virtue of his appointment and in course of executing his assignment, should demonstrate some professional skills and competencies as well as upholding requisite professional ethics. Competence, fairness, due care, objectivity and independence are some of the requirements;

i. The auditor, in course of work, may be held liable under contract, under law of tort and/or under criminal law;

j. The auditor also has a responsibility towards the client's compliance with laws and regulations

MULTIPLE-CHOICE QUESTIONS

1. Which of the following is **NOT** a specific audit problem in insurance companies?

   A. The treatment of premium income
   B. Unexpired risks
   C. The calculation of outstanding claims
   D. Outstanding directors' remuneration
   E. Allocation of underwriting claims handling and investment expenses

2. Which of the following is **NOT** required as part of financial statements under Section 377 of CAMA?

   A. A Statement of Value Added
   B. Statement of Cash flow
   C. Statements of Accounting Policies
   D. Statement of Financial Position as at the end of the year
   E. The Chairman's Report

3. The statement that shows how the benefits of an effort of an enterprise are shared between employees, providers of capital and the amount of re-investment is known as

   A. Statement of Cash flow
   B. Statement of Value Added
   C. Financial Statement
   D. Statement of Comprehensive Income
   E. Auditor's Report

4. Which of the following letters confirms the acceptance and understanding of the audit assignment?

   A. Comfort Letter
   B. Letter of Consent
   C. Engagement Letter
   D. Management Letter
   E. Letter of Representation

5. Statements which show how the basic procedure contained in the standard is to be applied is described as

   A. Accounting Standard
   B. Professional Pronouncements
   C. Guidelines

D. Auditing Standards
E. International Financial Reporting Standards

SHORT ANSWER QUESTIONS

6. Pronouncement or statements being issued by government legislation, which regulates the implementation of auditing functions is called..................................

7. Those pronouncements or statements issued by professional bodies e.g. ICAN, FRC, etc. which state the basic procedures to be adopted by auditors when carrying out their audit functions of planning, examining and reporting on the financial statements prepared by the enterprise is called………..

8. When should an engagement letter be sent to a prospective client?

9. What is the penalty for laying or delivering defective financial statements as specified by CAMA 2020?

10. The work of an external auditor is regulated mainly through legal and professional pronouncements. State TWO of the sources of these pronouncements.

MULTIPLE-CHOICE QUESTIONS SOLUTION

1. D

2. E

3. B

4. C

5. C

SHORT ANSWER QUESTIONS SOLUTION

6. Statutory regulation

7. Accounting standards

8. Immediately the auditor is appointed.

9. A fine as specified by the Commission for any subsection not complied with on every person who is a Director for private company

10. Any two of:

a. CAMA 2020

b. Professional pronouncement by ICAN

c. Accounting standards issued by FRC

d. BOFIA 2020

e. Insurance Act 2020

f. Internal guidelines issued by the firm

CHAPTER THREE

PROFESSIONAL ETHICS

CHAPTER CONTENTS

a. Fundamental Principles of ICAN code of Ethics and Conduct

b. Professional Conduct for the members of ICAN

c. Requirement and Application of Professional Ethics in the conduct of Auditors as set out in ICAN's code of conduct and guide for members as regards independence, objectivity, integrity and confidentiality.

OBJECTIVES

After studying this chapter, the **reader should be able to understand:**

- Fundamental principles of ICAN code of Ethics and Conduct
- Professional conduct for ICAN Members
- Applications of Professional Ethics responsibilities
- Auditor's responsibilities in relation to confidentiality

3.1 FUNDAMENTAL PRINCIPLES OF ICAN CODE OF ETHICS

Ethics refers to a system or code of conduct based on moral duties, values and obligations that indicate how we should behave within a constituted body or society. In Nigeria, auditors must comply with the rules of professional conduct for members issued by their professional bodies and accounting standards issued by the Financial Reporting Council of Nigeria.

The ethical code issued by ICAN covers the following matters:

a. Fundamental principles

b. Integrity, objectivity and independence

c. Conflicts of interest

d. Confidentiality

e. Changes in professional appointment

f. Consultancy

g. Association with non-members

h. Fees

i. Obtaining professional work

j. The names and letterheads of practicing firms

k. Members in business and

l. Enforcement of ethical standards

3.2 PROFESSIONAL CONDUCT FOR THE MEMBERS OF ICAN

The following guidelines on professional conduct are issued by the Institute to guide its members in the efficient discharge of their professional duties. The contents of the Professional Code of Conduct and Guide for members serve as a guide to members of the Institute which require strict observance of these rules of conduct as condition for its membership.

Fundamental principles

a) A member should behave with integrity in all professional and business relationships. Integrity implies not mere honesty, but fair dealing and truthfulness.

b) A member should strive for objectivity in all professional and business judgments. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand, but no other.

c) A member should not accept or perform work which he or she is not competent to undertake unless he or she obtains such advice and assistance as will enable him or her competently carry them out.

d) A member should carry out his or her professional work with due skill, care, diligence and expedition with proper regard for technical and professional standards expected of him or her as a member.

e) A member should conduct himself or herself with courtesy and consideration towards all with whom he comes into contact during performing his or her work.

    e) A member should respect the confidentiality of information acquired as a result of professional and business relationship and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose.

3.3 APPLICATIONS OF PROFESSIONAL ETHICS

a) **Independence**

A member must exercise objectivity and independence required of an auditor. He or she must have both independence of mind and independence of appearance. He or she must be in a position to give an honest and unbiased opinion. Under no circumstances must a member knowingly allow his name to be associated with a financial statement that is misleading. Pursuant to the above and, in order to exercise his independence, members in public practice must not:

i. Possess any direct and/or indirect beneficial interest in any company for which he/she or his/her firm acts as auditors.

ii. Accept fees, the amount of which is based on the success of an assignment, except where this cannot be avoided because of legislation or agreement to which he is not a party.

iii. Accept fees, the amount of which is based on the turnover of the company for which he is acting as auditor.

iv. Act for any two opposing parties in respect of a negotiation, claim or settlement unless appointed as an arbitrator under due process or law

v. Carry out the work as an auditor concurrently with carrying out work for the client in an executive capacity

vi. Give or take loan from clients. Similarly anyone closely connected with him/her should not make loans to his/her client nor receive loan from clients. The same applies to guarantee. Overdue fees may in some circumstances constitute a loan

vii. Accept goods or services from a client or by anyone closely connected with him/her unless the value of that benefit is modest. Acceptance of undue hospitality poses a similar threat.

viii. Establish family or personal relationship with client's companies. It is desirable to avoid professional relationship where personal relationship exits. Examples of personal relationship include mutual business interests with members of the group comprising client, the audit firm, officers or employees of the client, partners or members of staff of the audit firm.

ix. Allow the existence of actual or threatened litigation. Litigation or threatened litigation (e.g. on auditor's negligence) between a client company and an audit firm would mean parties being placed in an adversarial situation which clearly undermines the auditor's objectivity

x. Allow influences outside the practice e.g. pressures from associated practices, bankers, solicitors, government or those introducing business

xi. Accept an audit assignment or any other professional assignment that will give rise to or bring a conflict of interest.

b) **Objectivity**

Objectivity is essential for any professional person exercising professional judgment. It is as essential for members in business as for practicing members. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other.

It is sometimes described as "independence mind". The need for objectivity is particularly evident in the case of a practicing accountant carrying out an audit or some other reporting role where his or her professional opinion is likely to affect rights between parties and decision they take.

Objectivity is contrasted with subjectivity. Subjective decisions are taken from the point of view of the individual concerned, taking into account the things that matter to them. These considerations might be friendship, loyalty or the instinct for self-preservation, while these subjective considerations are vital to making life go on, they have no place in professional decision making. The auditor should assemble all the relevant information available based on the books of account submitted to him and express his opinion or base decisions only on that data and the guiding principle of the profession.

3.4 AUDITORS' RESPONSIBILITIES WITH REGARD TO CONFIDENTIALITY

The IFAC Code of Ethics states that professional accountants have an obligation to respect the confidentiality of information about a client's or employer's affairs acquired in the course of professional services. The duty of confidentiality continues even after the end of the relationship between the professional accountant and the client or employer.

ICAN Professional Code of Conduct and guide for members states that the principle of confidentiality imposes an obligation on members in public practice to refrain from:

a) i. Disclosing to persons outside the firm and on a need to know basis to persons within the firm or employing organisation, confidential information acquired as a result of professional and business relationships without proper and specific authority unless there is a legal or professional right or duty to disclose such, and

ii. Using confidential information acquired as a result of professional and business relationship to their personal advantage or the advantage of third parties.

b) Members should maintain confidentiality even in a social environment.

c) Members should be alert to the possibility of inadvertent disclosure, particularly in circumstances involving long association with a business associate or a close or immediate family member.

d) Members should maintain confidentiality of information disclosed by a prospective client or employer.

e) Members should consider the need to maintain confidentiality of information within the firm or employing organisation.

f) Members in public practice should take all reasonable steps to ensure that staff under their control and persons from whom advice and assistance is obtained respect the member's duty of confidentiality.

EXCEPTIONS TO THE DUTY OF CONFIDENTIALITY

The following are circumstances where members are or may be required to disclose confidential information or when such disclosure may be appropriate.

i. Disclosure is permitted by law and or is authorised by the client or the employer.

ii. Disclosure is required by law for example

- production of documents or other provision of evidence in the course of legal proceedings; or
- disclosure to the appropriate public authorities of infringements of the law that came to light.

iii. There is a professional duty or right to disclose, when not prohibited by law:

- To comply with the quality review of a member body or professional body.
- To respond to an inquiry or investigation by a member body or regulatory body.
- To protect the professional interests of a member in legal proceedings.

iv. To comply with technical standards and ethics requirement.

In deciding whether to disclose confidential information, members should consider the following points:

- Whether the interest of all parties including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by members in public practice.
- Whether all the relevant information is known and substantiated, to the extent that it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment should be used in determining the type of disclosure to be made if any and
- The type of communication that is expected and to whom it is addressed in particular, members should be satisfied that the parties to whom the communication is addressed are appropriate recipients.

3.5 CHAPTER SUMMARY

i. This chapter extensively dealt with the various professional pronouncements in respect of guidelines, standards, code of ethics and general conduct for professional accountants issued by The Institute of Chartered Accountants of Nigeria (ICAN).

ii. Readers are also provided with the opportunity of familiarising themselves with all up to date fundamental principles and guidelines to be followed while carrying out an audit assignment and in their other relationship with clients and people they come across while carrying out their professional duties.

iii. The chapter also discussed threat to audit independence and their resolutions, conflicts of interests, including beneficial shareholding and financial involvement of an auditor in client's affairs.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is **NOT** an objective of auditing standard and guidelines?

   A. To minimize engagement risk.

   B. To ensure quality control of an audit.

   C. To enhance the initiative of the auditor.

   D. To ensure uniformity in carrying out audit assignment.

   E. To increase auditors' image in the eyes of the users of the financial statements.

2. The fundamental principles of professional conduct are as follows **EXCEPT**

A. A member should behave with integrity in all professional and business relationships.

B. A member should strive for objectivity in all professional and business judgment.

C. A member should not accept or perform work which he or she is not competent to undertake.

D. A member should carry out his or her professional work with due skill, care, diligence and expedition.

E. A member should always obtain the advice and guideline of senior members in all professional engagement.

3. Which of the following is a safeguard created by the profession against threats to independence, objectivity and integrity?

A. Continuing professional education requirement

B. A corporate governance structure

C. Peer pressures towards integrity and objectivity

D. Partners high regard for their careers and reputation

E. Emphasis on integrity and objectivity as hallmark qualities

4. According to the professional code of conduct for members of ICAN, a member who discovers information which adversely affects accounts or statement that he is currently preparing or auditing should

A. Stop work on it immediately

B. Report to police

C. Qualify his report on the accounts

D. Report to the tax office

E. Resign his appointment as auditors and refund all fees already received for the exercise

5. Which of the sanctions listed below is **NOT** imposed by The Institute of Chartered Accountants of Nigeria for misconduct of its members

   A. Reprimand

   B. Payment of costs

   C. Closure of practising office of the members

   D. Suspension from membership

   E. Removal of name from membership register

SHORT ANSWER QUESTIONS

6. Where a standard or guideline issued by ICAN in Nigeria conflicts with that of IFAC standard or guideline, which one prevails?

7. The way and manner each member is to relate to other members on the one hand and to the society on the other hand both from a moral perspective is regulated by professional...............

8. According to the code of ethics issued by IFAC, independence requires both independence of .... and independence of......................

9. A member may disclose confidential information to third parties in certain circumstances: YES/NO.

10. According to ICAN professional code of conduct and guide for members, honesty, fair dealing and truthfulness implies........................

MULTIPLE-CHOICE ANSWERS

1. C
2. E
3. A
4. C
5. C

SHORT ANSWER QUESTION SOLUTIONS

6. ICAN Standard or guidelines shall prevail

7. Ethics

8. Mind and appearance

9. Yes

10. Integrity

CHAPTER FOUR

AUDITORS' LIABILITY

CHAPTER CONTENTS
a. Introduction
b. Auditors' liability for negligence under common law
c. Auditors' liability under statute
d. Criminal Liability under the Nigeria Criminal Code

OBJECTIVES
After studying this chapter, readers should be able to**:**
a. appreciate how liability arises in audit work;
b. describe how liability occurs under common law;
c. outline how criminal liability arises in auditing.

4.1 INTRODUCTION

Statutory auditors perform audits and sign audit reports. These reports are the auditors' opinion on the truth and fairness of financial statements. The auditor has responsibilities to shareholders and other third parties who may place a level of reliance on the financial statements certified by the auditor. If the auditor fails to meet the standard of care required and consequently a loss is suffered by any of the affected parties remedy can be obtained against the auditors in a constituted court. As his work is relied upon by others, the auditor clearly has a responsibility to do his work honestly and carefully. He must be honest, that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

What is "reasonable care and skill" in any given case depends on the circumstances and is very difficult to assess. What is clear is that:

a. an auditor may fail to exercise sufficient skill and care

b. consequently, fraud or error may not be uncovered, or he may fail to discover that the accounts fail to show a true and fair view, or may contain a material misstatement

c. consequently, somebody who relies on the work of the auditor may lose money

d. this loss of money flows from the failure of the auditor to do his job properly

Auditors may be liable for professional negligence. In recent years, this has become an issue of great concern to auditors. Some audit firms have resorted to taking professional indemnity insurance to safeguard their businesses, which in concrete terms, does not solve the problem.

Auditors can also be liable under statute and can face penalty under the criminal law for deception and reckless negligence. It is also not uncommon for auditors to be held liable under civil law for damages. What is more, auditors by nature of their contractual relationship with their clients, face potential liability under the law of contract. A client may bring an action under contract law to enforce auditors' responsibility for loss which has occurred through the failure of the auditor to carry out their duties imposed by the contract with the client. Furthermore, an auditor may be held liable under the law of tort for duty of care, especially, where a third party is involved.

4.2 AUDITORS' LIABILITY FOR NEGLIGENCE UNDER COMMON LAW

An auditor will incur liability under common law if he is found negligent in the performance of his duty and the client suffers a loss as a result of such negligence. At the same time, where loss has resulted, but no negligence can be attributed to the auditor, he cannot be held liable for damages. Common law may be referred to as the generally accepted code of conduct, or customs in interpersonal relationship. It is based on whatever is common in different cultural practices of the land.

What is Negligence?

Negligence means some act or omission which occurs because the person concerned (e.g. an auditor) failed to exercise that degree of reasonable skill and care which is reasonable to be expected in the circumstances of the case. What is reasonable is not what a super careful and expert auditor would do but what an ordinary skilful person would do in the circumstances.

Liability under Contract

When auditors accept appointment, they enter a contract which imposes certain obligations on them. These obligations arise from the terms of the contract. Both express and implied terms of contract impact upon auditors. In the case of a statutory audit, the Company Laws (i.e., Companies and Allied Matters Act 2020) prescribe the auditors' duties, responsibilities and rights and express terms of the audit. However, contract cannot override the statutory provisions.

The implied terms which the law will impute into an audit contract are as follows:

a. The auditors have a duty to exercise reasonable care;
b. The auditors have a duty to carry out the work required with reasonable expediency; and
c. The auditors have a right to reasonable remuneration.

4.3 STATUTORY LIABILITY

Auditors may be liable for financial damage in respect of civil offences of misfeasance and breach of trust. This normally happens when the auditors have misused their position of authority for personal gain. Thus, the law made the following provisions:

a. Under Section 415(1) of CAMA 2020, a company's auditor shall in the performance of his duties exercise all such care, diligence, and skill as is reasonably necessary in each particular circumstance.

b. Under Section 415(2) states that where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him by subsection (1) of this section, the auditor shall be liable for negligence and the directors may institute an action for negligence against him in the court.

c. If the directors fail to institute an action against the auditor under subsection (2) of this section, Section 415(3) states that any member may do so after the expiration of thirty (30) days' notice to the company of his intention to institute such action.

For a company that is in the process of winding up, the auditor may be held liable "as an officer" of the company and if found guilty of misfeasance, he may be required to contribute to the extent of the loss arising from the breach of trust.

4.4 CRIMINAL LIABILITY UNDER SECTION 436 OF THE NIGERIA CRIMINAL CODE

If any promoter, director, officer, or an auditor of a company makes, circulates, or publishes or concurs in the making, circulating, or publishing of any written statement or account which to his knowledge is false, in material particular in order to deceive or defraud any person to invest in such a company, such promoter, director, officer or auditor shall be guilty of felony and liable to an imprisonment of seven (7) years.

CHAPTER SUMMARY

i. Every company by law should have its financial statements audited before circulation to members and other stakeholders.

ii. The appointed auditor should be a professionally qualified accountant who has been duly licensed to practice.

iii. The auditor by virtue of his appointment and in the course of executing his assignment should demonstrate some professional skills and competencies as well.

iv. Upholding requisite professional ethics, competence, fairness, due care, objectivity, and independence are some of the required competencies.

v. The auditor also has a responsibility towards the clients' compliance with laws and regulations.

vi. Auditors can incur liability under common law, CAMA and the Criminal Code if he/she does not exercise care and due diligence in the performance of his/her duties.

MULTIPLE-CHOICE QUESTIONS

1) An auditor can be liable to client or third parties **EXCEPT** for**:**

A. Negligence under common law.
B. Obeying court order to release confidential information.
C. Section 643 of CAMA.

D. Section 436 of Nigeria Criminal Code.
E. Breach of Section 368 of CAMA.

2) The auditor can take the following precautions to prevent him from being liable during his audit assignment **EXCEPT:**
A. Maintaining quality control, use written audit programme and keep proper working papers.
B. Minimising reliance on client's representation or even third party confirmation.
C. Giving snap advice or where he does, make it clear that it is subject to limitation.
D. Agreeing the auditor's duties and responsibilities precisely in a letter of engagement.
E. Ignoring expectation gap.

3) An auditor who accepts an audit engagement and does not have any knowledge about the organisation should:
A. Engage financial experts familiar with the nature of the organisation.
B. Inform the management that he first needs to attend the MCPE programme before the commencement of the audit.
C. Obtain knowledge of matters that relate to the nature of the organisation.
D. Refer a substantial portion of the audit to another member who will act as principal auditor.
E. Write the organisation's legal adviser for legal advice.

4) An auditor must exercise due professional care by
A. Obtaining professional experience and formal education.
B. Examining all available corroborating evidence.
C. Critically reviewing the judgement exercised at every level of supervision.
D. Reducing audit risk to the barest minimum.
E. Preventing fraud and irregularities.

5) Which of the following statements is FALSE?
A. An auditor may fail to exercise sufficient skill and care.
B. The audit engagement is a contract.
C. An auditor could be imprisoned if he becomes criminally liable.
D. An auditor is above all forms of liability under common law.
E. Making a misleading statement could lead to criminal liability,

SHORT ANSWER QUESTIONS

6) What is "reasonable care and skill" depending on the circumstances and is very difficult to access in any given case. TRUE/FALSE.

7) An act or omission which occurs because a person (e.g., auditor) failed to exercise that degree of reasonable skill and care which is reasonably expected of him is called ………………………

8) When an auditor is found negligent in the performance of his duty and the client suffers a loss as a result, the auditor will incur……………and pay.....................

9) An appointed auditor should be a professionally qualified accountant who has been duly licensed to..

10) The law requires that the auditor has responsibility to shareholders and .... who may place reliance on the financial statements examined by him?

SOLUTIONS TO MULTI-CHOICE QUESTIONS

1. B
2. E
3. C
4. D
5. D

SOLUTIONS SHORT ANSWER QUESTIONS

6. True
7. Negligence
8. Liability, damages
9. Practise
10. Third parties

CHAPTER FIVE

AUDIT PLANNING AND DOCUMENTATION

CHAPTER CONTENTS

a. Audit Planning Procedures
b. Audit Planning Memorandum
c. Knowledge of the Client's business
d. Audit Risk Assessment and Planning for Materiality
e. Audit Documentation: Audit Files and Working Papers

OBJECTIVES

At the end of this chapter, the reader should be able to:

a. describe the aims of audit planning;
b. outline the audit planning procedures;
c. appreciate the need to have knowledge about a client's business before commencing actual audit work;
d. outline the aspects of a client's business that the auditor should know;
e. list the sources from where the knowledge of a client's business can be obtained;
f. understand the components of risks;
g. distinguish between risk-based, procedural, and other approaches to audit and review work.;
h. describe and illustrate the contents of audit plans and audit programmes;
i. explain the importance of audit documentation required for different types of assignments; and
j. Differentiate between current and permanent audit files.

5.1 AUDIT PLANNING PROCEDURES

An audit plan is the specific guideline to be followed when conducting an audit. It helps the auditor to obtain sufficient evidence for the audit and keeps the audit cost at a reasonable level. It also helps to avoid misunderstandings with the client.

In order to conduct an audit effectively and efficiently, the work needs to be planned and controlled.

The form and nature of the planning required for an audit will be affected by the size and complexity of the enterprise, the commercial environment in which it operates, the methods of processing transactions and the reporting requirements to which it is subjected.

Audit planning is the formulation of the general strategy for audit which sets the direction for the audit, describes the expected scope and conduct of the audit and provides guidance for the development of the audit programme.

Adequate planning of an audit work aims at:

a. Establishing the intended means of achieving the objectives of the audit
b. Assisting in the direction and control of the work
c. Helping to ensure that attention is devoted to critical aspects of the audit work
d. Ensuring that the work is completed expeditiously
e. Facilitating review of the audit work

f. Helping to assign the proper tasks to members of the audit team and co-ordinating outside experts.

5.1.1 Planning an Audit of Financial Statements

a. The auditor should plan the audit so that the engagement will be performed in an effective and efficient manner.

b. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level.

c. Planning involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process.

d. Adequate planning helps to ensure that appropriate attention is devoted to important aspects or areas of the audit; those potential problems are identified and resolved on a timely basis; and that the audit engagement is properly organized and managed in order to be performed in an effective and efficient manner.

e. Adequate planning also assists in the proper assignment of work to engagement team members; facilitates the direction and supervision of engagement team members and the review of their work; and helps, where applicable, in the coordination of work done by auditors of components and the experts.

The nature and extent of planning activities will vary according to the size and complexity of the entity, the auditor's previous experience with the entity, and changes in circumstances that occur during the audit engagement.

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. However, in planning an audit, the auditor considers the timing of certain planning activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, the auditor plans the discussion among engagement team members, the analytical procedures to be applied as risk assessment procedure, the obtaining of a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework, the determination of materiality, the involvement of experts and the performance of other risk assessment procedures prior to identifying and assessing the risks of material misstatement and performing further audit procedures at the assertion level for classes of transactions, account balances, and disclosures that are responsive to those risks.

5.1.2 Preliminary Engagement Activities

The auditor should perform the following activities at the beginning of the current audit engagement:

- Perform procedures regarding the continuance of the client relationship and the specific audit engagement
- Evaluate compliance with ethical requirements, including independence

- Establish an understanding of the terms of the engagement

The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the performance of the audit engagement as conditions and changes in circumstances occur. However, the auditor's initial procedures on both client continuance and evaluation of ethical requirements (including independence) are performed prior to performing other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

The purpose of performing these preliminary engagement activities is to help ensure that the auditor has considered any events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level. Performing these preliminary engagement activities helps to ensure that the auditor plans audit engagement for which:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement
- There is no misunderstanding with the client as to the terms of the engagement.

5.1.3 The Overall Audit Strategy

The Auditor should establish the overall audit strategy for the audit.
The overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The establishment of the overall audit strategy involves:

a. Determining the characteristics of the engagement that define its scope, such as the financial reporting framework used, industry-specific reporting requirements and the locations of the components of the entity;
b. Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, and key dates for expected communications with management and those charged with governance; and
c. Considering the important factors that will determine the focus of the engagement team's efforts, such as determination of appropriate materiality levels, preliminary identification of areas where there may be higher risks of material misstatement, preliminary identification of material components and account balances, evaluation of whether the auditor may plan to obtain evidence regarding the effectiveness of internal control, and identification of recent significant entity (specific, industry, financial reporting or other relevant) developments.

In developing the overall audit strategy, the auditor also considers the results of preliminary engagement activities and, where practicable, experience gained on other engagements performed for the entity.

The process of developing the overall audit strategy helps the auditor to ascertain the nature timing and extent of resources necessary to perform the engagement. The overall audit strategy sets out clearly:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
- The number of resources to allocate to specific audit areas, such as the material locations, the extent of review of other auditors work (in the case of group audits), or the audit budget in hours to allocate to high risk areas;
- When these resources are deployed, such as whether at an interim audit stage or at key cut-off dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and when to complete engagement quality control reviews.

Once the overall audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. Although the auditor ordinarily establishes the overall audit strategy before developing the detailed audit plan, the two planning activities are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in consequential changes to the other.

In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the audit engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team member). With a smaller team, co-ordination and communication between team members are easy. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity and the complexity of the audit. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, update and changed in the current period based on discussions with the owner-manager, can serve as the basis for planning the current audit engagement.

5.1.4 The Audit Plan

The auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level.

The audit plan is more detailed than the overall audit strategy and includes the nature, timing and extent of audit procedures to be performed by the engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan also serves as a record of the proper planning and performance of the audit procedures that can be reviewed and approved prior to the performance of further audit procedures.

The audit plan includes:

a. A description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement;
b. A description of the nature, timing, and extent of planned further audit procedures at the assertion level for each material class of transactions, account balance, and disclosure;
c. The plan for further audit procedures reflects the auditor's decision whether to test the operating effectiveness of controls, and the nature, timing, and extent of planned substantive procedures; and
d. Such other audit procedures required to be carried out for the engagement.

Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures ordinarily occurs early in the audit process. However, planning of nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures for some classes of transactions, account balances and disclosures before completing the more detailed audit plan of all remaining further audit procedures.

5.1.5 Changes to Planning Decisions during the Audit

The overall audit strategy and the audit plan should be updated and changed as necessary in the course of the audit.

Planning an audit is a continual and iterative process throughout the audit engagement. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures. Information may come to the auditor's attention that differs significantly from the information available when obtaining audit evidence through the performance of substantive procedures that contradicts the audit evidence obtained with respect to the testing of the operating effectiveness of controls. In such circumstances, the auditor re-evaluates the planned audit procedure, based on the revised consideration of assessed risks at the assertion level for all or some of the classes of transactions, account balances or disclosures.

5.1.6 Direction, Supervision and Review of Audit Work

The auditor should plan the nature, timing and extent of direction and supervision of engagement team members and review of their audit work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including the size and complexity of the entity, the area of audit, the risks of material misstatement, and the capabilities and competence of personnel performing the audit work.

The auditor plans the nature, timing and extent of direction and supervision of engagement team members based on the assessed risk of material misstatement. As the assessed risk of material misstatement increases, for the area of audit risk work, the auditor ordinarily increases the extent and timeliness of direction and supervision of engagement team members and performs a more detailed review of their work. Similarly, the auditor plans the nature, timing and extent of review of the engagement team's work based on the capabilities and competences of the individual team members performing the audit work.

In audits of small entities, an audit may be carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations, questions of direction and supervision of engagement team members and review of their work do not arise as the audit engagement partner, having personally conducted all aspects of the work, is aware of all material issues. The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with International Standard on Auditing (ISA). Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual performed the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to plan to consult with other suitably-experienced auditors or the auditor's professional body.

5.1.7 Procedures of Audit Planning

The auditor should consider the outline audit approach he proposes to adopt, including the extent to which he may wish to rely on internal controls and any aspect of the audit which needs particular attention. He should also consider in his planning, any additional work which he has agreed to undertake.

Preparatory procedures which the auditor should consider include the following:

a. reviewing matters raised in the audit of the previous year which may have continuing relevance in the current year;

b. assessing the effects of any changes in legislation or accounting practice affecting the financial statements;

c. reviewing interim or management accounts where these are available and consulting with the management and staff of the enterprise. Matters which should be considered include current trading circumstances, significant changes in the business carried on and in the management of the enterprise;

d. identifying any significant changes in the enterprise's accounting procedures, such as the introduction of a new accounting software;

e. determining the number of audit staff required, the experience and special skills they need to possess and the timing of their audit visits;

f. briefing audit team members about the client company's affairs and the nature and scope of the work they are required to carry out;

g. considering the need for expert help and the involvement of auditors in group audits;

h. preparing the planning memorandum, setting out the outline audit approach;

i. establishing materiality and risks factors;

j. setting out the audit programme of tests to be undertaken;

k. establishing initial sample sizes for testing;

l. setting staff allocation and a fee budget. The budget should be used to control the time spent on the audit and any major variations in time spent (both under and over), should be investigated by the engagement manager;

m. informing the client of the expected date of attendance by the auditor's staff; and

n. liaising or consulting with the joint auditors to determine the allocation of the work to be undertaken and the procedures for its control and review (in the case of joint audits).

5.2 AUDIT PLANNING MEMORANDUM (APM)

It is essential that the auditor documents the overall audit plan to cover the following areas:

a. The timing of the audit work
b. The changes in the client's business since the previous audit
c. The various decisions taken as a result of the planning process
d. The assessment of the internal audit of the client
e. The briefing instructions to the audit team
f. The control of the audit, and the supervision, and review of the audit work
g. The staff and time budget

The work of planning is a continuous process throughout the audit. Although the planning memorandum is prepared before the start of the audit work, it is worth noting that the planning work does not end there.

As the audit work progresses, the auditor reviews the plan and revises it appropriately.

In recent times, many auditing firms have formalized the documentation of their planning process by the use of Standard Audit Planning Memorandum. This standard document is used to record the initial planning decisions and is reviewed during the audit to suit the peculiar circumstances of the client and the audit assignment.

The following is a specimen audit planning memorandum of an auditing firm in Ghana.

	Prepared By	Date:	
	Reviewed by:	Date	
	Planning Memorandum		
1.	Job Time Table	Planned date	Actual date
	• Give provisional dates of timing of the audit • Planning meeting with client • Commencement of interim audit • Conclusion of interim audit • Debtors/creditors circularisation		
2.	***Changes since previous audit***	Detailed comments	
	changes in product range, terms of sales, etc.)		
	• In the management structure or key financial personnel • In the accounting system (including those resulting from previous management letters) • In external requirements (for example, accounting standards, legislation, rules, etc).		
3.	***Planning decisions***	Detailed comments	
	• The main changes in the audit programme from the previous period • Indicate those areas in which material errors have been identified in previous periods and audit emphasis to be placed thereon • The systems that are to be flowcharted • The sections of the permanent audit file that are to be created / updated • Specialist assistance required (specify) • Indicate whether an audit committee is mandatory for this client prior to signing of the audit report • Prepare a summary of schedules and other details that client staff will provide • State briefly other services the firm provides for the client and their impact on nature and timing of audit.		
4.	***Internal Audit department***	Detailed comments	

	• Indicate to what extent the audit tests will be reduced by relying on the work of the internal auditor. • State briefly the liaison with the internal auditors at the planning stage of the audit during the transaction audit at the final stage	
5.	***Briefing Instructions*** • State any sequence in which the work is to be carried out • State any specific points which require any particular attention or parts to be borne by a specific person	<u>Date</u> <u>Name</u> <u>Level</u>
	• Insert date when briefing meeting with audit team was held and names and levels of staff briefed	
6.	***Supervision and Review***	<u>Date Name Level</u>
	• State any particular stages (or area of difficulty) at which the senior is to refer back to the manager ***• State how and at what stages it is proposed to supervise and review the transaction audit.***	
	Time budget Engagement Partner 5 hours Manager 15 hours Assistant Manager 30 hours Supervisor 60 hours 2 Audit Seniors 150 hours 5 Audit Assistants 400 hours	
	State briefly the reasons for significant variances in the current year budget when compared with the budget and actual time of the previous year.	

KNOWLEDGE OF THE CLIENTS' BUSINESS

5.3.1 Introduction

Prior to acceptance of an engagement, the auditors should obtain a preliminary knowledge of the industry and ownership, management and operations of the prospective client, sufficient to enable the auditors to consider their ability and willingness to undertake the audit.

Following acceptance of an engagement, the auditors should obtain more detailed knowledge and information sufficient to enable them plan the audit, develop effective audit approach and understand the events and practices that have significant effect on the financial statement or their audit work.

What should be known about the client company include:

a. general economic factors and industry conditions affecting the entity's business
b. important characteristics of the entity, its business, its financial performance, and its reporting requirements; including changes since the date of the last audit exercise
c. the general level of competence of management and recent management changes
d. the accounting policies adopted by the entity and changes in those policies
e. the effect of new legislation, accounting or auditing pronouncements
f. the regulatory framework, if any
g. the auditors' cumulative knowledge of the accounting and internal control systems and any expected changes.

In succeeding periods, the auditors should consider the information gathered previously and should perform procedures designed to identify significant changes that have taken place since the last audit.

5.3.2 Sources of Knowledge

The auditors can obtain knowledge of the industry and the entity from several sources, including the:

a. previous experience with the entity and of its industry;
b. discussion with people within the entity (for example the junior and senior managers);
c. discussion with internal audit personnel and review of internal audit reports;
d. discussion with auditors (including predecessor auditors) and with legal and other advisors who have provided services for the entity or within the industry;
e. discussion with knowledgeable people outside the entity, (for example industry economists, industry regulators, customers, suppliers, competitors);
f. publications relating to the industry (from government, banks and regulators, financial newspapers), etc.;
g. legislations and regulations that significantly affect the entity;
h. visits to the entity's premises and plant facilities;
i. internal documents produced by the entity (for example minutes of meetings, materials sent to shareholders, promotional literature, prior-years' annual and financial reports, budgets, management reports, interim financial reports, management policies, accounts, job descriptions, marketing and sales plans; and
j. Industry-specific guidance (e.g., circulars from the government and the regulators).

5.3.3 Using the Knowledge

Understanding the business and using this information appropriately assist the auditors in:

a. Assessing risks and identifying problems

b. Planning and performing the audit effectively and efficiently
c. Evaluating audit evidence

The auditors make judgements about many matters throughout the course of the audit where knowledge of the business is important, for example:

i. Assessing inherent and control risks
ii. Considering business risks and management's response thereto
iii. Developing the overall audit plan and the audit programme
iv. Determining a materiality level and assessing whether the materiality level chosen remains appropriate
v. Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions
vi. Evaluating accounting estimates and management representations
vii. Identifying areas where special audit considerations and skilled may be necessary
viii. Identifying related parties and related party transactions
ix. Recognizing conflicting information (for example contradictory representations)
x. Making informed inquiries and assessing the reasonableness of answers
xi. Considering the appropriateness of accounting policies and financial statement disclosures.

The audit engagement partner should ensure that assistants assigned to an audit engagement obtain sufficient knowledge of the business of the entity being audited to enable them to carry out audit work delegated to them. Such knowledge may be passed to assistants initially by means of the audit planning memorandum or an audit-briefing meeting and subsequently during the course of the audit.

In addition, the audit engagement partner must ensure that audit assistants understand the need to be aware of and to share additional information.

5.3.4 Matters to Consider in Relation to Knowledge of the Clients' Business

The following matters are to be considered in relation to knowledge of the clients" business.

General Economic Factors:

a. General level of economic activity (for example growth, recession, etc.) in the country.
b. Interest rate and availability of financing
c. Inflation
d. Government's monetary, fiscal and trade restriction policies
e. Foreign currency rates and control

The Industrial Conditions Affecting the Clients' Business:

a. The market and competition
b. Cyclical and seasonal activities
c. Changes in product technology
d. Business risk (for example high technology, high fashion, ease of entry for competition)
e. Declining or expanding operations

f. Adverse conditions (for example declining demand, excess capacity, serious price competition)
g. Key ratios and operating statistics
h. Specific accounting practices and problems
i. Environmental requirements and problems
j. Regulatory framework
k. Energy supply and cost
l. Specific or unique practices (for example reacting to labour contracts, financing methods, accounting methods)
m. Management and Ownership of the Entity
n. Corporate structure – private, public, government
o. Beneficial owners and related parties (family, local, foreign, business reputation and experience)
p. The relationship between owners, directors, and management
q. Capital structure (including any recent or planned changes)
r. Organizational structure
s. Management objectives, philosophy, and strategic plans
t. Acquisitions, mergers, or disposals of business activities planned or recently executed
u. Sources and methods of financing (current, historical)
v. Board of directors (composition, business reputation and experience, independence from and control over operating management, frequency of meetings, existence of audit committee and scope of its activities, existence of policy on corporate conduct, changes in professional advisors)
w. Operating management (experience and reputation, turnover, key financial personnel, and other status in the organization, staffing of accounting department,
x. incentive or bonus plans as part of remuneration, use of forecasts and budgets, pressures on management, management information systems)
y. Internal Audit function (existence, quality, etc.)
z. Attitude to internal control environment.

The Entity's Business – Products, Markets, Suppliers, Expenses and Operations:

a. Nature of business (for example manufacturer, wholesaler, financial services, imports/exports)
b. Location of production facilities, warehouses, offices, etc.
c. Employment (for example by location, supply, wage levels, union contracts, pension commitments, government regulations)
d. Products or services and markets (for example major customers and contracts, terms of payments, profit margins, reputation of products warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
e. Important suppliers of goods and services (for example long term contracts, stability of supply, terms of payment, imports, methods of delivery)
f. Inventories (for example location, quantities)
g. Franchises, licenses, patents
h. Important expense categories
i. Research and development
j. Foreign currency assets, liabilities and transactions by currency, hedging
k. Legislation and regulations that significantly affect the entity

l. Information systems (including computerized information systems) – current plans to change
m. Debt structure, including covenants and restrictions.

Financial Performances:

Factors concerning the entity's financial conditions and Profitability are:

a. Accounting policies
b. Earnings and cash-flow trends
c. Leasing and other financial commitments
d. Availability of lines of credit
e. Off statement of financial position finance issues
f. Foreign exchange and interest rate exposures
g. Comparison with industrial trends

Reporting Environment:

External influences which affect the directors in the preparation of the financial statements are:

a. Legislation
b. Regulatory environment and requirements
c. Taxation
d. Accounting requirements
e. Measurement and disclosure issues peculiar to the business
f. Audit reporting requirements
g. Users of the financial statements
h. Communication of Knowledge about the Business

Knowledge of the clients business becomes useful to the auditors if it is made known to the audit team members. The audit engagement partner should therefore ensure that the audit team obtains such knowledge of the business of the entity being audited as may reasonably be expected to be sufficient to enable it to carry out the audit work effectively. Such information will be provided in the planning documentation but the partner should ensure that staffs regularly share any subsequent knowledge they have gained with the rest of the team.

AUDIT RISKS ASSESSMENT AND PLANNING FOR MATERIALITY

5.4.1 Introduction

There are some levels of risks associated with audit assignments. The riskier the nature of the client business, the more work the auditor will have to do before expressing an audit opinion.

Risk based audit is used by auditors to concentrate resources on the high-risk clients and on high risks areas of a client's business.

Risk- based audit

It is the system of audit used by auditors in order to concentrate on the high-risk clients and on high risks areas of a client's business rather than performing detailed audit tests on all areas of a client's business. It enables achievement of cost effectiveness in audits.

At this stage, we would discuss what constitutes audit risk and the components of audit risks

Total Audit risk

This is the risk of giving an inappropriate opinion when the financial statements are materially misstated. This is the risk that the auditor issues an unqualified opinion when the financial statement is not in conformity with the applicable financial reporting framework. Total audit risk has three components:

a. Inherent risk
b. Control risk
c. Detection risk

5.4.2 Inherent Risk

Inherent risk is the susceptibility of an account balance or class of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes, while assuming no related internal controls.

In developing the overall audit plan, the auditors should assess inherent risk at the financial statement level. In developing the audit programme, the auditor should relate such assessments to material account balances and classes of transactions.

In the absence of knowledge or information to enable the auditors to make an assessment of inherent risk for a specific material account balance or class of transactions, the auditors assume that inherent risk is high.

To assess inherent risk, the auditors use their experience of the client company from their previous audits together with professional judgement to evaluate numerous factors, example of which are:

At the financial statement level

a. The integrity of management
b. Management experience and knowledge and changes in management during the period, for example the inexperience of management may affect the preparation of the financial statements of the entity.
c. Unusual pressures on management. For example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
d. The nature of the entity's business, for example the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.

e. Factors affecting the industry in which the entity operates, for example economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the account balance and class of transactions level

a. The financial statements are likely to be susceptible to misstatement if for example some accounts require adjustments in the previous period or involve a high degree of estimation.
b. The complexity of understanding transactions and other events which might require the use of the work of an expert.
c. The degree of judgement involved in determining account balances.
d. Susceptibility of assets to loss or misappropriation, for example assets which are highly desirable and movable such as cash and cash equivalents.
e. The completion of unusual and complex transactions, particularly at or near period end
f. Transactions not subjected to ordinary processing either by commission or omission.

5.4.3 Control Risk

"Control risk" is the risk that material misstatement could occur in account balance or class of transactions, either individually or when aggregated with misstatements in other balances or classes, and not be prevented, or detected on a timely basis, by the accounting and internal control systems.

After obtaining an understanding of the accounting system and control environment, the auditors should make a preliminary assessment of control risk for material financial statement assertions.

The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing and correcting materials misstatements. There is always some control risk because of the inherent limitations of any internal control system.

The more effective the entity's accounting and internal control systems are assessed to be, the lower the auditor's assessment of control risk. In addition, where the auditors obtain satisfactory audit evidence from tests of control as to the effectiveness of the accounting and internal control systems, the extent of substantive procedures may be reduced.

Where the auditors conclude that the accounting and internal control systems are not effective, the audit approach should be as if they had made an adverse preliminary assessment of control risk, and sufficient appropriate audit evidence needs to be obtained entirely from substantive procedures.

When control risk is assessed at less than high, the auditors need to document the basis for the conclusion.

Different techniques may be used to document information relating to accounting and internal control systems and the assessment of control risk. Selection of a particular technique is a matter for the auditor's judgement.

Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts (these techniques are discussed in detail in the chapter on internal controls).

The form and extent of this documentation are influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control systems. Generally, the more complex the entity's accounting and internal control systems, the more extensive the auditor's procedures and the more extensive the auditor's documentation needs to be.

Relationship between the assessment of inherent and control risks

Management often reacts to situations where inherent risk is high by designing accounting and internal control systems to prevent and detect misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated.

In such a situation, if the auditors attempt to assess inherent risks and control risks separately, there is a possibility of inappropriate risk assessment.

As a result, the effects of inherent risk and the preliminary assessment of control risk are often performed simultaneously.

5.4.4 Detection Risk

"Detection Risk" is the risk that auditors' substantive procedures (tests of details of transactions and balances or analytical procedures) would not detect a material misstatement that exists in an account balance or class of transactions, either individually or when aggregated with misstatement in other balances or classes.

Regardless of the assessed levels of inherent and control risks, the auditors should perform some substantive procedures for material account balances and transactions classes. The higher the assessment of inherent and control risks the more audit evidence the auditors should obtain from the performance of substantive procedures.

When both inherent and control risk are assessed as high, the auditors need to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level.

When the auditors determine that detection risk regarding a material financial statement assertion cannot be reduced to an acceptably low level, the auditors need to consider the implication for their audit report and may consider whether to withdraw from the engagement.

The auditors' assessment of the components of audit risk may change during the cause of an audit, for example information may come to the auditor's attention (when performing substantive procedures) that differs significantly from the information on which the auditors originally assessed inherent and control risks. In such cases, the auditors need to modify the planned substantive procedures based on a revision of the assessed-levels of inherent and control risks for the relevant financial statement assertions.

5.4.5 Planning Materiality

Introduction

The auditor should consider materiality and its relationship with audit risk when conducting an audit.

According to International Standards on Auditing (ISA) 320, financial information is "material" if its omission or misstatement could influence the economic decisions taken by the users on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic. The auditor must have this information if it is to be useful.

Materiality

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The assessment of what is material is a matter of professional judgment.

In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and the nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

The auditor needs to consider the possibility of misstatements of relatively small amounts that cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated in the following month(s).

The auditor considers materiality at both the overall financial statement level and in relation to classes of transactions, account balances, and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to classes of transaction, account balances, and disclosures and their relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered.

Materiality should be considered by the auditor when:

a. Determining the nature, timing, and extent of audit procedures; and
b. Evaluating the effect of misstatements.

The relationship between materiality and audit risk

When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing the risks of material misstatement of the financial statements and responding to those risks throughout the audit. It also assists the auditor to establish materiality and in evaluating whether the judgment about materiality remains appropriate as the audit progresses. The auditor's assessment of materiality, related to classes of transactions, account balances, and disclosures, helps the auditor decide such questions as what items to examine and whether to use sampling and substantive analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk on an acceptably low level.

Materiality and audit risk in evaluating audit evidence

The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from the time of evaluating the results of audit procedures. This could be because of a change in circumstances or because of a change in the auditor's knowledge as a result of performing audit procedures. For example, if audit procedures are performed prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the effect of misstatements

In evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.

The aggregate of uncorrected misstatements comprises:

a) Specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods: and
b) The auditor's best estimate of other misstatements which cannot be specifically identified (i.e. projected errors).

The auditor needs to consider whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor needs to consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements. In any event, management may want to adjust the financial statements for the misstatements identified.

If management refuses to adjust the financial statements and the result of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider an appropriate modification to the auditor's report.

Communication of Errors

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

Public Sector Perspective

In assessing materiality, the public sector auditor must, in addition to exercising professional judgment, consider any legislation or regulation which may impact that assessment. In the public sector, materiality is also based on the "context and nature" of an item and includes, for example, sensitivity as well as value. Sensitivity covers a variety of matters such as compliance with authorities, legislative concern, or public interest.

6.3 AUDIT DOCUMENTATION: AUDIT FILES AND WORKING PAPERS

5.5.1 Introduction

The Auditors should document matters, which are important in providing evidence to support the audit opinion and evidence that the audit was carried out in accordance with acceptable standards.

Nothing enhances the efficiency with which an audit may be conducted more than the careful compilation and maintenance of audit files and the constituent working papers. From the very beginning of an audit, the files should be built up systematically and staff involved in audit assignments should be constantly reminded of the importance of recording material issues that arise from their audit and to ensure that audit papers are kept in an orderly manner at all times

5.5.2 Audit Working Papers

Audit working papers refer to the materials the auditors prepare or obtain, and retain in connection with the performance of the audit work. Working papers may be in the form of data stored on paper, electronic or other media.

Working papers are the record of planning and performance of the audit, the supervision and review of the audit work and the evidence resulting from the audit work performed to support the auditor's opinion.

Form and Contents of Working Papers

Working papers should record the auditors' planning, the nature, timing, and extent of the auditing work procedures performed, and the conclusions drawn from the evidence.

Working papers should include the auditors' reasoning on all significant matters, which require the exercise of judgement, together with the auditors' conclusions therein.

The form and content of working papers are affected by matters such as:

a. The nature of the engagement
b. The form of the auditors' report

c. The nature and complexity of the entity's business
d. The nature and condition of other entity's accounting and internal control system
e. The needs in the circumstances from direction, supervision and review of the work of assistants.
f. The specific methodology and technology the auditors use; and
g. The client's chart of accounts and its reporting requirements.

Working papers are designed and organized to meet the circumstances and the auditors' needs for each individual audit. The use of standardized working papers, (for example checklists, specimen letters, standard organization of working papers), may improve the efficiency with which such working papers are prepared and reviewed.

To improve audit efficiency, the auditors may use schedules, analyses and other documentation prepared by the entity. In such circumstances the auditors require evidence that such information is properly prepared. Working papers include the following:

a. Information concerning the legal and organizational structure of the client company
b. Extracts or copies of important legal documents, agreements, and minutes
c. Evidence of the planning process including audit programmes and any changes thereto
d. Evidence of the auditors understanding of the accounting and internal control systems
e. Evidence of the inherent and control risk assessments and any revisions thereof
f. Evidence of the auditors consideration of the work of internal audit and their conclusions thereon
g. Analyses of transactions and balances
h. Analyses of significant ratios and trends
i. A record of the nature, timing and extent of auditing procedures undertaken and the results of such procedures.
j. Details of procedures regarding companies whose financial statements are audited by other auditors
k. Copies of communications with other auditors, expert and other third parties
l. Copies of correspondence with the entity, reports to management and note of discussions with the entity's management
m. A summary of the significant aspects of the audit including details of the information available, the amounts involved, management views, the conclusions reached and how these matters are resolved or treated, and
n. Copies of the approved financial statements and the auditor's report.

5.5.3 Audit Files

In the case of recurring audits, some working papers may be classified as permanent audit files which are updated with new information of continuing importance. This is distinct from current audit files which contain information relating primarily to the audit of a single period.

Permanent Audit File

The permanent file usually contains documents and matters of continuing importance which will be required for more than one audit. It is usually indexed.

Contents include the following:-

a. Statutory materials governing the conduct, accounts, and audit of the enterprise e.g. Companies Code, stock Exchange Regulations, etc.

b. The rules and Regulation of the enterprise

c. Copies of documents of continuing importance and relevant to the auditors, e.g.

    i. Letter of engagement and extract of the minutes appointing the auditor
    ii. Trade license and royalty agreements entered into by the client
    iii. Debenture deeds
    iv. Leases
    v. Addresses of the registered office and all other business locations of the client company
    vi. An organization chart showing the various departments, sections, authority – responsibility relationships and names of responsible managers and officers.
    vii. Lists of books and other records and where they are kept, together with designation, names, and signatures of responsible officers.
    viii. An outline history of the organization including history of Stated Capital/Share capital, Capital Surplus/General Reserve, Prospectuses, and record of important ratios.
    ix. List of accounting matters of importance e.g., accounting policies with respect to Inventories, work-in-Progress, Depreciation, Research and Development etc.
    x. Notes of interviews and correspondence in respect of Internal Control matters and all past management letters.
    xi. Client's internal audits and Accounting Instructions.
    xii. A list of the company's directors, their shareholdings and service contracts.
    xiii. A list of the company's property and investments with notes on verifications.
    xiv. A list of the company's bankers, stockbrokers, solicitors, valuers, insurance brokers, etc.

It is essential that the permanent file be updated prior to commencement of a new financial year's audit.

The Current Audit File

The Current file contains matters relating to the current year's audit. The contents include the following:

a. A copy of the accounts being audited
b. An index to the file
c. A description of the Internal Control System in the form of ICQ, Flowcharts, or written description together with supervision documents.
d. Cross reference to the Internal Control record and letter of weakness.
e. A schedule for each item in the Balance Sheet (the Statement of Financial Position).
f. A schedule for each item in the Statement of Profit or Loss and Other Comprehensive Income showing its makeup.
g. A schedule of important statistics including output, sales composition, employment, accounting ratios.
h. Letters of representation
i. Letters to the client setting out Internal control weaknesses.

5.5.4 Confidentiality, Custody and Ownership of Working Papers

The auditors should adopt appropriate procedures for maintaining the confidentiality and safe custody of their working papers.

There are no specific statutory requirements regarding the period of retention of audit working papers. The auditors need to exercise judgement to determine the appropriate period of retention. However, it is considered advisable for auditors to retain their working papers for a period of at least six years from the completion of the relevant audit and then, prior to their destruction, to obtain satisfaction that there is unlikely to be a need to refer to them again. Working papers are the property of the auditors. They are not a substitute for the entity's accounting records.

5.6 CHAPTER SUMMARY

i. The purpose of audit planning are to ensure that appropriate attention is paid to the different areas of the audit, to ensure that potential problem areas are identified, and to facilitate review.
ii. Planning procedures vary from one audit to another but generally audit adopts systematic approach to the planning process.
iii. Planning is a continuous process and it takes place throughout the audit.
iv. Some auditing firms have formalised the planning process by using a standardized audit planning memorandum (APM).
v. There may be a risk involved in auditing some clients; the riskier the client is, the more work the auditor will plan to perform.
vi. Risk based audit is used by auditors to concentrate resources on high-risk clients and on high-risk areas of each client's business.
vii. The total audit risk consists of three components: Inherent risk, Control risk and Detection risk.
viii. In planning the audit, the auditor needs to establish materiality levels to ensure that any material misstatement or omissions in the accounting records are discovered.
ix. An overall materiality level is set based on the evaluation of the risks in the client's environment.
x. It is important for auditors to record their reasoning on significant matters that require the exercise of judgement.
xi. Audit working papers are usually filed in two separate files: the Permanent file and the Current file.

MULTIPLE CHOICE QUESTIONS

1) The following risks are relevant to the auditor EXCEPT
   A. Inherent Risk
   B. Control Risk
   C. The possibility of fraud or misrepresentation involving collusion of staff and/or management.
   D. Failure to draw the correct inference from audit evidence and the analytical review.
   E. Risk of not being able to recover audit working papers.

2) Which one of the following is **NOT** a relevant consideration for determining whether a client is of high risk?

A. Evidence of client engagement in fraudulent or illegal activities

B. The state of the economic sector in which the client operates

C. Diversification of the client's business into new areas to increase profitability

D. The general abilities of the client management

E. Evidence of management internationally failing to record a material transaction.

3) The procedures outlined in an audit programme are designed to

A. Obtain audit evidence

B. Detect errors or irregularities

C. Protect the auditor against litigation

D. Highlight movement in the accounts between years

E. Ensure early completion of the audit

4) In assessing control risk an auditor ordinarily selects from a variety of techniques including

A. Inquiry and analytical procedures

B. Re-performance and observation

C. Comparison and confirmation

D. Inspection and verification

E. Reassessment and re-performance

5) Matters for auditors to consider in developing the overall plan, with particular regard to the knowledge of the entity's business may include

A. General economic factors and industry conditions affecting the entity's business

B. Important characteristics of the entity, its business, principal business strategies, its financing performance and its reporting requirements, including changes since the previous audit.

C. The operating style and control consciousness of directors and management

D. The auditor's cumulative knowledge of the accounting and internal control systems and any expected changes in the period

E. All the above four cases

SHORT ANSWER QUESTIONS

6. Those documents which the auditors prepare or obtain and retain in connection with the performance of their audit work is called......................

7. The file that contains documents and matters of continuing importance which will be required for more than one audit is called.........................

8. The process of formalising audit arrangements ahead of time of implementing is called...........................

9. A quantitative statement of the cost and revenue expectations of an audit assignment which will enable the auditor to determine the profitability of the audit is called..............................

10. Those schedules prepared by auditors setting out those procedures to be executed during the audit in order to obtain audit evidence from which the auditors draw conclusions on the financial statements is called....................................

SOLUTIONS TO MULTIPLE CHOICE QUESTIONS

1. E
2. D
3. A
4. B
5. E

SOLUTIONS TO SHORT ANSWER QUESTIONS

6. Working papers
7. Permanent Audit file
8. Audit planning
9. Audit budget
10. Audit programme

CHAPTER SIX

AUDIT EVIDENCE AND VERIFICATION PROCEDURES

CHAPTER CONTENTS

a. Nature and Scope of Audit Evidence
b. Obtaining Audit Evidence
c. Sources of Audit Evidence
d. Third Party Confirmations
e. Reliability of Third-Party Evidence
f. Using the Work of an Expert
g. Management Representation
h. Verification of Asset and Liabilities
i. Quality Control
j. Peer Review

OBJECTIVES

At the end of this chapter, the reader should be able to:

(a) describe the sources and relative merits of different types of evidence available;
(b) describe what is sufficiently appropriate audit evidence;
(c) describe the financial statement assertions commonly reported on;
(d) explain how the auditor uses assertions in obtaining audit evidence;
(e) outline the audit procedures for obtaining audit evidence;
(f) outline examples of situations where external confirmation may be used;
(g) describe how the auditor should design external confirmation requests.
(h) distinguish between positive and negative confirmation.
(i) explain how the auditor should deal with responses from external confirmations; and
(j) explain the importance of Management representation as audit evidence.

6.1 NATURE AND SCOPE OF AUDIT EVIDENCE

The purpose of this session is to provide guidance on what constitutes audit evidence in an audit of financial statements, the quantity and quality of audit evidence to be obtained, and the audit procedures that auditors use for obtaining that audit evidence.

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

6.1.1 THE CONCEPT OF AUDIT EVIDENCE

"Audit evidence" is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. It includes the information contained in the accounting records underlying the financial statements prepared by management and other information.

Auditors are not expected to address all information that may exist. In forming the audit opinion, the auditor does not examine all the information available because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor ordinarily finds it necessary to rely on audit evidence that is persuasive rather than conclusive. However, to obtain reasonable assurance, the auditor is not satisfied with audit evidence that is less than persuasive. The auditor uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of audit evidence, and thus, its sufficiency and appropriateness, to support the audit opinion.

6.1.2 Types of Audit Evidence

Audit evidence can be obtained in various forms. They include the following:

a. **Accounting Records**

Accounting records generally include the records of initial entries and supporting records, such as cheques and records of electronic fund transfers, invoices, contracts, the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in formal journal entries, and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations and compliance objectives.

b. **Financial Statements Prepared by Management**

Management is responsible for the preparation of the financial statements based upon the accounting records of the entity. The auditor obtains some audit evidence by testing the accounting records, for example, through analysis and review, re-performing procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

However, because accounting records alone do not provide sufficient audit evidence on which to base an audit opinion on the financial statements, the auditor will need to obtain other audit evidence.

c. **Other Audit Evidence**

Other information that the auditor may use as audit evidence includes: minutes of meetings; confirmations from third parties; analysts reports; information obtained by the auditor from such audit procedures as inquiry; observation; and inspection; and other information developed by; or available to; the auditor that permits the auditor to reach conclusions through valid reasoning.

6.1.3 Sufficient ~~a~~nd Appropriate Audit Evidence

Sufficiency is the measure of the quantity of audit evidence. ***Appropriateness*** is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also, by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of records and documents related to the collection of receivables after the period end may provide audit evidence regarding both existence and valuation, although, not necessarily the appropriateness of period-end cut-offs. On the other hand, the auditor often obtains audit evidence from different sources or of a different nature that is relevant to the same assertion.

For example, the auditor may analyse the aging of accounts receivable and the subsequent collection of receivables to obtain audit evidence relating to the valuation of the allowance for doubtful accounts. Furthermore, obtaining audit evidence relating to a particular assertion (for example, the physical existence of inventory), is not a substitute for obtaining audit evidence regarding another assertion (for example, the valuation of inventory).

The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made, however, such generalizations are subject to important exceptions. Even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

a. Audit evidence is more reliable when it is obtained from independent sources outside the entity.
b. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
c. Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
d. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
e. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

An audit rarely involves the authentication of documentation, nor is the auditor trained as or expected to be an expert in such authentication. However, the auditor must consider the reliability of the information to be used as audit evidence: for examples, photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information. In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity's information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence which is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations, the auditor may determine that additional audit procedures are needed. For example, the additional procedures may include using computer-assisted audit techniques (CAATs) to recalculate the information.

The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from a management representation. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional audit procedures are necessary to resolve the inconsistency.

The auditor considers the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an audit procedure for which there is no alternative.

6.2 OBTAINING AUDIT EVIDENCE.

The auditor obtains audit evidence using assertions and through audit procedures.

a. **The Use of Assertions in Obtaining Audit Evidence**

Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. In representing that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

The auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby, designing audit procedures that are responsive to the assessed risks.

Assertion used by the auditor fall into the following categories:

i. Assertions about classes of transactions and events for the period under audit, which include;
   - occurrence – transactions and events that have been recorded have occurred and pertain to the entity,
   - accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately,
   - cut-off transactions and events have been recorded in the correct accounting period, and
   - classification – transactions and events have been recorded in the proper accounts.

ii. Assertions about account balances at the period end, which include;
   - existence – assets, liabilities, and equity interests exist,
   - rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity,
   - completeness – all assets, liabilities and equity interests that should have been recorded have been recorded, and
   - valuation and allocation – assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Assertions about presentation and disclosure, which include;
   - occurrence and rights and obligations – disclosed events, transactions, and other matters have occurred and pertain to the entity,
   - completeness – all disclosures that should have been included in the financial statements have been included,
   - classification and understandability – financial information is appropriately presented and described, and disclosures are clearly expressed, and
   - accuracy and valuation on financial and other information are disclosed fairly and at appropriate amounts.

The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the "assertions about transactions and events" with the "assertions about account balances". As another example, there may not be a separate assertion related to cut-off of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

b. **The use of Audit Procedures for Obtaining Audit Evidence**

The auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:

i. obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels (audit procedures performed for this purpose are referred to as "risk assessment procedures");

ii. test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (Audit procedures performed for this purpose are referred to as "tests of controls"); and

iii. detect material misstatements at the assertion level (audit procedures performed for this purpose are referred to as "substantive procedures" and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures).

iv. The auditor always performs ***risk assessment procedures*** to provide a satisfactory basis for the assessment of risks at the financial statement and assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion, however, they are supplemented by further audit procedures in the form of tests of controls, when necessary, and substantive procedures.

Tests of controls are necessary in two circumstances. When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor is required to test those controls to support the risk assessment. In addition, when substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor is required to perform tests of controls to obtain audit evidence about their operating effectiveness.

The auditor plans and performs substantive *procedures* to be responsive to the related assessment of the risks of material misstatement, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental, however, it may not be sufficiently precise to identity all risks of material misstatement. Also, there are inherent limitations to internal control, including the risk of management override, the possibility of human error and the effect of systems changes. Therefore, substantive procedures for material classes of transactions, account balances, and disclosures are always required to obtain sufficient appropriate audit evidence.

6.3 SOURCES OF AUDIT EVIDENCE

Specifically, the auditor uses one or more of the following types of audit procedures to obtain audit evidence:

i. Inspection of records or documents;
ii. Physical Inspection of tangible assets;
iii. Observation;
iv. Inquiry;
v. Confirmation;
vi. Recalculation;
vii. Re-performance; and
viii. Analytical Procedures.

These audit procedures, or combinations thereof, may be used as risk assessment procedures, test of controls or substantive procedures, depending on the context in which they are applied by the auditor. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance.

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. Source documents, such as purchase orders, bills of lading, invoices, and cheques may be replaced with electronic messages. For example, entities may use electronic commerce or image processing systems. In electronic commerce, the entity and its customers or suppliers use connected computers over a public network, such as the internet, to transact business electronically. Purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. In images processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic information may exist at a certain point in time. However, such information may not be retrievable after a specified period of time if files are changed and if backup files do not exist. An entity's data retention policies may require the auditor to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

When the information is in electronic form, the auditor may carry out certain of the audit procedures described below through Computer Assisted Audit Techniques (CAATs.)

i Inspection of Records or Documents

Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form, or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source, and in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of control is inspection of records or documents for evidence of authorization.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In additions, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Documentary evidence is least reliable if created and held by the entity (e.g. invoices). It is more reliable if created by third parties and held by the entity (e.g. a supplier's Statement). It is most reliable if it is created by third parties and held by the auditor (e.g. responses to debtor circularization).

The auditors should consider whether the conclusions drawn from different sources are consistent with each other. When evidence obtained from different sources are inconsistent with each other, the reliability of each becomes doubtful and would require further corroboration from other sources.

ii. **Physical Inspection of Tangible Assets**

Inspection of tangible assets consists of physical examination of the assets. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.

iii. **Observation**

Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. (See ISA 501, "Audit Evidence – Additional Considerations for Specific Items" for further guidance on observation of the counting of inventory).

iv. **Inquiry**

Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedure.

The auditor performs audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide a sufficient audit evidence to material misstatement at the assertion level. Moreover, inquiry alone is insufficient to test the operation effectiveness of controls.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions with respect to assets or liabilities, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information about management's intent.

In respect of some matters, the auditor obtains written representations from management to confirm responses to oral inquiries. For example, the auditor ordinarily obtains written representations from management on material matters when other sufficient appropriate audit evidence cannot reasonably be expected to exist or when the other audit evidence obtained is of a lower quality.

v. **Confirmation**

Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, the auditor may seek direct confirmation of receivables by communication with debtors. Confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. Confirmations are also used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

vi. **Re-calculation**

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed through the use of information technology, for example, by obtaining an electronic file from the entity and using CAATs to check the accuracy of the summarization of the file.

vii. **Re-performance**

Re - performance is the auditor's independent execution of procedures of controls that were originally performed as part of the entity's internal control, either manually or through the use of CAATs, for example, re-performing the ageing of accounts receivable.

viii. **Analytical Procedures**

Analytical procedures consist of evaluation of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts

Examples of analytical procedures include the following:

- A comparison of payroll costs on a monthly basis taking account of wage rises, starters and leavers and seasonal work
- A comparison of sales with expenses, on a monthly basis and as a comparison with prior years
- A comparison of the ageing inventory or debtors on a monthly or quarterly basis and calculation of debtor days or invemtory turnover

Analytical procedures are widely used but its usefulness is limited by such factors as the predictability of relationships and the availability, relevance and comparability of information. They are also limited by the auditor's knowledge of the client's business and the availability of other types of evidence.

6.4 RELIABILITY OF THIRD-PARTY EVIDENCE

The purpose of this session is to provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.

The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.

The reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

Accordingly, audit evidence in the form of original written responses to confirmation requested and received directly by the auditor from third parties who are not related to the entity being audited, may assist in reducing the risk of material misstatement for the related assertions to an acceptably low level.

6.4.1 Meaning of External Confirmation

External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related disclosures. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

External confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, what the relevant details are. External confirmations may also be used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. Other examples of situations where external confirmations may be used include the following:

a. Bank balances and other information from bankers;
b. Accounts receivable balances;
c. Inventories held by third parties at bonded warehouses for processing or on consignment;
d. Property title deeds held by lawyers or financiers for safe custody or as security
e. Investment purchased from stockbrokers but not delivered at the statement of financial position date;
f. Loans from lenders; and
g. Accounts payable balances.

The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate audit procedures in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

6.4.2 Designing of the External Confirmation Request

The auditor should tailor external confirmation requests to the specific audit objective. When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the audit evidence obtained through external confirmation procedures.

6..4.3 Use of Positive and Negative Confirmations

The auditor may use ***positive*** or ***negative*** external confirmation requests or a combination of both.

a. ***A positive external confirmation request*** asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct.

   The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.

b. ***A negative external confirmation request*** asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit audit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests, ordinarily provides less reliable audit evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

   Negative confirmation requests may be used to reduce the risk of material misstatement to an acceptable level when:

   i. the assessed risk of material misstatement is lower;
   ii. a large number of small balances is involved;
   iii. a substantial number of errors is not expected; and
   iv. the auditor has no reason to believe that respondents will disregard these requests.

   A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small numbers of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

6.4.4 Management Requests

When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.

If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.

When considering the reasons provided by management, the auditor applies an attitude of professional scepticism and considers whether the request has any implications regarding management's integrity. The auditor considers whether management's request may indicate the possible existence of fraud or error. The auditor also considers whether the alternative audit procedures will provide sufficient appropriate audit evidence regarding that matter.

6.4.5 Characteristics of Respondents

The reliability of audit evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

The auditor may also assess whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention.

6.4.6 The External Confirmation Process

When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests. Control is maintained over communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor ensures that:

- it is the auditor who sends out the confirmation requests;
- that the requests are properly addressed; and
- it is requested that all replies are sent directly to the auditor.

The auditor considers whether replies have come from the purported senders.

6.4.7 No Response to a Positive Confirmation Request

The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.

Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor uses alternative audit procedures. The nature of alternative audit procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative audit procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide audit evidence for the existence assertion, and examination of sales near the period-end to provide audit evidence for the cut-off assertion. In the examination of accounts payable, alternative audit procedures may include examination of subsequent cash disbursements or correspondence from third parties and examination of other records, such as goods received notes.

6.4.8 Reliability of Responses Received

The auditor considers whether there is any indication that external confirmations received may not be reliable. The auditor considers the response's authenticity and performs audit procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor requests the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor considers validating the source of replies received in electronic format (for example, fax or electronic mail). Oral confirmations are documented in the working papers. If the information in the oral confirmation is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor.

6.4.9 Causes and Frequency of Exceptions

When the auditor forms a conclusion that the confirmation process and alternative audit procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should perform additional audit procedures to obtain sufficient appropriate audit evidence.

In forming the conclusion, the auditor considers the:

a) reliability of the confirmations and alterative audit procedures;

b) nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; and

c) audit evidence provided by other audit procedures.

Based on this evaluation, the auditor determines whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

The auditor also considers the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the audit evidence required.

6.4.10 Evaluating the Results of the Confirmation Process

The auditor should evaluate whether the results of the external confirmation process together with the results from any other audit procedures performed, provide sufficient appropriate audit evidence regarding the assertion being audited.

6.4.11 External Confirmations Prior to the Year-End

When the auditor uses confirmation as at a date prior to the statement of financial position to obtain audit evidence to support an assertion, the auditor obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated. Depending on the assessed risk of material misstatement, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the statement of financial position date. As with all types of pre-year-end work, the auditor considers the need to obtain further audit evidence relating to the remainder of the period.

6.5 SPECIFIC EXAMPLES OF THIRD-PARTY CONFIRMATIONS

Commonly used external verification procedures are circularization of debtors, bank confirmations, and confirmation of pending legal matters.

6.5.1 Debtors Circularization:

Debtors' circularization is a verification procedure whereby trade debtors are contacted directly to confirm their balances. It is the normal means of checking whether the debtors really owe the amount stated in the sales ledger of the client company.

Many audit firms use debtors‟ circularization so extensively that they have developed standardized formats for the purpose.

Circularization should produce a written statement from each debtor contacted that the amount owed at the date of the circularization is correct. This is reliable audit evidence, being from an independent source, and in a documentary form. Circularization is essentially an act of the client, who alone can authorize third parties to divulge information to the auditors. Should the client refuse to co-operate in the circularization, the auditors will have to consider whether they should qualify their audit report, as they may not be able to satisfy themselves, by means of other procedures, the validity and accuracy of the debtor's balances.

Ideally, the circularization should be done immediately after the year end to enable it cover the year-end balances included in the statement of financial position . Where time constraint would not make this ideal timing possible, it may be appropriate and acceptable to carry out the circularization some time prior to the year-end. It is recommended that prior year-end circularization should be done not more than two months before the year-end. Prior year circularization may be appropriate in a situation where the internal control system is strong enough to ensure that the circularization and reconciliation of the movements in the sales ledger balances in the intervening period will provide the auditors with reasonable assurance.

When circularization is done, the method of requesting the information from the debtors may be either "positive" or "negative"; in either case the debtor is requested to reply directly to the auditors.

a) Positive Circularization

This requires, in every case, confirmation of details of sums shown as outstanding in the records of the debtors. It is appropriate under the following circumstances, where:

i. the auditor is not satisfied with the control systems governing sales and maintenance of debtors accounts;

ii. other verification work on the records of sales and debtors did not show satisfactory results; and

iii. the usefulness of the positive method depends largely upon the auditor's tenacity in following up the non-replies through telephone and personal calls.

Specimen of positive confirmation letter
Praise-him Plc,
P. O. Box 4268,
Monrovia,
30 November, 2021

Goodman Enterprise

BALANCE AS AT 30 NOVEMBER, 2021

In accordance with the request of our auditors, Messrs PPP Chartered Accountants, we ask that you kindly confirm to them directly, your indebtedness to us as at 30 November 2021, which according to our records amounted to L$300,000,000 shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter "direct to" our auditors in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors directly of the amount shown by your records, and if possible detail in the reverse of this letter full particulars of the difference.

Yours faithfully,
For: Praise-him Plc

Alhaji Baba
Financial Accountant

- (Tear off Slip)

The amount shown above is/is not in agreement with our records as at 30 November 2021

Account No. 72100009 Signature ………………………….

Date: …………………………. Position …………………………...

The position according to our records is shown overleaf:

Note; * The letter is on the client company's letterhead, signed by the client,
* A copy of the statements is attached, and
* The response is sent directly to the auditor in a prepaid envelope.

b) Negative Circularisation

This requires, a reply only if the debtors disputes the balance shown on the form. Even, if this method is simpler and requires no follow up, it should only be used in the following circumstances, where:

i. the auditor already has a good deal of faith in the internal control governing sales and debtors;

ii. other verification work on the records of sales and debtors has already been executed and has shown a satisfactory result; and

iii. in conjunction, with a large and carefully selected sample, otherwise the value of the test may be negated by the number of debtors who simply throw such requests into the waste paper baskets.

c) **Sample Selection**

Skill is needed in selecting the sample of debtors account for circularization. It is important for the auditors to scrutinize the accounts individually to ensure that the sample includes the special cases of accounts which may be significant, such as:

i. Accounts which show credit balances;
ii. Accounts which have been written off as bad, or against which specific provision for loss has been made;
iii. Active accounts which have nil balances;
iv. Accounts which remain unpaid beyond the normal period;
v. Accounts showing balances which habitually exceed the designated credit limits; and
vi. Accounts showing balances which are materially smaller at the statement of financial position date than the usual amount outstanding, i.e. where it appears that the balance has been specially reduced at the year end to escape the auditor's attention;
vii. Accounts of debtors known to have connections with the client company or its officers
viii. Accounts which reveal usually favourable terms of trade in terms of discounts, credit period and credit terms allowed
ix. Accounts which, when in arrears, do not appear to be followed up by normal credit control procedures and vigorously as would be expected.

d) **Follow-up procedures**

The auditor will have to carry out further work in relation to those debtors who disagree with the balances stated and those who do not respond. In the case of disagreements, the debtor's response should have identified specific amounts which are disputed.

In the case of positive circularization, the auditors must follow-up, by all practical means those debtors who fail to respond. Second request should be sent out in the event of no reply being received within two or three weeks and where necessary, this may be followed by telephoning the customer, with the client's permission.

Where the auditors face any limitation in the follow-up procedures, they may apply other auditing tests to establish the validity and accuracy of the debtors balance at the date of verification.

Alternative procedures in lieu of confirmation of individual debtors include the following:

i. Checking cash receipts from debtors after date; verify valid purchase orders;
ii. Examining the account to find out if the balance outstanding represents specific invoices and confirm their validity;
iii. Obtaining explanations for invoices remaining unpaid after subsequent ones have been paid;

iv. Checking if the balance on the account is growing, and if so, why? and

v. Testing the company's control over the issue of credit notes and the writing off of bad debts.

Additional procedures where circularization is carried out before year end include:

Review and reconcile entries made in the debtors control account for the intervening period

Reconcile entries in the sales journal, sales invoices and dispatch notes to entries in the debtors control account

Check the correctness and appropriateness of credit entries made in respect of returned goods and other allowances

Select a sample from the cash received records and ensure that receipts have been credited to the control account

Review the list of balances at the circularization date and year-end

Investigate any unexpected movements or lack of them. It may be necessary to send further confirmation requests at the year-end to material debtors where review results are unsatisfactory

Carry out analytical review procedures, comparing debtors' ratios at the confirmation date and year-end

Carry out-year-end cut-off tests, in addition to any performed at the dated of the confirmation

e. **Recording and Evaluation of Circularization Results**

It is essential that all circularization results are properly recorded and evaluated. All balances disagreements and non-replies must be followed up and their effect on total debtors evaluated. Differences arising that merely represent invoices or cash in transit generally, do not require adjustment, but disputed amounts, and errors by the client might require adjustment.

6.5.2 Bank Confirmations

Auditors rely heavily on bank confirmation for verification of completeness, existence, rights, obligations and valuations of bank balance.

Specimen of Bank Confirmation Letter

CAT, RAT & CO
(CHARTERED ACCOUNTANTS)

11 April, 2022

The Manager
Excellent Bank Ghana Limited
Opeibea House Branch
P. O. Box KIA 2020
Monrovia

Dear Sir,

KEEPWELL PLC

BANK CONFIRMATION - AUDIT FOR THE YEAR ENDING 31 DECEMBER 2021

In connection with our audit of the financial statements of the above, and with the authority evidenced by the company's stamp and signature below, we request that you provide us with a certificate giving the following information on its account with you at the close of business on **31 DECEMBER 2021**

a. Balances on all current, deposit and term accounts, stating whether these are free, blocked, or subject to any other withdrawal or restriction such as compensating balances or special – purpose funds. If any of the accounts, although having operated during the last twelve months, have no balance at the above stated date, please give a description of such accounts in your reply;

b. The name and date of closure of any accounts, which have been closed during the year, ending on the above date;

c. Balances on all advance, loan or overdraft accounts stating the terms, interests, etc. and collateral security or guarantees that you hold in connection therewith;

d. Its liability in connection with notes receivable or bills of exchange which it has discounted with you or deposited with you for collection;

e. Any guarantees you have given on its behalf or that it has given to you on behalf of third parties;

f. A list of all share certificates and securities deposited with you for its accounts, indicating whether these were free for withdrawal or were subject to any lien, pledge or other restriction;

g. Amounts of interest and charges to be paid by it, and of interest due to it, not yet included in the balances as of the above stated date;

h. Details of any other operations with you, and of any matters in the course of execution, which have not been included in the above paragraphs; and

i. A lists of officers entitled to sign cheques on all of the accounts which it has with you, indicating the way in which they must be combined;

It is desired that your certificate should cover all of the above matters and it should indicate by an appropriate mention those that are not applicable in its case.

Your prompt reply direct to the above address would be appreciated.

Thanking you in advance for your co-operation.

Yours faithfully,

CAT, RAT & CO
(CHARTERED ACCOUNTANTS)

We hereby give authority to supply the information requested by our auditors.

Company stamp Authorizing signature

Company name Name(s)

Matters excluded from the Standard Bank letter

The standard bank letter contains all items found to be regularly required for audit purpose. In case of doubt, or specific requirement, auditors may wish to make supplementary requests regarding other items which are not regularly required. These may include the following:

i. copies of bank statement;
ii. copies of paying-in-slips for specified lodgments on specified dates;
iii. details showing make-up of those lodgments;
iv. any list of securities or any document of title which have been logged by a bank with its customer us security for deposit with that bank (this particular matter would probably apply only between banking organizations);

v. interest on any account paid to or by third parties, and the names of those third parties;
vi. receipts for fire and other insurance and similar documents in the banks possession;
vii. returned paid cheques;
viii. stopped cheques – these are normally presented through the banking system within the audit period and therefore there should be no need to seek specific details;
ix. details of third party securities, including director's guarantees. If this information is required, the request must be accompanied by a specific authority from the appropriate third parties; and
x. details of outstanding forward foreign exchange contracts, including the particulars of each contract, the dates of maturity and the currencies concerned.

6.5.3 Legal Confirmation -Pending Legal Matters

Confirmation will often be required from a client company's legal advisors or solicitors regarding contingent liabilities arising from legal matters outstanding at the statement of financial position date. From the audit view-point, pending law suits and other actions and claims against the client company may present problems both of ascertainment and appraisal.

The following audit procedures are relevant for the verification of the existence of such claims, (though they will not necessarily provide the auditor with adequate information on the likely amounts for which the company may ultimately be responsible):

(a) Reviewing the claims system of recording claims and the procedure for bringing these to the attention of the management;
(b) Discussing the arrangements for instructing solicitor's with the official responsibility for legal matters (for example, the head of the legal department, if any, or the company secretary);
(c) Examining the minutes of the board of directors or other relevant committee for references to or indication of possible claims;
(d) Examining bills rendered by solicitors and correspondence with them;

(e) Obtaining a list of matters referred to solicitors from the appropriate director or official with estimates of the possible ultimate liabilities; and
(f) Obtaining a written assurance from the appropriate director or official that he is not aware of any matters referred to solicitors other than those disclosed.

In appropriate circumstances, auditors may decide to obtain written confirmations from third parties of certain representations made by directors, for example the identification and appraisal of contingent liabilities. In the field of legal actions, the normal and proper source of such confirmation is the company's legal advisors.

Requests for such confirmations should be kept within the solicitor – client relationship and the client should request that a copy of the reply should be sent direct to the auditors.

In order to ascertain whether the information provided by the directors is complete, auditors may decide to arrange for solicitors to be requested to advise whether they have matters in hand which are not listed in the letter of request, and to provide information as to the likely amounts involved.

If the outcome of the enquiries set out above appears satisfactory, auditors would not normally regard the absence of a corroboration of the completeness of a list of legal matters as a reason in itself for qualifying their report.

If the enquiries lead to the discovery of significant matters not previously identified, the auditors will wish to extend their enquiries and to request their clients to address further enquiries to, or arrange a meeting with, the solicitors, at which the auditors will wish to be present.

If however, having regard to all the circumstances, the auditors are unable to satisfy themselves that they have received all the information they require for the purpose of their audit, they must qualify their report.

Specimen of Lawyer's Confirmation

29 May 2022

Bob and Sons Legal Consults
523 Eko Street,
Victoria Island
Lagos   Nigeria

Dear Sir,

RE: LEGAL CONFIRMATION- PEACE AND PROSPERITY PLC FOR THE YEAR ENDED 31 DECEMBER 2021

In connection with the audit of our financial statements as of 31 December 2021 and for the year then ended, please furnish to our independent auditors, CAT, RAT & Co Chartered Accountants, P.O Box KA 4040, Beach Street, Victoria Island, Lagos, a brief description of any litigation involving our Company as either plaintiff or defendant, which was pending or threatened at the date indicated above or which has subsequently been initiated and with respect to which you have devoted substantive attention or represented or counselled. In addition, please furnish a description of any other matters with respect to which you have given substantive attention or represented or counselled, involving a claim or potential claim or contingent liability by or against this Company at 31 December 2021

Please, furnish directly to CAT, RAT & Co Chartered Accountants such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters with respect to which your views may differ from those stated and identification of the omission of any material settled litigation and claims relating to this company.

Your response should include matters that existed as of 31 December 2021 and additional information about those matters or new matters that arose during the period from 31 December to the effective date of your response.

Please specifically identify the nature of and reasons for any limitation on your response to this letter.

Your response will not be quoted or referred to in our financial statements without prior consultation with you.

Please send your response directly to CAT, RAT & Co Chartered Accountants; P.O Box KA 4040 Beach Street, Victoria Island, Lagos, with a copy to us.

Yours faithfully,

Pa Joe
Chief Executive Officer

6.5.4 Summary of third-party confirmations

The circumstances under which auditors, in course of their verification process, requests for external confirmation are varied. The table below, however, provides some examples of assets and liabilities whose verification may require third party confirmation.

Table 6.1

Assets/Liabilities	Confirming Third Party
Bank balance, Security, Bank loans Contingent liabilities, Accrued interests	Bank
Debtors and creditors balances	Individual Debtors and Creditors
Staff Loans, advances, Mortgages Accrued Interest	Individual members of staff/ Financial Houses
Assets held abroad, Goods sent to agents, on consignment, and out on sale or return, Liabilities repayable abroad	Overseas agents, Association firms, Agents, Consignees and Sales or return holders
Information pertaining to investments in subsidiary companies	Auditors of subsidiaries

Goods held in bond or in warehouse	Harbour board, Warehouse Company
Lease premises	Landlord of leased premises
Pending litigation possible damages, costs and legal fees outstanding	Solicitors

6.6 THE RELIABILITY OF AUDIT EVIDENCE

The reliability of audit evidence is influenced by its sources (internal or external) and by its nature (Visual, documentary or oral). The generalisations may help in assessing that reliability. These factors are as stated below:

a) Audit evidence from external sources (e.g. confirmation received from a third party) is more reliable than that obtained from the entity's records;

b) Audit evidence obtained from the entity's record is more reliable when the related accounting and internal control system operates effectively;

c) Evidence obtained directly by auditors is more reliable than that obtained by or from the entity;

d) Evidence in the form of documents and written representations is more reliable than oral representations; and

e) Original document are more reliable than photocopies, telexes or facsimiles.

Consistency of audit evidence from different sources will have a collaborating effect, making the evidence more persuasive where such evidence is inconsistent, the auditors must determine what additional procedure are necessary to resolve the inconsistency.

Auditors must consider the cost-benefit relationship of obtaining evidence but any difficulty or expense is not in itself a valid basis for omitting a necessary procedure.

6.7 USING THE WORK OF AN EXPERT

The purpose of this sub-chapter is to provide guidance on using the work of an expert as audit evidence.

When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.

"Expert" means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation, such as an actuary or engineer.

An expert may be:

a) Engaged by the entity;
b) Engaged by the auditor;
c) Employed by the entity; or
d) Employed by the auditor.

When the auditor uses the work of an expert employed by him, that work is used in the employee's capacity as an expert rather than as an assistant on the audit. Accordingly, in such circumstances the auditor will need to apply relevant procedures to the employee's work and findings but will not ordinarily need to evaluate for each engagement, the employee's skills and competence.

6.7.1 Determining the Need to Use the Work of an Expert

In obtaining an understanding of the entity and performing further procedures in response to assessed risks, the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples include the following:

a. Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones;
b. Determination of quantities or physical condition of assets, for example, minerals stored in inventory piles, underground mineral and petroleum reserves, and the remaining useful life of plant and machinery;
c. Determination of amounts using specialized techniques or methods, for example, an actuarial valuation;
d. The measurement of work completed and to be completed on contracts in progress; and
e. Legal opinions concerning interpretations of agreements, statutes and regulations.

When determining the need to use the work of an expert, the auditor would consider:

i. The engagement team's knowledge and previous experience of the matter being considered;
ii. The risk of material misstatement based on the nature, complexity, and materiality of the matter being considered; and
iii. The quantity and quality of other audit evidence expected to be obtained.

6.7.2 Competence and Objectivity of the Expert

When planning to use the work of an expert, the auditor should evaluate the professional competence of the expert. This will involve considering the expert's:

a) Professional certification or licensing by, or membership in, an appropriate professional body; and

b) Experience and reputation in the field in which the auditor is seeking audit evidence.

The auditor should evaluate the objectivity of the expert.

The risk that an expert's objectivity will be impaired increases when the expert is:

i) employed by the entity; or

ii) related in some other manner to the entity, for example, by being financially dependent upon or having an investment in the entity.

If the auditor is concerned regarding the competence or objectivity of the expert, the auditor needs to discuss any reservations with management and consider whether sufficient appropriate audit evidence can be obtained concerning the work of an expert. The auditor may need to undertake additional audit procedures or seek audit evidence from another expert

6.7.3 Scope of the Expert's Work

The auditor should obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purposes of the audit. Audit evidence may be obtained through a review of the terms of reference which are often set out in written instructions from the entity to the expert. Such instructions to the expert may cover matters such as the following:

a. The objectives and scope of the expert's work;

b. A general outline as to the specific matters the auditor expects the expert's report to cover;

c. The intended use by the auditor of the expert's work, including the possible communication to third parties of the expert's identity and extent of involvement;

d. The extent of the expert's access to appropriate records and files;

e. Clarification of the expert's relationship with the entity, if any;

f. Confidentiality of the entity's information; and

g. Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods.

In the event that these matters are not clearly set out in written instructions to the expert, the auditor may need to communicate with the expert directly to obtain audit evidence in this regard. In obtaining an understanding of the entity, the auditor also considers whether to include the expert during the engagement team's discussion of the susceptibility of the entity's financial statements to material misstatement.

6.7.4 Evaluating the Work of the Expert

The auditor should evaluate the appropriateness of the expert's work as audit evidence regarding the assertion being considered. This will involve evaluation of whether the substance of the expert's findings is properly reflected in the financial statements or supports the assertions, and consideration of:

a. Source data used;

b. Assumptions and methods used and their consistency with prior periods; and

c. Results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures.

When considering whether the expert has used source data which is appropriate in the circumstances, the auditor would consider the following procedures:

i. Making inquiries regarding any procedures undertaken by the expert to establish whether the source data is relevant and reliable; and
ii. Reviewing or testing the data used by the expert.

The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor will need to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.

If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter. This may involve discussions with the entity and the expert, applying additional audit procedures, including possibly engaging another expert, or modifying the auditor's report.

6.7.5 Reference to an Expert in the Auditor's Report

When issuing an unmodified auditor's report, the auditor should not refer to the work of an expert. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

If, as a result of the work of an expert, the auditor decides to issue a modified auditor's report, in some circumstances it may be appropriate, in explaining the nature of the modification, to refer to or describe the work of the expert's (including the identity of the expert and the extent of the expert's involvement). In these circumstances, the auditor would obtain the permission of the expert before making such a reference. If permission is refused and the auditor believes a reference is necessary, the auditor may need to seek legal advice.

6.8 MANAGEMENT REPRESENTATION

The purpose of this sub-chapter is to provide guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

Acknowledgement by Management of its Responsibility for the Financial Statements

The auditor should obtain audit evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements. The auditor can obtain audit evidence of management's acknowledgment of such responsibility and approval from relevant minutes of meetings of those charged with governance or by obtaining a written representation from management or a signed copy of the financial statements.

Representations by Management as Audit Evidence

The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing, *(Matters which might be included in a letter from management or in a confirmatory letter to management are contained in the example of a management representation letter in the Appendix to this section)*

Written representations requested from management may be limited to matters that are considered either individually or collectively material to the financial statements. Regarding certain items, it may be necessary to inform management of the auditor's understanding of materiality.

The auditor should obtain written representation from management that:

a) it acknowledges its responsibility for the design and implementation of internal control to prevent and detect error; and
b) it believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.

During an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements, the auditor will need to:

i. seek corroborative audit evidence from sources inside or outside the entity;

ii. evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
iii. consider whether the individuals making the representations can be expected to be well informed on the matters.

Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has, or may have, a material effect on the financial statements and such audit evidence is expected to be available; this will constitute a limitation in the scope of the audit, even if a representation from management has been received on the matter.

In certain instances, audit evidence other than that obtained by performing inquiry, may not be reasonably expected to be available, therefore the auditor obtains a written representation by management. For example, the auditor may not be able to obtain other audit evidence to corroborate management's intention to hold a specific investment for long-term appreciation or managements' intention to call up a debt before month end balancing and granting the facility again at the beginning of the new month.

If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

Documentation of Representations by Management

The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.

A written representation is ordinarily more reliable audit evidence than an oral representation and can take the form of:

a) a representation letter from management;
b) a letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or
c) relevant minutes of meeting of the board of directors or similar body or a signed copy of the financial statements.

Basic Elements of a Management Representation Letter

When requesting a management representation letter, the auditor would request that it be addressed to the auditor, contain specified information and be appropriately dated and signed.

A management representation letter would ordinarily be dated the same date as the auditor's report. However, in certain circumstances, a separate representation letter regarding specific transactions or other events may also be obtained during the audit or at a date after the date of the auditor's report, for example, on the date of a public offering.

A management representation letter would ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects (ordinarily the Chief Executive Officer and the Chief Financial Officer) based on the best of their knowledge and belief. In certain circumstances, the auditor may wish to obtain representation letters from other members of management. For example, the auditor may wish to obtain a written representation about the completeness of all minutes of the meetings of shareholders, the board of directors and important committees from the individual responsible for keeping such minutes.

Example of a Management Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next.

Although seeking representations from management on a variety of matters may serve to focus management's attention on those matters, and thus cause management to specifically address those matters in more detail than would otherwise be the case, the auditor needs to be cognizant of the limitations of management representations as audit evidence.

(Entity Letterhead)

(Date)

(To Auditor)

LETTER OF REPRESENTATION

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended 31 December, XXXX. For the purpose of expressing an opinion as to whether the financial position of ABC Company as of 31December, XXXX and of the results of its operations and its cash flows for the year then ended in accordance with (indicate applicable financial reporting framework).

We acknowledge our responsibility for the fair presentation of the financial statements in accordance with provisions of International Financial Reporting Standards.

We confirm, to the best of our knowledge and belief, the following representations:

a. There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements;

b. We have made available to you all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors (namely those held on 15March, XXXX and 30 September, XXXX respectively);

c. We confirm the completeness of the information provided regarding the identification of related parties;

d. The financial statements are free of material misstatements, including omissions;

e. The Company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance;

f. The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements;

   i. The identity of, and balances and transactions with, related parties,
   ii. Losses arising from sale and purchase commitments,
   iii. Agreements and options to buy back assets previously sold, and
   iv. Assets pledged as collateral.

g. We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements;

h. We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realisable value;

i. The Company has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements;

j. We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note X to the financial statements all guarantees that we have given to third parties;

k. Other than……… described in Note X to the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or Notes thereto;

l. The ……… claim by XYZ company has been settled for the total sum of XXX which has been properly accrued in the financial statements. No other claims in connection with litigation have been or are expected to be received;

m. There are no formal or informal compensating balance arrangements with any of our cash and investment account. Except as disclosed in Note X to the financial statements, we have no other line of credit arrangements; and

n. We have properly recorded or disclosed in the financial statements the capital stock repurchase options and agreements, and capital stock reserved for options, warrants, conversions and other requirements.

Signed

(Chief Financial Officer)

Signed

(Chief Executive Officer)

Action if Management Refuses to Provide Representations

If management refuses to provide a representation that the auditor considers necessary, the audit should discuss it with management. The refusal constitutes a scope of limitation and the auditor should express a modified opinion. In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider if the other implications of the refusal may have any additional effect on the auditor's report.

6.9 VERIFICATION OF ASSETS AND LIABILITIES

In the auditing standard, it is expected of the auditor to ascertain the existence of the company's assets and liabilities at a statement of financial position date. This would enable the auditor to be able to form an opinion on the true and fair view of the financial statements as at the statement of financial position date, the auditor has a duty to verify all the assets and liabilities appearing in the statement of financial position as well as to ensure that there are no other assets and liabilities which ought to appear in the statement of financial position.

6.9.1 Verification of Assets

In assets verification, the auditor seeks to establish:

a) Cost;
b) Authorisation;
c) Value;
d) Existence;
e) Beneficial ownership; and
f) Presentation in the account.

These aspects can be remembered by the mnemonic CAVEBOP. It is very important that the client's internal accounting system be studied, documented, tested and evaluated by the auditor. When verifying assets at a statement of financial position date, it is possible to divide the aspects into four classes:

i) Valuation;
ii) Existence;
iii) Beneficial ownership; and

iv) Presentation and the disclosure in the accounts

However, the cost and authorisation of such assets would have been verified in the year of acquisition hence, we use another mnemonic VEBOP. In respect of assets acquired during the current year under review, the verification steps of CAVEBOP will apply.

6.9.2 Verification of Trade Debtors and Creditors

Reference has been made to the independent verification of certain assets and liabilities by means of externally derived confirmations. This method has the obvious advantage of minimising the risk of collusion between third parties and the company's staff with a view to deceiving the auditor. As a general rule, we may regard any form of independent documentary evidence as superior, in terms of usefulness to the auditor, to documentary evidence compiled by members of the company's staff, irrespective of their level of authority.

It is common practice for auditors to circularise a carefully selected sample of the company's debtors and creditors respectively as means of:

a) ensuring the accuracy of book entries in the sales and bought ledger, and the resulting balances;
b) ensuring the proper functioning of the system of credit control as laid down by the directors;
c) identifying accounts in dispute; and
d) ensuring that records concerned are completely up to date.

Where suppliers are circularized, the independence confirmations received will support not only the creditors ledger balances, but also the monthly statements which most suppliers send to their customers anyway.

Circularisation of Debtors: Many audit firms use external confirmations so extensively that they have developed standardised formats for the purpose. The circularisation (with the client's permission) of a sample of debtors, requesting them to confirm the amounts outstanding, is an obvious example. Despite the low response rate, this is still a common practice and takes two forms:

a. the negative circular, which requires a reply only if the debtor disputes the balance shown on the form; and

b. the positive circular, which requests in every case confirmation of details of sums shown as outstanding in the records of the debtor.

The negative method is simpler and requires no follow up. The usefulness of the positive method, by contrast, depends largely upon the auditor's tenacity in following up the non-replies, by telephone or even personal call if necessary.

It is essential that replies be sent to the auditor directly at his own office, otherwise there is a risk of tampering or suppression by client staff.

6.9.3 Verification of Inventory and Work In Progress (WIP)

It is the responsibility of the management of an entity to ensure that the amount of which stocks are shown in the financial statements represents stocks physically in existence and includes all inventories owned by the entity, while the auditor has a duty to obtain necessary evidence to satisfy himself as to the ownership, existence and condition of inventories valued at the year end.

The reasons why auditors pay particular attention to audit of inventories and WIP are that inventory usually constitutes one of the largest items in the statement of financial position, hence a relative small error in inventory will have a material effect on the financial statements. The following are other reasons:

a. Closing inventory affects cost of sales and therefore profit and loss directly
b. Invemtory could be manipulated to achieve a targeted profit and loss
c. Different accounting bases are used in the valuation of inventory
d. There may be problem of valuation, determination of the existence and stages of development of some specialised Inventory in livestock, production product etc.

The objectives of inventory taking include:

a. To verify the condition of inventories;
b. To verify the existence of inventories
c. To establish title of inventory;
d. To determine the accuracy of cut-off;
e. To ascertain the effectiveness of internal control system over inventory
f. To provide a basis for checking the correctness of inventory records;
g. To ensure that adequate provision has been made for slow moving and obsolete inventories;
h. To provide a basis for the quantity required for the valuation of inventories; and
i. To determine the accuracy of inventory valuation

6.9.4 Liability Verification

A statement of financial position will contain many liabilities grouped under various headings. The heading may include:

a) Equity
b) Reserves;
c) Creditors: amounts falling due after more than one year;
d) Provisions for liabilities and charges;
e) Creditors: amount falling due within one year; and
f) Contingent liabilities

However, the auditor's duty is to:

i. verify the existence of liabilities shown in the statement of financial position
ii. verify the correctness of the money amount of such liabilities
iii. verify the correctness of the money amount of such liabilities
iv. verify the appropriateness of the description given in the accounts and the adequacy of disclosure
v. verify that all existing liabilities are actually included in the accounts

Verification Procedures

It is not possible to detail the procedures for verifying all possible liabilities.

However, some general principles can be discerned and these should be applied according to the particular set of circumstances met within practice or in an examination. Some of them are:

a. **Schedule**: Request or make a schedule for each liability or a class of liabilities;

b. **Cut-off**: Verify cut-off. For example a trade creditor should not be included unless the goods were acquired before the year end;

c. **Reasonableness**: Consider reasonableness of the liability;

d. **Internal control:** Determine, evaluate and test internal control procedures;

e. **Previous date clearance**: Consider the liabilities at the previous accounting date. Have they all been cleared?

f. **Authority**: The authority for all liabilities should be sought;

g. **Description**: Ensure that the description in the accounts of each liability is adequate;

h. **Documents**: Examine all relevant documents. These will include invoices, correspondence, debenture title deeds etc; according to the type of liability;

i. **Vouching**: The creation of each liability should be vouched, e.g. receipt of a loan;

j. **Accounting policies**: The auditor must satisfy himself that appropriate accounting policies have been adopted and applied consistently.;

k. **Disclosure**: All matters which need to be known to receive a true and fair view must be disclosed;

l. **External verification:** With many liabilities, it is possible to verify the liability directly with the creditors;

m. **Materiality**: Materiality comes into all accounting and auditing decisions;

n. **Post-statement of financial position event**: Very important in this area than in any other;

o. **Accounting standards**: Liabilities must be accounted for in accordance with the relevant accounting and auditing standards; and

p. **Risk:** Assess the risk of misstatement

6.9.5 Verification of Non-Current Assets

The verification of non-current assets will often commence with an examination of asset registers. One main use of asset registers to the auditor is to facilitate the identification of assets during a physical check. They also form an important part of the system of internal control. The register must be agreed with the financial records and enquiries as to the extent and frequency of checks by company officials on the reconciliation of financial records, assets register and physical assets.

An asset register will normally contain the following information for each asset:

i. Suppliers name;
ii. date of purchase;
iii. original cost;
iv. estimated useful life;
v. estimated residual value;
vi. summary of expenditure on repairs to date;
vii. estimated replacement cost entered at annual intervals; and
viii. details of eventual disposal

6.9.6 Verification of Intangible Assets

The types of assets we are likely to encounter under this heading include goodwill, patents, trademarks, copyrights, etc. All intangibles have a finite economic life and should hence be amortised. The following special points may provide a brief but useful summary of documents to be examined and procedures to be observed in relation to these types of assets.

a. **Goodwill**

In a company, situation will arise on purchase of a business. Then:
i. examine contract and allocation of purchase price to asset; and
ii. Normally remains in accounts at cost.

b. **Patents**

i. Examine patent and assignment, which can only be granted to individual (perhaps employee), who will assign to company;
ii. Payment of renewal fees; and
iii. Accounting for royalties' receivable.

c. **Trademarks**

i. Certificate issued by patent office;
ii. Assignment if purchased;

iii. Reasonableness of design costs capitalised; and
iv. Payment of renewal fees.

d. **Copyrights**

i. Document of title;

ii. Assignment if purchased; and

iv. Life is author's life plus 50 years.

6.9.7 Physical Examination

This is part of the procedures used by the auditor during the course of carrying out the audit exercise in order to support his or her conclusion regarding fairness of the assertions contained in the financial statement. The auditor uses his or her professional judgment in determining when sufficient evidence has been gathered. In exercising that judgment, the auditor should consider the nature of the item under examination, the materiality of possible errors and irregularities associated with the items, the degree of relative risk associated with the item and the quality and quantity of evidential matter that is readily available to him or her on a cost effective basis. It involves physical inspection to ascertain existence of assets and liabilities.

6.10 QUALITY CONTROL

Introduction

According to International Standard on Quality Control (ISQC) the audit design establishes a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm are appropriate in the circumstance. Quality control should also promote observance if the personal standards are relevant to the work of an auditor. The objectives of quality control procedures are the same for all firms. It is important for all firms to put in place a functional-quality control process. For each firm, the exact nature and extent of the procedures needed will depend on its size and the nature of its practice, the number of its officers and its organisation.

The following procedures should be adopted to control an audit plan:

a. Allocate work to audit staff, spelling out when each aspect of the job is supposed to be completed; and
b. Brief staff fully on the following;

i. Determine the standard of performance required; and
ii. State the possible problems that may crop up.

The Audit Risk areas that demand special attention are:

a. Precise instruction should be given to audit staff that they should bring the following to the attention of the team leader:
   - Problem(s) encountered; and
   - Any put upon enquiry i.e. benefits of doubts

b. Audit working papers should be thoroughly and meticulously completed to ensure that all audit actions taken are recorded.

c. Review of audit work done and the working papers completed by the more senior partner who should make their own comments and observation and further instructions, alongside what are recorded by the audit staff.

Use of completion checklist: Each audit staff should tick off a section he has completed on the check list including the final review by the partner who is not necessarily on the audit assignment but who may determine as appropriate for the exercise of overall quality control.

Features of Audit Quality Control

The quality control procedure of any audit can normally take the following features or characteristics:

a. **Hierarchy of Control within the Firm**

The lines of communication inside a firm flow along the following hierarchy either way.

i. The partner;
ii. The manager;
iii. The audit senior;
iv. The senior audit trainee; and
v. The junior audit trainee

The ultimate responsibility for the quality control of audit work rests with the relevant reporting partner.

b. **Audit Planning**

More often than not, audit firms audit many business organisations whose financial years end on the same date with each one clamouring for audit visits and the firm is usually constrained by limited staff, to plan their audit so as to make the maximum use of their staff at minimum cost in terms of time and money to their clients without compromising on efficiency and quality.

c. **Audit Staff**

The audit team for a particular audit should whenever possible, contain experienced staff already familiar with that audit. Any new staff should be given adequate training.

d. **Communication with Client and Third Parties**

Communication with the client should be along three lines. In the first place, the head of the accounts department of the client organisation should be consulted to verify the readiness of his department to receive the audit team. Second, the internal audit department should be contacted for possible help and cooperation. Last but not the least, there should be a close liaison, all the year round, with top management of the client organisation with a view to securing first-hand information such as structural changes and legal actions and decisions without delay.

e. **Timing of the Audit**

The importance of having audited account promptly and the need to keep down audit cost necessitate the breaking up of the audit work into areas which can be done before, during and after the end of the financial year.

f. **Audit Field Work**

The field work involves the proper execution of the audit plan. There should be an adequate assessment and thorough evaluation of the existing internal control and accounting system to determine the scope of the audit.

g. **Audit Reviews and Consultation**

Before the audit report is finalised, the reporting partner should carry out a thorough review of all the audit field work. All recordings, documents and evidence arising from the field work and programmes used should be reviewed, in conjunction with the letter of engagement and the audit completion check list.

h. **Audit Report**

The audit report should reflect the sum total of the audit work carried out and the evidence collected. It should be worded in such a way as to leave the reader in no doubt as to the meaning and implication it has for the financial statements audited. The report should state the compliance or otherwise of the financial statement with regulatory requirements, accounting principles and auditing standards.

6.11 PEER REVIEW

The audit firms have suffered serious consequences as a result of negligence in the work they perform. In order to mitigate the incidence of litigation giving rise to losses, firms have taken measures to ensure that they improve on the quality of their work and reduce the losses they suffer.

Peer review is the process through which the firms have agreed to set up mechanisms for the review of the processes adopted by each other with a view to identifying practice weaknesses which could be addressed to improve the quality standards in the respective practices.

This is a new audit approach that is not common in Nigeria. It involves a review of an audit firm's systems, procedures and strategies by another audit firm of comparable size, reputation and standard.

Peer review is not so common for the following reasons

a. Cost may be prohibitive;
b. Legality and confidentiality of allowing others to go through a client's file is not protected; and
c. Exposure of one procedure and standard to competing audit firm is inevitable.
   The reviewer is expected to report on the following:
   i. Acceptance and retention of client;
   ii. Means of engaging, training, allocating and motivating staff;
   iii. Independence, integrity and competence; and
   iv. The conduct of individual audit and other engagements.

6.12 CHAPTER SUMMARY

a. The financial statement assertions are existence, rights and obligations, occurrence, completeness, valuation, measurement, presentation and disclosure;
b. Auditors are required to obtain sufficient appropriate audit evidence on which to base audit opinions;
c. Substantive tests may be incorporated with other procedures like tests of control to obtain the required audit evidence;
d. Documentary evidence is least reliable if created and held by the entity, most reliable if created and held by third parties;
e. Among the key techniques used to obtain audit evidence are Inspection, Observation, Enquiry, Confirmation, Computation, Re-performance and analytical procedures; and
f. Examples of third party confirmations include debtors and creditors circularization, and request for bank references through bank letter.
g. Management representations are also sought to provide evidence in key areas where other sources may be less reliable. This is normally given in the form of management representation letter.

MULTIPLE-CHOICE QUESTIONS

1. The examination of the documentary evidence in support of the transactions of an organisation is known as

   A. Verification
   B Observation
   C Vouching
   D Physical inspection
   E Analytical review

2. Positive method of circularising debtors can be used in the following situations **EXCEPT:**

A. Where there are numerous small accounts to be circularised
B. Where there is need to confirm the existence and amount of the debt
C. Where the condition of the internal control system is not satisfactory
D. Where the condition of the internal control system is satisfactory
E. Where the amount of the debt is material

3. "Auditors should plan the audit work so as to perform the audit in an effective manner"

A The statement is true
B The statement is not true
C Writing audit planning is enough
D Writing management report will suffice
E Auditors' prior year knowledge will suffice

4. The following assertions about audit evidence are correct **EXCEPT:**

A. Evidence is more reliable when it is obtained from sources outside the entity
B. All evidence is acceptable
C. Evidence provided by original documents is more reliable
D. Reliability of audit evidence is influenced by its source
E. Internally generated evidence is reliable when control is effective

5. Situations where external confirmations may be used include all **BUT ONE** of the following:

A. Account Receivable balances
B. Bank balances and other information from bankers
C. Account Payable Balances
D. Property agreed in prior year audit
E. Inventories held by third parties at bonded warehouse for processing

SHORT ANSWER QUESTIONS

6. Information obtained by the auditor which enables him to arrive at the conclusions necessary for his opinion on financial statements is called ....

7. Written requests by a client to its debtors or creditors for confirmation of their outstanding balances as at a given date is called...

8. When planning to use the work of an expert, the auditor should evaluate the .... and .... of the expert.

9. The representations by management, explicit or otherwise that are embodied in the financial statements are called ....

10. State **TWO** methods of obtaining audit evidence.

SOLUTIONS TO MULTIPLE CHOICE QUESTIONS

1. C
2. A
3. A
4. B
5. D

SOLUTIONS TO SHORT ANSWER AND MULTIPLE-CHOICE QUESTIONS

6. Audit evidence

7. Circularisation

8. Any two of the following:

   - Professional competence
   - Independence
   - Experience
   - Reputation

9. Assertions

10. Any two of:

    a) Physical inspection

    b) Observation e.g. inventory taking

    c) Enquiry i.e. communicating with third party
    d) Computation e.g. arithmetical accuracy
    e) Analytical procedures e.g. ratios
    f) Re-computation

CHAPTER SEVEN

AUDIT TESTS AND SAMPLING PROCEDURES

CHAPTER CONTENTS

a. Audit Sampling
b. Substantive testing procedures
c. Verification of statement of financial position items
d. Analytical procedures
e. Audit procedures for subsequent events and contingencies
f. Audit procedures for going concern basis in financial statements g. Quality control for Audit Work

OBJECTIVES

After completion of this chapter, the reader should be able to:

a. explain the role sampling techniques play in auditing;

b. draw audit programmes appropriate for substantive testing for key audit areas;

c. verify the existence, valuation, ownership, presentation and disclosure of statement of financial position items;

d. conduct analytical review procedures;

e. outline audit procedures relevant to events occurring after the statement of financial position date and contingencies;

f. outline the indications for going concern difficulties; and

g. describe the quality control procedures required at assignment level and at the firm level.

7.1 AUDIT SAMPLING

The purpose of this chapter is to provide guidance on the use of audit sampling for selecting items for testing when designing audit procedures to gather audit evidence.

When designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather sufficient appropriate audit evidence to meet the objectives of the audit procedures.

7.1.1 Definitions

a. ***Audit sampling*** involves the application of audit procedures to less than 100 percent of items within a class of transactions or account balance such that all sampling units have a chance of being selected. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.

b. ***Error*** means either control deviations, when performing tests of controls, or misstatements, when performing tests of details. Similarly, total error is used to mean either the rate of deviation or total misstatement.

c. ***Anomalous error*** means an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.

d. ***Population*** means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. For example, all of the items in a class of transactions or account balance constitute a population. A population may be divided into strata, or sub-populations, with each stratum being examined separately. The term population is used to include the term stratum.

e. ***Sampling risk*** arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same procedures e.g.:

   i) The risk the auditor will conclude, the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material error does not exist when in fact it does. This type of risk affects audit effectiveness and is more likely to lead to an inappropriate audit opinion

   ii) The risk the auditor will conclude, in the case of a test of controls, that controls, are less effective than they actually are, or in the case of a test of details, that a material error exists when in fact it does not. This type of risk affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect. The mathematical complements of these risks are termed confidence levels.

f. **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. For example, ordinarily the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive, the auditor might use inappropriate audit procedures, or the auditor might misinterpret audit evidence and fail to recognize an error.

g. **Sampling Unit** means the individual items constituting a population (for example cheques listed on deposit, credit entries on bank statements, sales invoices or debtors balances) or a monetary unit.

h. ***Statistical sampling*** means any approach to sampling that has the following characteristics:

   i. Random selection of a sample items; and;
   ii. The use of probability theory to evaluate sample results, including measurement of sampling risk.

   A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling

i. ***Stratification*** is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

j. ***Tolerable Error*** is the maximum error in a population that the auditor is willing to accept.

7.1.2 Selecting Items for Testing to Gather Audit Evidence

When designing audit procedures, the auditor should determine appropriate means of selecting items for testing. The means available to the auditor are:

a) Selecting all items (100 percent examination);
b) Selecting specific items; and
c) Audit sampling

The decision as to which approach to use will depend on the circumstances, and the application of any one or combination of the above means may be appropriate in particular circumstances. While the decision as to which means, or combination of means, to use is made on the basis of the risk of material misstatement related to the assertion being tested and audit efficiency, the auditor needs to be satisfied that the methods used are effective in providing sufficient appropriate audit evidence to meet the objectives of the audit procedure.

Selecting all Items

The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). One hundred (100) percent examination is unlikely in the case of tests of controls; however, it is more common for tests of details. For example, 100 percent examination may be appropriate when the population constitutes a small number of large value items, when there is a significant risk and other means do not provide sufficient appropriate audit evidence, or when the repetitive nature of a calculation or other processes performed automatically by an information system makes a 100 percent examination cost effective, for example, through the use of Computer-Assisted Audit Techniques (CAATs).

Selecting Specific Items

The auditor may decide to select specific items from a population based on such factors as the auditor's understanding of the entity, the assessed risk of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

a. *High Value or key items:* The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristics, for example items that are suspicious, unusual, particularly risk-prone or that have a history of error.

b. *All items over a certain amount:* The auditor may decide to examine items whose values exceed a certain amount so as to verify a large proportion of the total amount of class of transactions or account balance.

c. *Items to obtain information:* The auditor may examine items to obtain information about matters such as the nature of the entity, the nature of transactions and internal control.

d. *Items to test control activities:* The auditor uses judgment to select and examine specific items to determine whether or not a particular control activity is being performed.

While selective examination of specific items from a class of transactions or account balance will often be an efficient means of gathering audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population. The auditor considers the need to obtain sufficient appropriate audit evidence regarding the remainder of the population when that remainder is material.

The auditors should select sample items in such a way that the sample can be expected to be representative of the population. For a sample to be representative of a population, all items in the population are required to have an opportunity of being selected.

Audit sampling

The auditor may decide to apply audit sampling to a class of transactions or account balances. Audit sampling can be applied using either non-statistical or statistical sampling methods.

a. **Statistical versus non-statistical sampling approaches**

The decision whether to use a statistical or non-statistical approach is a matter for the auditor's judgment regarding the most efficient manner to obtain sufficient appropriate audit evidence in the particular circumstances. For example, in the case of tests of controls the auditor's analysis of the nature and cause of errors will often be more important than the statistical analysis of the mere presence or absence (that is, the count) of errors. In such a situation, non-statistical sampling may be most appropriate.

When applying statistical sampling the sample size can be determined using either probability theory or professional judgment. Moreover, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Often, while the approach adopted does not meet the definition of statistical sampling elements of a statistical approach are used, for example the use of random selection using computer generated random numbers. However, only when the approach adopted has the characteristics of statistical sampling are statistical measurements of sampling risk valid.

b. **Conditions favouring the use of statistical sampling**

The following factors (conditions) need to be present before the use of statistical sampling can be contemplated:

i. The population (the total number of items or transactions to be examined) must be sufficiently large. The potential margin of error is minimal with large numbers. The question of what the minimum size of population should be to justify the use of statistical sampling can best be answered in a particular context.

ii. The system that produces the records to be tested must be sufficiently reliable. If there is no system worthy of the name, it would be dangerous for the auditor to believe that any transaction recorded within it is representative. Where orderliness and regularity are absent, there may be little alternative but to conduct vouching audit involving the detailed examination of almost all the recorded transactions.

iii. All items within a particular population must be homogenous i.e. they must fall within the same category. Thus, items must fall within the same materiality bands and the recording of all items within the population must be effected in the same manner and must be subjected to the same internal checks and control.

iv. All items within the population must be both identifiable and accessible. The validity of any sample depends on the requirement that each item within the population must stand on equal chance of being selected for examination. It is when all the items within the population are identifiable and accessible that this requirement can be met.

c. **Advantages associated with statistical sampling**

The following advantages are associated with statistical sampling:

i. At the conclusion of a test, the auditors are able to state with a definite level of confidence that the whole population conforms to the sample result, within a stated precision limit.
ii. Sample size is objectively determined; having regard to the degree of risk the auditors are prepared to accept for each application.
iii. The process of fixing required precision and confidence levels compels the auditors to consider and clarify audit objectives.
iv. The results of test can be expressed in precise mathematical terms
v. To a large extent, bias in selecting sample units is eliminated.

d. ***Disadvantages of statistical sampling***

Disadvantages of statistical sampling include the following:

i. Auditing has never been a mathematical discipline, and a highly developed intuition has always been a more valuable audit attribute than the possession of mathematical knowledge.
ii. Mathematically valid sampling schemes take long time, during which time a good deal of representative random sampling could have been conducted, with the reasonable assurance that its conclusions might be valid for audit purposes.
iii. Statistical sampling invariably results in the examination of sample size much smaller than those traditionally used by auditors. The validity of the conclusion drawn therefore depends upon rigid adherence to the tenets of the discipline and thus upon the technical grasp by all members of the audit team of the statistical principles involved.
iv. Many of the decisions which have to be reached before a sampling scheme can be implemented are invariably based on subjective view. Many auditors are therefore suspicious of the validity of the technique or in the least analysis, of how a court of law might view audit conclusion arrived at in this way.
v. Statistical sampling often needs back-up by further tests within the population reviewed: large items, non-routine items, sensitive items etc.

7.1.3 Judgmental Sampling

This means selecting a sample of appropriate size on the basis of the auditor's judgment of what is desirable.

a. Advantages associated with non-statistical (judgmental) sampling

The advantages associated with non-statistical (judgmental) sampling are as follows:

i. It has been in use for many years and lend itself for easy application through experience.
ii. No special knowledge of statistics is required, after all auditing has never been a quantitative subject.
iii. No time is wasted in playing with mathematics
iv. The auditor can bring his judgment to play, using the sixth sense.

b. **Disadvantages of judgmental sampling**

i. It is unscientific
ii. It is wasteful-usually sample size are too large
iii. No quantitative results are obtained
iv. Personal basis in the selection of samples is unavoidable
v. There is no real logic to the selection of the sample or its size
vi. The sample selection can be imbalanced to meet the auditor's need e.g. selection of items, near the year end to help with cut-off evaluation
vii. The conclusion reached on the evidence from samples is usually vague.

7.1.4 Design of the Sample

When designing an audit sample, the auditor should consider the objectives of the audit procedure and the attributes of the population from which the sample will be drawn. These are:

a. The auditor first considers the specific objectives to be achieved and the combination of audit procedures which is likely to best achieve those objectives. Consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling.

b. The auditor considers what conditions constitute an error by reference to the objectives of the audit procedure. A clear understanding of what constitutes an error is important to ensure that all, and only, those conditions that are relevant to the objectives of the audit procedure are included in the projection of errors. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client are not considered an error. Also, a mis-posting between customer accounts does not affect the total accounts receivable balance. Therefore, it is not appropriate to consider this an error in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the likelihood of fraud or the adequacy of the allowance for doubtful accounts.

c. When performing tests of controls, the auditor generally makes an assessment of the rate of error the auditor expects to find in the population to be tested.

The assessment is based on the auditor's understanding of the design of the relevant controls and whether they have been implemented or the examination of a small number of items from the population. Similarly, for tests of details, the auditor generally assesses the expected amount of error in the population. These assessments are useful for designing an audit sample and in determining sample size. For example, if the expected rate of error is unacceptably high, tests of controls will normally not be performed. However, when performing tests of details, if the expected amount of error is high, 100% examination or the use of a large sample size may be appropriate.

7.1.5 P*opulation*

It is important for the auditor to ensure that the population is:

a) *Appropriate* to the objective of the audit procedure, which will include consideration of the direction of testing. For example, if the auditor's objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing. On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers'-statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable; and

b) *Complete*. For example, if the auditor intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless the auditor is satisfied that all vouchers have in fact been filed. Similarly, if the auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period.

7.1.6 Value Weighted Selection

It will often be efficient in performing tests of details, particularly when testing for overstatements, to identify the sampling unit as the individual monetary units (for example, naira, dalasi, cedi, leone, CFA, etc.) that make up a class of transactions or account balance. Having selected specific monetary units from within the population for example, the accounts receivable balance, the auditor then examines the particular items, for example, individual balances, that contain those monetary units. This approach to defining the sampling unit ensures that audit efforts is directed to the larger value items because they have a greater chance of selection and can result in smaller sample sizes.

7.1.7 Sampling Size

In determining the sample size, the auditor should consider whether sampling risk is reduced to an acceptably low level. Sample size is affected by the level of sampling risk that the auditor is willing to accept. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.
The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment objectively applied to the circumstances.

7.1.8 Selecting the Sample

The auditor should select items for the sample with the expectation that all sampling units in the population have a chance of selection. Statistical sampling requires that sample items are selected at random so that each sampling unit has a known chance of being selected. The sampling units might be physical items (such as invoices) or monetary units. With non-statistical sampling, an auditor uses professional judgment to select the items for a sample. Because the purpose of sampling is to draw conclusions about the entire population, the auditor endeavours to select a representative sample by choosing sample items which have characteristics typical of the population, and the sample needs to be selected so that bias is avoided.

Selection Methods

The selection methods commonly used are:

(a) Random Sampling: This ensures that all items in the population have an equal chance of selection, for example by use of random number tables.

(b) Systematic Sampling: This involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection, the auditors need to ensure that sampling interval corresponds with a particular pattern in the population.

(c) Haphazard Sampling: This may be an acceptable alternative to random selection provided the auditors are satisfied that the sample is not unrepresentative of the entire population. When auditors use this method, care needs to be taken to guard against selecting which is biased, for example, towards items which are easily located, as they may not be representatives.

(d) Stratified Sampling: This involves the division of the population into layers or strata, each stratum being subjected to a separate test which could be conducted by random or interval sampling methods.
This technique is appropriate where the population consists of a wide range of values among the items under examination. Under such circumstances, the entire population would be split into a number of layers, each covering a specific range of values or prices, and each layer would then be subjected to a separate test.
The relative materiality of each stratum would determine the confidence level and precision range required.

(e) Cluster Sampling: This is suitable when data to be examined are stored in such a manner that the selection of group, or cluster, would be appropriate test. In these circumstances, each cluster cloud be allocated a number, the particular cluster to be tested being selected by the use of random table. The contents of the cluster selected could in turn be tested completely, or by random number, or by interval sampling.

The most precise results with this method will be obtained when each cluster contains a varied mixture as possible and any one cluster is as nearly like any other cluster as possible.

Cluster sampling is helpful when the population is so dispersed as to make other forms of selection either burdensome or excessively time consuming.

7.1.9 Performing the Audit Procedure

The auditor should perform audit procedures appropriate to the particular audit objective on each item selected.

If selected item is not appropriate for the application of the audit procedure, the audit procedure is ordinarily performed on a replacement item. For example, avoided check may be selected when testing for evidence of payment authorization. If the auditor is satisfied that the check had been properly voided such that it does not constitute an error, an appropriately chosen replacement is examined.

Sometimes however, the auditor is unable to apply the designed audit procedures to a selected item because, for instance, documentation relating to that item has been lost. If suitable alternative audit procedures cannot be performed on that item, the auditor ordinarily considers that item to be in error. An example of a suitable alternative audit procedure might be the examination of subsequent receipts when no reply has been received in response to a positive confirmation request.

7.1.10 Nature and Causes of Errors

The auditor should consider the sample results, the nature and cause of any errors identified, and their possible effect on the audit objective and on other areas of the audit.

When performing tests of controls, the auditor is primarily concerned with obtaining audit evidence that controls operated effectively throughout the period of reliance. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they applied, and by whom or by what means they were applied. The concept of effectiveness of the operation of controls recognizes that some errors in the way controls are applied by the entity may occur. However, when such errors are identified, the auditor makes specific inquiries to understand these matters and needs to consider matters such as:

a) The direct effect of identified errors on the financial statements; and

b) The effectiveness of internal control and their effect on the audit approach when, for example, the errors result from management override of a control

In these cases, the auditor determines whether the tests of controls performed provide an appropriate basis for use as audit evidence, whether additional tests of controls are necessary, or whether the potential risks of misstatement need to be addressed using substantive procedures.

Sometimes, the auditor may be able to establish that an error arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of similar errors in the population (an anomalous error). To be considered an anomalous error, the auditor has to have a high degree of certainty that such error is not representative of the population. The auditor obtains this certainty by performing additional audit procedures. The additional audit procedures depend on the situation, but are adequate to provide the auditor with sufficient appropriate audit evidence that the error does not affect the remaining part of the population. One example is an error caused by a computer breakdown that is known to have occurred on only one day during the period. In that case, the auditor assesses the effect of the breakdown, for example by examining specific transactions processed on that day and considers the effect of the cause of the breakdown on audit procedures and conclusions. Another example is an error that is found to be caused by use of an incorrect formula in calculating all inventory values at one branch. To establish that this is an anomalous error, the auditor needs to ensure the correct formula has been used at other branches.

Projecting Monetary Errors in Tests of Details

For tests of details, 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 audit objective and on other areas of the audit. The auditor projects the total error for the population to obtain a broad view of the scale of errors, and to compare this to the tolerable error. For tests of details, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the auditor's materiality used for the individual class of transactions or account balances being audited.

7.1.11 Evaluating the Sample Results

The auditor should evaluate the sample results to determine whether the assessment of the relevant characteristic of the population is confirmed or needs to be revised. In the case of tests of controls, an unexpectedly high sample error rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. In the case of tests of details, an unexpectedly high error amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

If the total amount of projected error plus anomalous error is less than but close to that which the auditor deems tolerable, the auditor considers the persuasiveness of the sample results in the light of other audit procedures and may consider it appropriate to obtain additional audit evidence. The total of projected error plus anomalous error is the auditor's best estimate of error in the population. However, sampling results are affected by sampling risk. Thus, when the best estimate of error is close to the tolerable error, the auditor recognizes the risk that a different sample would result in a different best estimate that could exceed the tolerable error. Considering the results of other audit procedures helps the auditor to assess this risk, while the risk is reduced if additional audit evidence is obtained.

If the evaluation of sample results indicates that the assessment of the relevant characteristic of the population needs to be revised, the auditor may:

a) Request management to investigate identified errors and the potential for further errors, and to make any necessary adjustments; and/or
b) Modify the nature, timing and extent of further audit procedures. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures; and/or
c) Consider the effect on the audit report.

7.1.12 Summary of Steps in Audit Sampling

The steps involved in audit sampling are summarised below:

a. Define the audit objective. Why is this test being carried out and what contribution does it make to the overall assessment of true and fair view.

b. Clearly define the population category. All units within the population must be complete.
c. Define the sample size. What percentage of the entire population is, or how many units within the population are to be selected for testing.
d. Selection of the items to be tested using the appropriate selection technique
e. Testing selected sample units
f. Evaluation of the results:

   i. analyses the error or deviation detected in relationship to the expected error rates
   ii. estimate the total error in the population based on the results of the sample testing conducted.
   iii. Ensure that the final expression of the conclusion is valid and is clearly documented in the current file.

7.2 SUBSTANTIVE TESTING PROCEDURES

Substantive procedures are performed in order to detect material misstatement of the assertion level, and include tests of details of class of transactions, account balances and disclosures and substantive analytical procedures.

The auditor plans and performs substantive procedures to be responsive to the related assessment of the risk of material misstatement irrespective of the assessed risk the auditor should design and perform substantive procedures for each material class of transactions, account balances and disclosure. The auditors' substantive procedures should include the following audit procedures related to the financial statement closing process.

a. agreeing the financial statement to the underlying accounting records and

b. examining material journal entries and other adjustments made during the course of preparing the financial statements.

When the auditor had determined that an assessed risk of material misstatement at the assertion level is a significant risk; the auditor should perform substantive procedures that are specifically responsive to that risk.

7.2.1 Nature of Substantive Procedures

Substantive analytical procedures are applied on large volume of transactions, which are predictable overtime. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain assertions about account balances, including existence and valuation. In designing substantive analytical procedures, the auditor considers such matters as the following:

a. the suitability of using substantive analytical procedures given assertions

b. the reliability of the data, whether internal or external from which the expectation of recorded amounts or ratios is developed
c. whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.

d. the amount of any difference is recorded amounts from expected values that is acceptable.

7.2.2 Substantive Testing Procedures for Key Audit Areas

A summary of basic substantive depth test which might be undertaken on the accounting transaction under the following key areas are listed as follows:

a. Sales and Receipts
b. Purchases and payments
c. Payroll

a. **Sales and Receipts Objectives**

i. To confirm the reliability, accuracy and completeness of the accounting.

ii. To confirm that all goods supplied were duly and properly invoiced and recorded.

Audit Programme

i. Test numerical sequence of dispatch notes
ii. Select a sample of transaction from the goods dispatched notes/goods outwards records (if no such record from sales day book)
  - Check to sales invoice
  - Check to sales day book
  - Trace goods from inventory records
  - Trace to proof of delivery records
iii. For each sales invoice selected:
  - Check with customer's orders
  - Check that credit procedures have been applied
iv. Compare prices charged with price lists, quotations or correspondence
v. Check calculations and additions of invoices
vi. Check analysis in sales daybook if applicable
vii. Check posting to the ledger
viii. For each receipt selected:
  - Check that the invoice has been paid per the sales ledger
  - Cash receipt to cashbook
  - Check to copy paying in slip identifying individual amount and trace to bank statement
ix. Test numerical sequence of sales invoice
x. Test the cast and cross-cast of the sales daybook and control account
xi. Test the postings of the sale daybook throughout the year for large or unusual items
xii. Selecting a sample of credit notes from the sales day book and vouch as follows:
  - vouch with correspondence or other original documents

- see those copies of credit note have been signed as authorized by a director or other senior official
- trace goods back into inventory where appropriate
- check analysis in sales daybook
- where returns affect commissions, check that proper adjustments have been made

xiii. Review the sales daybook throughout the year for large or unusual items

xiv. Check the sales daybook throughout the year for large unusual items

xv. Check credit notes through the year and verify that they have been signed and authorized by a director or other senior official. Vouch any large or unusual items

xvi. Test the assets and cross-casts of the receipts in the cash book

xvii. Confirm that discounts taken by credit customers are in accordance with the client's terms of trade

For each invoice selected:

- Ensure that payment has been made per purchase ledger
- Trace to cashbook, ensuring correct allocation to purchase ledger column
- Trace to Bank Statement
- Vouch returned cheques

xviii. Test numerical sequence of purchase invoice

xix. Test the casts and cross casts of the purchase day book to the nominal ledger

xx. Review the purchase daybook throughout the year for large or unusual items

xxi. Select a sample of goods returned to suppliers and ensure that credit notes have been received

xxii. Check additional and calculations on credit notes

xxiii. Select a sample of miscellaneous payments from the cash book

- verify authorization
- check additions and calculations on invoices
- check nominal ledger allocation
- vouch returned cheques

xxiv. Test the casts and cross-casts of the payment cash book

xxv. Test the postings of the payments cash book to the nominal ledger

xxvi. Test the posting of payments to replenish petty cash to the petty cash book

xxvii. Select a sample of payments from the petty cash book and

- vouch with supporting voucher and any independent evidence
- verify authorization
- check nominal ledge allocation

xxviii. Test miscellaneous receipts with supporting evidence

xxix. Scrutinize a sample of sales ledger accounts through the year and up to date of the audit, noting any large or unusual items

xxx. Scrutinize a sample of sales ledger accounts throughout the year and ensure that all credit items originate from books of prime entry that been subjected to audit testing.

b. **Purchase and Payments**

Objectives:

(i) To confirm the reliability, accuracy and completeness of the accounting:

(ii) To confirm that all incurred liabilities are recorded and that they represent goods or services actually received by the client.

Audit Programme:

i. Test numerical sequence of goods received notes
ii. Trace goods received notes to invoice or entry in day book
iii. Select a sample of invoice from the purchase day book (or payment from the cash book if no purchase day book) and perform the following:
    - verify authorisation
    - confirm that cash discounts were correctly taken
    - very price with order or agreements
    - confirm receipt of goods with delivery notes
    - check addition and calculations on invoice (including VAT)
    - check allocation in day books
    - check to inventory records
    - check to Work-in-progress records
iv. Scrutinize petty cash receipts for miscellaneous receipts. Vouch with available evidence and ensure correct ledger allocation

v. Test the casts and cross-casts of the petty cash book

vi. Test the posting of the petty cash book to the nominal ledger

viii. Scrutinize the petty cash throughout the year for large or unusual items.

c. **Payroll**

Objectives:

i. To ensure that levels of pay are in order
ii. To check accuracy and validity of deductions
iii. To confirm proper payments
iv. To test reasonableness of net pay figures
v. To confirm reliability, accuracy and completeness of the accounting entries
vi. To ensure correct treatment of PAYE and social security deductions.

Audit Programme

(i) Select a sample of employees from different periods in the year from both weekly payroll and monthly salaries and ensure that gross pay has been properly authorized by checking to:
    - lists of hourly rates;
    - lists of piece-work rates;
    - lists of overtime rates;
    - lists of annual salaries; and

- contracts of employment.

ii) For hourly paid employees, check the hours worked with the time records, and the authorisation of overtime and bonus payment
iii) For piece workers, check quantities with output returns of job slips initiated by a foreman
iv) Check that hours/quantities/gross pay (as appropriate) have been entered into cost records
v) Check additions of PAYE and NSITF deduction and cross-cast to Net pay
vi) For payments in cash, inspect receipts given by employees
vii) Trace gross wages to Income Tax deductions and to holiday pay records
viii) Trace a sample of net wages to cash book and vouch returned cheques
ix) Check wages summaries, check casts and cross-casts of summaries and check postings from summaries to the nominal ledger
x) Review month/weekly total payroll cost and investigate any unusual variations
xi) Check that authorisation of payroll is evidenced
xii) Trace a sample of joiners and leaver to the payroll ensuring that payments commence and end in the correct periods
xiii) Test payroll with contract of employment to ensure that all employees have valid contracts
xiv) If there are significant amounts paid in cash, then consider attending to observe pay-out procedures.

7.3 VERIFICATION OF STATEMENT OF FINANCIAL POSITION ITEMS

Verification is the process by which auditors seek confirmation of the existence, ownership, cost/valuation and appropriate presentation/disclosure of assets and liabilities.

Verification procedures rely heavily on the vouching work having been properly executed.

7.3.1 Specific Verification Objectives

The more specific verification objectives may be summarized as follows:

a. **Cost:** The auditor must ascertain what the client paid in acquiring or producing the asset. This must be supported by supplier's invoice and receipts; and the payment traced to the bank statement and cash book.

b. **Authorisation:** The auditor is concerned with the process of acquiring the asset. The acquisition must have passed through company's procedures for necessary approval and they must be supported by documents as evidence.

c. **Valuation**: The auditor must be satisfied that the assets appear in the statement of financial position at a fair value which may be, of course, different from the original cost. He is also concerned that liabilities are fairly valued i.e. they are stated at amounts at which they are likely to materialise for settlement. Auditors therefore ensure that apart from the correct determination of cost, depreciation or any other fall in value of assets has been fully taken into account on an acceptable basis.

d. **Existence**: The auditor should rely on physical verification procedures, wherever practicable, to verify the existence of assets and liabilities. Such physical tests should be carried out on a random selection basis (if 100% inspection is not practicable).

e. **Beneficial Ownership**: The auditor must conduct test to establish that the client is the beneficial owner of the assets existing and that the liabilities concerned are in fact required to be met by the client. In some instances, it is possible to verify ownership by reference to a `document such as leases or deeds in relation to a property; in other case, however, it may be necessary to rely on corroborative evidence or the representations of outside parties.

f. **Presentation/Disclosure**: The auditors must verify that the items in the Statement of financial position are appropriately presented and recognition has been given to full disclosure.

7.3.2 Verification Procedures

Procedures auditors may adopt to verify assets and liabilities include:

- Observation
- Inspection
- Enquiring and confirmation
- Computation
- Analytical review

(Refer to the chapter on audit evidence for detailed explanation of these procedures)

7.3.3 Verification Objectives and Programmes for Some Assets

a. **Non-Current Assets Objectives:**
- To determine whether non-current assets in the Statement of Financial Position are owned by the client company
- To verify that any non-current asset built or manufactured by the client has been capitalized
- To ascertain that assets have been recorded at cost or valuation and to determine whether depreciation and other provisions for fall in value have been computed on reasonable and consistent basis
- To verify physical existence
- To determine whether the amounts shown in the accounts are properly classified and presented.

Audit Programme:

- Obtain a summary of non-current assets under categories showing how the figures in the Statement of Financial Position are made up and reconcile with the figures shown in the previous statement of financial position. Cast and cross-cast
- Obtain schedules of additions during the year and for all classes of assets
- Test items with suppliers' invoices or other independent vouchers like the architects' certificates
- Test capital expenditure authorizations
- Check appropriateness of capitalization policies with respect to assets constructed by own labour
- Obtain schedules of disposals and test proceeds of sale with independent evidence like sale agreements
- Find out about assets scrapped during the year. Test authority for disposal
- Verify that original cost and accumulated depreciation have been eliminated from the fixed asset account
- Check calculations of profit or loss on disposals and agree with entries in the Statement of Profit or Loss and other Comprehensive Income
- Inspect or obtain certificates for title deeds and leases
- If any assets have been revalued during the year, obtain a copy of the valuation report. If the valuation is to be incorporated into the accounts then verify that the basis of the valuation is acceptable
- Verify the independence and qualifications of the valuers
- Confirm accounts disclosures
- Physically inspect samples of all types of assets
- Inspect assets registration documents, especially motor vehicles
- Obtain or prepare a schedule of outstanding capital expenditure distinguishing between items contracted for but not provided and items authorized by directors but not contracted for
- Verify depreciation rates have been approved by the board and review their reasonableness. If rates have been changed in the current year, obtain explanation
- Check calculations of depreciation
- Reconcile asset register with accounts
- Verify the adequacy of insurance cover on non-current assets.

b. Investments

Objectives:

- To determine whether there is documentary evidence of the ownership of the investment.
- To determine whether changes during the period represented *bonafide* transactions.

- To ascertain whether the basis on which the investments are stated is appropriate and the method employed in valuation has been consistently applied.
- To determine whether the amount shown in the statement of financial position are properly classified and described.

Audit Programme:

- Obtain or prepare analysis of investments and test clerical accuracy of the analysis
- Obtain third party confirmation and or make physical inspection of securities listed on the analysis
- Test interest and dividend incomes received and accrued by reference to supporting documents
- Check for additional acquisitions and redemptions during the year
- Review the treatments of capital distributions, bonus and rights issue
- Verify quoted prices for listed investments at statement of financial position date
- Determine whether unlisted investments at statement of financial position date are appropriately valued
- Check whether investments are properly described and classified as current assets or long term investments

c. **Debtors**

Objectives:

- To confirm accuracy and collectability of trade debtors balance
- To confirm provision for doubtful debts and its adequacy

Audit Programme:

- Examine sample of ledger accounts and all accounts with balances equal to or over the materiality factor and trace balances to summary lists
- Check the additions of the lists of balances and cross cast if analysed. Trace total to lead schedule
- Check that the total balances agree with the balances on the control account
- Examine control account for the year and verify unusual items
- Select balances for direct confirmation through debtor's circularization. Investigate discrepancies and reconcile
- If no circularization of debtors has been carried out, select a sample of balances and check payment after date. Trace such receipts to the paying in-book
- Examine accounts with credit balances and ensure that payments in respect of credit balances are authorized by responsible officials
- Ensure credit balances are separated and shown under creditors
- Verify that provision for doubtful debts and discounts are both reasonable and adequate

- Examine the credit control procedures and consider if any recommendations should be made. Check for the compliance with credit policy of the entity with respect to credit limits, credit period, cash discounts, etc.
- Verify that bad debts written off during the period were properly authorised and that all reasonable recovery procedures have been taken prior to the write-offs
- Examine ledger for transfer between accounts throughout the year. Verify reasons for this, and check authorization
- Examine credit notes issued after the year end and verify whether they relate to genuine sales
- Test returns during the period and ensure that credit notes are raised and posted accordingly.

d. **Cash at bank and in hand**:

Objectives:

- To confirm the existence and accuracy of the year-end balances
- To confirm the amounts shown in the statement of financial position are properly classified and adequately described

Audit Programme

Bank

- Obtain a copy of the year end bank reconciliation
- Compare cash book and bank statements in detail covering items in the reconciliation
- Trace all outstanding cheques to subsequent bank statements and ensure that they are cleared
- Verify by reference to paying-in-slips that lodgments outstanding were lodged with the bank prior to the end of the year
- Scrutinize bank statements for dishonoured cheques and investigate any such items
- Obtain direct from bankers a certificate of balance and check to reconciliation
- Check notes and security for overdraft to facilities agreement with the bankers.

Cash

- Obtain a statement setting out details of the cash in hand
- Count the cash at the year-end in presence of the cashier. Reconcile balance to year-end figure
- Verify that monies received on the last day of the financial year were duly banked on that date or included in the cash in hand balance

- Examine the pre-and post-yearend cash count and verify that all cheques drawn to replenish the petty cash fund have been entered in the records

e. **Trade Creditors**

Objectives:

- To confirm that all creditors existing or incurred at the statement of financial position date are recorded at the correct amount
- To confirm that all creditors shown represent genuine claims on the business
- to confirm that amounts included in the statement of financial position are stated on a consistent basis and properly described and classified

Audit Programme

- Test extraction of purchases ledger
- Reconcile ledger balances with suppliers statements
- Where suppliers statements are not available, verify the balances through circularization
- Check casting of list of balances and trace total to lead schedule
- Verify that the list of balances agrees to the control account
- Examine list of debit balances and ensure separated and shown under debtors
- Enquire into the reasons for debt balances and ensure that they are recoverable
- Review the procedures adopted for ensuring that goods received up to the statement of financial position, but not invoiced by the supplier have been provided for and taken up as inventory (if appropriate) and test by reference to delivery note and goods received notes
- Review terms of trade of major suppliers to determine whether their terms of trade include a reservation of title
- Reconcile inter-company or inter branch balance
- Check for correct classification and disclosure.

7.4 VERIFICATION OF INVENTORIES

7.4.1 Problems Associated with Verification of Inventories.

Of all the statement of financial position items of manufacturing and trading organizations the one that requires attention in terms of verification is inventories (Raw materials, consumables, Work-in-progress, parts, loose tools, finished goods, lubricants and fuel, etc.). From the auditor's point of view, this had always been the asset that possess the greatest verification difficulties. This is because:

- The amount at which the inventories are stated in the financial statements is almost always material especially in the case of manufacturing companies
- The amount at which it is stated has direct „one-to-one effect on the company’s financial results. Any overstatement of the inventory figure represents an overstatement by equal amount of the profit figure (or understatement of the loss)

It is the only item in the published accounts which does not also feature in the closing trial balance, i.e. it does not arise from the double entry process itself. In some accounting systems, production costing and financial accounting will be integrated to give a book figure for work-in-progress, but in majority of cases, the determination of inventories is largely dependent upon physical inventory taking procedures. This factor makes the inventory figure the most susceptible to manipulation

In the case of manufacturing companies, it is not really one asset at all. It consists of raw materials, components, spare parts, work-in-progress, advertising materials, consumables, finished goods, and each of these creates their own verification difficulties.

The verification process sometimes involves a special highly technical approach which lies far beyond the auditors‟ expertise

Apart from identification of goods, there is also the question of their condition. Example of categorization (each of which is quite distinct and carries its own valuation basis) include:

- sound
- defective
- slow moving
- obsolete
- scrap, etc.

Such categorization may have significant impact upon statement of financial position values, yet the auditor, in most cases, would lack the required competence to question or comment on the categorization.

- Another verification problem is the fact that inventories may be held in a variety of locations, counting of which should take place simultaneously to avoid omission and double counting caused by subsequent movement of inventory between locations.

- Further, the location of a particular inventory may be a moving production line or a construction site to and from which inventories and machines are constantly being conveyed, and is it unlikely that work will be deliberately halted purposely for inventory taking.

- Yet another problem is the fact that certain inventory items pose identification and measuring problems, for example, how does one measure large volumes of power on liquid? It is by volume or by weight

7.4.2 Verification Objectives

Objectives which verification of inventories and work-progress seeks to achieve include the following:-

- To confirm that all inventory inventories and work-in-progress belonging to the client has been brought into accounts
- To confirm that all inventories belonging to others in possession of the client have been separately identified, counted, reconciled and excluded from the valuation
- To confirm that all obsolete, damaged or slow moving inventories have been separately identified and stated at realizable value
- The value at which inventory and work-in-progress is stated in the statement of financial position is correctly calculated on a basis consistent with previous years
- Security arrangements for safe custody of inventory and work-in-progress are adequate.

7.4.3 Audit Programme for Verification of Inventory Quantity

a. Prior to the inventory-take, review the client's own inventory taking instructions to its staff and consider whether they are adequate. Ensure that the inventory taking procedures questionnaire has been completed.

   Note any weakness in the system which would invalidate the reliability of the count and bring to the audit manager's attention immediately so that he may discuss the problem with the client.

b. Attend to observe the physical count and ensure that the client's inventory taking procedures are followed and in particular, that:

   i. All slow moving, obsolete or damaged inventories are segregated and counted separately and clearly marked on the inventory sheets

   ii. All store~~s~~ locations are covered by the count

   iii. All slow moving, obsolete or damaged inventories are segregated and counted separately and clearly marked on the inventory sheets

   iv. All inventories belonging to third parties are counted and segregated on inventory sheets

v. All inventories sheets issued are accounted for, completed properly, dated and signed by the personnel carrying out the count.

c. Complete the standard inventory taking report

d. Obtain details of the last few goods outward and goods inwards/delivery notes for use in cut off tests

e. Ensure that all rough inventory sheets have been processed to make up the final inventory sheets

f. Check all quantities test checked at observation to final sheets

g. Test the extension and additions on the final inventory sheets

h. Check all final inventory sheets to inventory summary

i. Scrutinize the inventory sheets for obvious errors and compare with the comparative sheets for the previous years to ensure that no section of the inventory has been excluded

j. Select a sample of goods outward notes and check that the goods have been entered in the inventory records in the current year. Carry out a similar test for goods inwards/delivery notes

k. Compare final inventory sheets with any perpetual inventory records maintained (e.g. bin cards, stores ledgers). Note any discrepancies and obtain adequate explanations for the differences. Ensure that all necessary adjustments are made to the inventory records

l. Reconcile inventory and work in progress figure in the final accounts with amounts shown in total by the perpetual inventory records or management accounts. Prepare a schedule giving the reason for the divergence, stating the evidence obtained to verify the explanations given

m. Obtain certificates direct from third parties in respect of inventory held by them. The certificate should identify the nature of the stock, the quantities held and the purpose for which it is held. It should also confirm that the inventory held is in good condition and not subjected to any lien or charges. Confirm that all necessary deductions are made in respect of slow moving damaged or obsolete inventories.

7.4.4 Audit Programmes for the Verification of Inventory-Valuation

a. Test the price of the final inventory sheets to purchase invoices

b. Scrutinize the bin cards or inventory records to identify any apparently obsolete inventory.

c. Review all slow moving and obsolete inventories with storekeeper and responsible officials

d. Consider the value placed upon the items in the previous year, the prospect of sale in the immediate future and decide what reduction in value is appropriate

e. Enter details on a schedule and bring to the manager's attention.

7.4.5 Audit Programme for the Verification of Value of Work-in-Progress:

a. Test the reliability of work-in-progress by examining the costing system in force. Ensure that:

   Methods of accounting and control over stores issues and labour usage are adequate

   - Method of allocation of overhead is reasonable. Confirm by calculation that the amount added is in line with the actual rate incurred during the year under review unless the factory operated below normal capacity in which case the normal activity rate should be used, and

   - Method of valuation of work-in-progress (WIP) is consistent with previous years and has not been distorted by changes in the level of production.

b. Compare the prices of the selected items of WIP with selling price by adding estimate of the cost required to complete. The projected/actual final cost should be compared with selling price and any anticipated losses provided for

c. For long term contracts, determine whether the basis for the calculation of WIP is permissible and in accordance with the relevant accounting standard.

7.4.6 Audit Programme for the Value of Inventories - General

a. Obtain or prepare a schedule summarizing the inventory and WIP by general category, showing the comparative figures for the previous year. Reconcile the total with the amount shown in the statement of financial position and with the final inventory sheets. State on the schedule the basis of valuation used and the nature of the evidence obtained to verify the quantity of inventory

b. State on the schedule of inventory and work in progress the amount and proportion of value which were subject to observation at a inventory count and other audit tests

c. Compare the ratios of inventory and WIP to sales, raw material to cost of sales, WIP to cost of sales, and finished goods to cost of sales with those for the previous period. Prepare a schedule stating reasons for significant changes in the above ratios and evidence obtained to verify the explanations given.

d. Review the inventory valuation on a current cost basis. If materially different, discuss possible disclosure with the directors.

7.4.7 Attendance at inventory taking

In accordance with the Auditors Operational Standard, the auditor should obtain relevant and reliable audit evidence sufficient to enable him draw reasonable conclusions there from. The guideline gives guidance on how the above is related to attendance at inventory taking.

Responsibility of management

It is the responsibility of the management of an enterprise to ensure that the amount at which inventories are shown in the financial statements represents inventories physically in existence and includes all inventories owned by the enterprise

Management satisfies this responsibility by carrying out appropriate procedures which will normally involve ensuring that all inventories are subject to a count at least once in every financial year. Further, where the auditor attends any physical count of inventories in order to obtain audit evidence, this responsibility will not be reduced.

Management also has the responsibility to maintain proper accounting records and to include all statements of inventory taking in those records.

It is the responsibility of the auditor to obtain audit evidence in order to enable him to draw conclusions about the validity of the quantities upon which are based the amount of inventories shown in the financial statements.

The principal sources of this evidence test counts made by the auditor himself. By reviewing the enterprises inventory records, and inventory control systems and the results of any inventory taking test counts made by the auditor himself. By reviewing the enterprises inventory records, and inventory control systems, the auditor can decide to what extent he needs to rely upon attendance at inventory taking to obtain the necessary audit evidence

Attendance as a means of providing evidence

Where inventories are material in the enterprise's financial statements, and the auditor is placing reliance upon the management's inventory take in order to provide evidence of existence, then the auditor should attend the inventory taking.

This is because attendance at inventory taking is normally the best way of providing evidence of the proper functioning of management's inventory taking procedures, and hence of the existence of inventories and their conditions.

Evidence of the existence of WIP will frequently be obtained by a inventory take. However, the nature of the WIP may be such that it is impracticable to determine its existence by a count. Management may place substantial reliance on internal controls designated to ensure the completeness and accuracy of records of work-in-progress. In such circumstances there may not be inventory take which could be attended by the auditor. Nevertheless, inspection of the work-in-progress will assist the auditor to plan his audit procedures, and it may also help on such matters as the determination of the stage of completion or engineering work in progress.

7.4.8 Types of inventory taking

Physical verification of inventories may be by means of a full count (or measurement in the case of bulk inventory) of all the inventories at the yea-rend or at a selected date before or shortly after the year end, or by means of a count of part of the inventories in which case it may be possible to extrapolate the total statistically. Alternatively, verification may be by means of the counting or measurement of inventories during the course of the year using continuous inventory-checking methods. Some business enterprise use continuous inventory-checking methods for certain inventories and carry out a full count of other inventories at a selected date.

The evidence of the existence of inventories provided by the inventory take results is most effective when inventory taking is carried out at the end of the financial year. Inventory taking carried out before or after the year end may also be acceptable for audit purposes provided records of inventory movement in the period are such that the movements can be examined and substantiated.

The auditor should bear in mind that the greater the interval between the inventory taking and the year end, the greater will be his difficulties in substantiating the amount of inventory at the statement of financial position date. Such difficulties will, however, be lessened by the existence of a well-developed system of internal control and satisfactory inventory records.

Where continuous inventory-checking methods are being used, the auditor should perform tests designed to confirm that management,

a. maintains adequate inventory records that are kept up-to-date;

b. has satisfactory procedures for inventory taking and test-counting, so that in normal circumstances the programme of counts will cover all inventories at least once during the year; and

c. investigates and corrects all materials differences between the book inventory records and the physical counts.

7.4.9 Inventory taking Procedures

The following are the principal procedures which may be carried out by an auditor when attending a inventory take.

Before the Inventory taking: Planning

The auditor should plan his audit coverage of a inventory take by:

i. reviewing his working papers for the previous year, where applicable, and discussing with management any significant changes in inventories over the year

ii. discussing inventory taking arrangements and instructions with management

iii. familiarizing himself with the nature and volume of the inventories, the identification of high value items and the method of accounting for inventories

iv. considering the location of the inventory and assessing the implications of this for inventory control and recording

v. reviewing the systems of internal and accounting relating to inventories, so as to identify potential areas of difficulty (for example cut off).

vi. considering any internal audit involvement, with a view to deciding the reliance which can be placed on it

vii. ensuring that a representative selection of locations, inventories and procedures are covered, and particular attention is given to high value items where these form a significant proportion of total inventory value

viii. arranging to obtain third party confirmation of inventories held by them, but if the auditor considers that such inventories are a material part of the enterprise's total inventory, or the third party is not considered to be independent or reliable, then arranging, (where appropriate) either for him or for the third party's auditor to attend a inventory take at the party's premises; and

ix. establishing whether expert help needs to be obtained to substantiate quantities, or to identify the nature and condition of the inventory, where they are very specialized.

The auditor should examine the way the inventory taking is organized and should evaluate the adequacy of the client's inventory taking instructions. Such instructions should preferably be in writing, cover all phases of the inventory taking procedures, be issued in good time and be discussed with those responsible for carrying out the inventory taking to ensure that the procedures are understood and that potential difficulties are anticipated. If the instructions are found to be inadequate, the auditor seeks improvements to them.

During the Inventory taking

a) During the inventory taking, the auditor should ascertain whether the client's employees are carrying out their instructions properly so as to provide reasonable assurance that the inventory taking will be accurate. He should make test count to satisfy himself that procedures and internal control relating to the inventory taking are effective or if the results of the test counts are not satisfactory, the auditor should immediately draw the matter to the attention of the management supervising the inventory taking and he may have to request a recount of part, or all of the inventories

b) When carrying out the inventory count, the auditor should select items both from count records and from the physical inventories and should check one to the other to gain assurance as to the completeness and accuracy of the count records. In this context, he should give particular consideration to those inventories which he believes to have a high value either individually or as a category of inventory.

The auditor should include in his working papers items for subsequent testing, such as photocopies of rough inventory sheets and details of the sequence of inventory sheets.

c) The auditor should determine whether the procedures for identifying damaged, obsolete and slow moving inventories operate properly. He should obtain information about the inventories condition, age, usage, and in the case of work-in-progress, its stage of completion. Further, he should ascertain that inventories held on behalf of third parties are separately identified and accounted for

d) The auditor should consider whether the management has instituted adequate cut-off procedures, i.e. procedures intended to ensure that movements into, within and out of inventory are properly identified and reflected in the accounting records

e) The auditor should conclude whether the inventory taking has been properly carried out and is sufficiently reliable as a basis of determining the existence of inventories

f) The auditor should consider whether any amendment is necessary to his subsequent audit procedures

g) The auditor should try to gain from his observations an overall impression of the levels and values of inventories held so that he may, in due course, judge whether the figure for inventories appearing in the financial statements is reasonable

h) The auditor's working papers should include details of his observations and tests, the manner in which points that are relevant and material to the inventories being counted or measured have been dealt with by the client, instances where the client's procedures have not been satisfactorily carried out and the auditor's conclusions.

After Inventory taking

a) After the inventory taking the matters recorded in the auditors' working papers at the time of the count or measurement should be followed up. Photocopies of or extracts from rough inventory sheets and details of test counts may be used to check that the final inventory sheets are accurate and complete.

b) he should check replies from third parties about inventories held by or for them, follow up all queries and notify senior management of serious problems encountered during the inventory taking.

7.5 ANALYTICAL PROCEDURES

The purpose of this section is to provide guidance on the application of analytical procedures during audit.

The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit. Analytical procedures may also be applied as substantive procedures.

"Analytical procedures" means evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

7.5.1 Nature and Purpose of Analytical Procedures

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

a) Comparable information for prior periods.

b) Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation. Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships:

i. Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.

ii. Between financial information and relevant non-financial information,such as payroll costs to number of employees.

Various methods may be used in performing the above audit procedures. The auditor's choice of audit procedures, methods and level of application is a matter of professional judgment.

Analytical procedures are used for the following purposes:

- As risk assessment procedures to obtain an understanding of the entity and its environment.
- As substantive procedures when their use can be more effective or efficient than tests of details in reducing the risk of material misstatement at the assertion level to an acceptably low level.
- As an overall review of the financial statements at the end of the audit.

7.5.2 Analytical Procedures as Risk Assessment Procedures

The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment. Application of analytical procedures may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order determine the nature, timing and extent of further audit procedures.

Analytical procedures applied as risk assessment procedures use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

7.5.3 Analytical Procedures as Substantive Procedures

The auditor designs and performs substantive procedures to be responsive to the related assessment of the risk of material misstatement at the assertion level. The auditor's substantive procedures at the assertions level may be derived from tests of details, from substantive analytical procedures, or from a combination of both.

The decision about which audit procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures in reducing the assessed risk of material misstatement.

The auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures and the results of any procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.

When designing and performing analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the following:

a. The suitability of using substantive analytical procedures given the assertions.

b. The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.

c. Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.

d. The amount of any difference of recorded amounts from expected values that is acceptable.

7.5.4 Suitability of Using Substantive Analytical Procedure Given the Assertions

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of substantive analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions captured in the information produced by the entity's information system. However, reliance on the results of substantive analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

In determining the suitability of substantive analytical procedures given the assertions, the auditor considers the following:

a) *The assessment of the risk of material misstatement.* The auditor considers the understanding of the entity and its internal control, the materiality and likelihood of misstatement of the items involved, and nature of the assertion in determining whether substantive analytical procedures are suitable. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than substantive analytical procedures for assertions related to receivables. As another example, when inventory balances are material, the auditor ordinarily does not rely only on substantive analytical procedures when performing audit procedures on the existence assertion.

b) *Any tests of details directed toward the same assertion.* Substantive analytical procedures may also be considered appropriate when tests of details are performed on the same assertion. For example, when auditing the collectability of accounts receivable, the auditor may apply substantive analytical procedures to an aging of customers‟ accounts in addition to tests of details on subsequent cash receipts.

7.5.5 The Reliability of the Data

The reliability of data is influenced by its source and by its nature and is dependent on the circumstances under which it is obtained. In determining whether data is reliable for purposes of designing substantive analytical procedures, the auditor considers the following:

a) *Source of the information available.* For example, information is ordinarily more reliable when it is obtained from independent sources outside the entity.

b) *Comparability of the information available.* For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.

c) *Nature and relevance of the information available.* For example, whether budgets have been established as results to be expected rather than as goals to be achieved.

d) *Controls over the preparation of the information.* For example, controls over the preparation review and maintenance of budgets.

7.5.6 Whether the Expectation is Sufficiently Precise

In assessing whether the expectation can be developed sufficiently precise to identify a material misstatement at the desired level of assurance, the auditor considers factors such as the following:

a) The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

b) *The degree to which information can be disaggregated.* For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

c) *The availability of the information, both financial and non-financial.* For example, the auditor considers whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures.

7.5.7 Difference of Recorded Amounts from Acceptable Expectation

In designing and performing substantive analytical procedures, the auditor considers the amount of difference from expectation that can be accepted without further investigation.

This consideration is influenced primarily by materiality and the consistency with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount.

The auditor increases the desired level of assurance as the risk of material misstatement increases by reducing the amount of difference from the expectation that can be accepted without further investigation.

7.5.8 Analytical Procedures in the Overall Review at the End of the Audit

The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

The conclusions drawn from the results of such audit procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify a previously unrecognized risk of material misstatement. In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised considerations of assessed risks for all of some of the classes of transactions, account balances, or disclosures and related assertions.

7.5.9 Investigating Unusual Items

When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or those that deviated from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence.

The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

a) Corroboration of management's responses, for example, by comparing them with the auditor's understanding of the entity and other audit evidence obtained during the course of the audit; and

b) Consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

7.5.10 Public Sector Perspective

The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be appropriate in the audit of governments or other non-business public sector entities; for example, in many such public sector entities there is often little direct relationship between revenues and expenditures. In addition, because expenditure on the acquisition of assets is frequently non-capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. In addition, in the public sector, industry data or statistics for comparative purposes may not be available. However, other relationships may be relevant, for example, variations in the cost per kilometre of road construction or the number of vehicles acquired compared with vehicles retired. Where appropriate, reference has to be made to available private sector industry data and statistics. In certain instances, it may also be appropriate for the auditor to generate an in-house database of reference information.

7.5.11 The Practice of Analytical Procedures

Significant items

Among the items that are generally subjected to analytical procedures are the following:

a. Creditors and purchases

b. Inventories and cost of sales

c. Fixed Assets, deprecations, repairs and maintenance

d. Loans and Interest Loans

e. Investment and investment income

f. Debtors and bad debts expenses

g. Debtors and sales

Important Ratios

Among the ratios that are computed for the purposes of carrying out analytical procedures as the following:

a. Gross Profit Margin

b. Net Profit margin

c. Return on capital employed

d. Current ratio

e. Quick or acid test ratio

f. Debtors turnover period

g. Creditors payment period

h. Rate of inventory turnover

i. Gearing ratio

j. Price/Earnings ratio

k. Dividend per share

l. Earnings per share

m. Earnings yield

n. Return on net assets

In addition to the above ratios, the auditors should examine the clients" circumstance and compute other relevant ratios e.g. revenue per passenger mile for an airfare operator.

7.5.12 Other Areas that Auditors May Examine as Part of the Analytical Procedures include the following:

a. Examination of changes in products, customers, distribution chain and levels of return

b. Assessment of the effect of inflation, industrial disputes, changes in technology of production and changes in activity on the wages paid

c. Explanations for all major variances analysed using a standard costing system. Particular attention should be paid to those relating to the over or under absorption of overheads since these may, inter-alia, affect inventory valuations

d. Examination of trends in production and sale and assess the effect on any provisions for obsolete inventories.

e. Changes in the percentage labour or overhead content of production costs are also reflected in the inventory valuation

f. Review of other expenditure items with particular emphasis on comparisons of the following:

    (i) Rent payment with rent agreement

    (ii) Rates with previous year and known industrial rates variations

    (iii) Interest payable with previous year's figure and loan agreements

    (iv) Vehicle running expenses with previous year's figure and changes in fleet of vehicles used

g. Review of Statement of Profit and Loss and Other Comprehensive Income with items which may have been omitted

h. Review where variations from the following have occurred: - Industry or local trends
   - Known disturbances of trading pattern (for example strikes, depot closures, failure of suppliers).

7.6 AUDITING PROCEDURES FOR SUBSEQUENT EVENTS

Some events happen after the balance sheet date which have bearing on the results and financial position reported in the annual accounts. It stands reasonable that the auditors examine these events in order to form an objective opinion as to their truth and fairness. Two of such events are:

7.6.1 Classification of Subsequent Events

A subsequent event is an event (favourable or unfavourable) which occurs between the financial position date and the date on which the financial statements are approved by the board of directors. Events occurring after the financial position date may be classified into two categories: adjusting events and non-adjusting events.

a. ***Adjusting Events:***

Adjusting events are events which provide additional evidence relating to conditions existing at the balance sheet date. They require changes in amounts to be included in the financial statements. Examples of adjusting events are as follows:

i. Non-Current Assets: The subsequent determination of the purchase price or of the proceeds of sale of assets purchased or sold before the year end.

ii) Property: A valuation, which provides evidence of a permanent diminution in value.

iii) Investments: The receipt of a copy of the financial statements or other information in respect of an unlisted company which provides evidence of a permanent diminution in the value of a long-term investment.

iv) Inventory and work in progress: The receipt of proceeds of sale after the date of statement of financial position) or other evidence concerning the net realizable value of inventories and the receipt of evidence that the previous estimate of accrued profit on a long-term contract was materially inaccurate.

v) Debtors: The renegotiation of amounts owing by debtors, or the insolvency of a debtor.

vi) Dividend receivable: The declaration of dividends by subsidiaries and associated companies relating to periods prior to the date of financial position of the holding company.

vii) Taxation: The receipt of information regarding rates of taxation.

viii) Claims: Amounts received or receivable in respect of insurance claims which were in the course of negotiation at the statement of financial position date.

ix) Discoveries: The discovering of errors or frauds which show that the financial statements were incorrect.

An adjusting post balance event requires changes in the amounts to be included in financial statement.

b. ***Non-adjusting events***:

Non-adjusting events are events which arise after the statement of financial position date and concern conditions which did not exist at that time. Consequently, they do not result in changes in amounts in the financial statements. They may, however, be of such materiality that their disclosure is required by way of notes to ensure that the financial statements are not misleading.

Examples of non-adjusting events which may require disclosure include:

i) Mergers and acquisitions

ii) Reconstructions and proposed reconstructions

iii) Issues of shares or debentures

iv) Purchase and sales of fixed assets and investments

v) Losses of fixed assets and investments

vi) Opening new trading activities or extending existing trading activities

vii) Closing a significant part of the trading activities if this was not anticipated at the year end

viii) Decline in the value of property and investments held as fixed assets, if can be demonstrated that the decline occurred after the year end

ix) Changes in rates of foreign exchange

x) Government actions such as nationalisation

xi) Strikes and other labour disputes

xii) Augmentation of pension benefits

7.6.2 Accounting Treatment

In respect of each subsequent event which is required to be disclosed, the following information should be stated by way of notes in the financial statements.

a. the nature of the events; and
b. an estimate of the financial effect, or a statement that it is not practicable to make such an estimate

The auditors should consider the effect in the financial statements and on the audit report of subsequent events.

The auditors should perform procedures designed to provide sufficient appropriate audit evidence that all material subsequent events up to the date of the audit report which require adjustment of or disclosure in the financial statements have been identified and properly reflected therein.

The auditors need to focus these procedures on any matters they may have become aware of during the course of the audit which may be susceptible to change after the period end. Such procedures are in addition to routine procedures which may be applied to specific period end, for example the testing of inventory cut-offs and payments to creditors.

7.6.3 Auditing Procedures

The procedures to identify subsequent events which may require adjustment of or disclosure in, the financial statements needs to be performed as near as practicable to the date of the audit report. These procedures include:

a. Enquiring into the procedures management has established to ensure that subsequent events are identified;

b. Reading minutes of the meetings of members, the board of directors and audit committee held after period end;

c. Enquiring about matters discussed at meetings for which minutes are not yet available.

d. Reading the entity’s latest available interim financial statements, - budgeted - cash flow forecasts and other related management reports and accounting records; and

e. Making enquiries of management as to whether any subsequent events have occurred which might affect the financial statements.

Examples of specific enquires which may be made of management are:

i) The current status of items involving subjective judgment or which were accounted for on the basis of preliminary data, for example litigation in progress

ii) Whether new commitments, borrowings or guarantees have been entered into

iii) Whether sales of assets have occurred or are planned

iv) Whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned

v) Whether any assets have been destroyed, for example by fire or flood

vi) Whether there have been any developments regarding risk areas and contingencies

vii) Whether any events have occurred or are likely to occur which might bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events might call into question the validity of the going concern presumptions.

When a component such as a division, branch or a subsidiary, is audited by other auditors, the auditors may need to consider the other auditors' procedures regarding subsequent events, any need to inform the other auditors of the planned date of the audit report, and in certain cases may wish to obtain representations from other auditors.

7.6.4 Auditing Procedures for Subsequent Events Discovered after the date of the Audit Report but before the Financial Statements have been Issued

The auditors do not have any responsibility to perform any enquiry regarding the financial statements after the date of the audit report. However, during the period from the date of the audit report to the date the financial statements are issued (for example to the shareholders) management may reasonably be expected to inform the auditors of any material subsequent events discovered which may affect the financial statement.

When after the date of the audit report but before the financial statements are issued, the auditors become aware of subsequent events which may materially affect the financial statements, the auditors should establish whether the financial statements need amendment, should discuss the matter with management and should consider the implications for their report, taking additional action as appropriate.

When management amends the financial statements, the appropriate action is for the auditors to carry out the audit procedures necessary in the circumstances, to provide management with a new audit report on the amended financial statements, dated not earliest than the date the amended financial statements are approved and to extend the procedures in the above paragraphs to the date of the new audit report.

When management does not amend the financial statements, in circumstances where the auditors believe they need to be amended and the audit report has not been released to the entity, the appropriate action is for the auditors to issue a qualified audit report.

If, however, in such circumstances the audit report has been released to the entity, the auditors need to request management not to issue the financial statements. If the financial statements are subsequently issued, the auditors need to take action to prevent reliance on the auditor's report and may need to take legal advice.

7.6.5 Audit Procedures for Subsequent Events discovered after the Financial Statements have been issued but before laying them before the Members:

After the financial statements have been issued, the auditors have no obligations to make any enquiry regarding such financial statements.

When, after the financial statements have been issued, but before they have been laid before the members or equivalent, the auditors become aware of subsequent events which had occurred by the date of the audit report and which, if known at the date, might have caused the auditors to issue a different audit report, the auditors should consider whether the financial statements need amendment, should discuss the matter with management, and should consider the implications for their report, taking additional action as appropriate.

When management amends the financial statements, the appropriate action is for the auditors to:

a. carry out the audit procedures necessary in the circumstances;

b. consider whether inventory exchange regulations require the amendment to be publicised

c. consider whether there is any requirement to communicate with any regulatory body

d. review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation, and

e. issue a new report on the amended financial statements

When auditors issue a new audit report, the appropriate action is for them to:

i. refer (in an explanatory paragraph) to the note to the financial statements which more extensively discusses the reason for the amendment of the previously issued financial statements or to set out such reason in their report;

ii. refer to the earlier report issued by the auditors on the financial statements

iii. date the new audit report not earlier than the date the amended financial statements are approved.

When management does not take the necessary steps to ensure that those in receipt of the previously issued financial statements together with the audit report thereon are informed of the situation, and does not amend the financial statements in circumstances where the auditors believe they need to be amended, the auditors need to notify management that action is to be taken by the auditors to prevent future reliance on the audit report and may need to take legal advice.

7.7 AUDIT PROCEDURES FOR CONTINGENCIES

The term contingency is applied to a condition which exists at the financial position date, where the outcome will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events. Uncertainties connected with accounting estimates do not fall within the scope of this definition, for example the lives of fixed assets, the amounts of bad debts, the net realisable value of inventories, the expected outcome of long term contracts or the valuation of properties and foreign currency balances.

Accounting Treatment

Contingencies existing at the statement of financial position date should be taken into account when preparing financial statements. Estimates of the outcome and of the financial effect of contingencies should be made by the board of directors of the company. These estimates will be based on consideration of information available up to the date on which the financial statements are approved by the board of directors and will include a review of events occurring after the - financial position date. As an example, in the case of a substantial legal claim against a company, the factors to be considered would include the progress of the claims at the date on which the financial statements are approved, the opinion of legal experts or other advisers and the experience of the company in similar cases.

A material contingent loss should be accrued in financial statements where it is probable that a future event will confirm a loss which can be estimated with reasonable accuracy at the date on which the financial statements are approved by the board of directors.

A material contingent loss not accrued should be disclosed except where the possibility of loss is remote.

Contingent gains should not be accrued in financial statements. A material contingent gain should be disclosed in financial statements only if it is probable that the gain will be realised. When the realisation of the gain becomes reasonably certain, then such a gain is not a contingency, and accrual is appropriate.

A material contingency which is not accounted for should be disclosed by way of notes in order to ensure that financial statements do not present a misleading position. Such disclosures should indicate

a. the nature of the contingency

b. the uncertainties which are expected to affect the ultimate outcome

c. a prudent estimate of the financial effect made at the date on which the financial statements are approved by the board of directors, or a statement that it is not practicable to make such estimate

   Where there is disclosure of an estimate of the financial effect of a contingency, the amount of disclosure should be the potential financial effect. In the case of a contingent loss, this should be reduced by:

   i. any amount accrued, and

   ii. the amount of any components where the possibility of loss is remote.

The net amount only need be disclosed.

The estimate of the financial effect should be disclosed before taking account of taxation, and the taxation implications of a contingency crystallising should be explained where necessary for a proper understanding of the financial position.

Auditing Procedures

The following auditing procedures relate to obtaining audit evidence about contingencies:

a. Review of the clients system of recording claims and the procedure for bringing these to the attention of the management or board.

b. Arrangements for instructing solicitors with official responsible for legal matters.

c. Examination of the minutes of the Board of Directors and or executives or other relevant committee for references to, or indications of, possible claim.

d. Examine bills rendered by solicitors and correspondence with them, in which connection the solicitors should be requested to furnish bills or estimates of charges to date, or to confirm that they have no unbilled charges.

e. The listing of matters referred to solicitors from the appropriate director or official with estimates of the possible ultimate liabilities

f. Written assurances from the appropriate directors or officials that they are not aware of any matters referred to solicitors other than those disclosed

g. Contingencies from prior year that may still be applicable

h. The nature of the client's business that may make certain contingencies likely (e.g. warranty claims).

7.8 AUDIT PROCEDURES FOR GOING CONCERN BASIS

Financial statements are usually prepared under the presumption that the audited entity is carrying on business as a going concern. Unless otherwise stated, it is assumed that the financial statements are prepared on this basis.

The auditors should assess whether it is appropriate for the directors to prepare the financial statements on the going concern basis, and should take account of the assessment in preparing their reports.

The auditors should:

i. consider a written assertion from the directors as to the directors' assessment of the appropriateness of the going concern basis of preparing the financial statements

ii. consider the adequacy of disclosures on the financial statements relevant to the appropriateness of the going concern basis, and

iii. take account of their findings in preparing their report.

7.8.1 Is the client a going concern?

Many firms have given careful consideration to compiling checklists of danger symptoms, and the presence of any of these would indicate the need to instigate further more specific and more detailed steps, before reaching a conclusion on this important question.

If, after pursuing all their enquiries, the auditors still find themselves uncertain as to whether the company will remain a going concern in the foreseeable future, they will obviously need to devise a suitable qualification in their report, ensuring that is as explicit as their knowledge of the situation permits.

There are several symptoms that may be used to diagnose going concern difficulties, and most checklists drafted for this purpose will incorporate some or all of the following:

i. Loan repayments are falling due in the near future, and refinancing facilities are not immediately available.
ii. High or increasing debt to equity ratios exist (high gearing)
iii. The company is heavily or increasingly dependent upon short term finance, particularly from trade creditors and overdrafts.
iv. There is inability to take advantage of discounts, the time taken to pay creditors is increasing, and suppliers impose cash terms.
v. Normal purchases are being deferred, thereby reducing inventories to dangerously low levels.
vi. Substantial losses are occurring, or the state of profitability is declining.
vii. Normal capital expenditure is being switched to leasing agreements.
viii. The company has a net deficiency of current assets or its ratio of current assets to current liabilities is declining.
ix. The company is near to its present borrowing limits, with no sign of reduction in requirements.
x. Collection rate from debtors is slowing down.
xi. Rapid development of business is in danger of creating an over trading situation.
xii. There is dependence upon a limited number of products, customers or suppliers.
xiii. There is evidence of major reductions or cancellations of capital projects.
xiv. There is heavy dependence on an overseas holding company for finance or trade.

Should the presence of one or more of such features cause the auditors concern, they should, at the very least,

- compare the client's cash flow forecast with the overdraft or other loan facilities available for up to twelve months from the accounting date.

- Obtain written confirmation from the board of the holding company (if any) that it intends its subsidiary to continue in business and will not withdraw existing finance facilities.

- Enquire into and obtain written evidence of the steps (if any) the client is taking in order to correct its decline in fortunes.

If the auditor cannot satisfy himself that the client will remain in business in the foreseeable future, then he must consider the validating of the going concern basis, and the need to qualify his audit report in appropriate terms.

7.8.2 Audit evidence

The auditors should request from the directors an adequate written assertion confirming the directors' considered view as to whether it is appropriate for them to adopt the going concern basis in preparing the financial statements.

The auditors should consider the following factors in deciding whether in their view the written assertion is adequate:

i. whether the assertion so obtained was supported by the directors with an explanation of these matters and any relevant assumptions, and

ii. whether the assertion has been made having regard to circumstances which the directors consider may occur during a period of at least one year from the date they approve the financial statements.

Where the auditors are unable to obtain written assertion from the directors supporting the evidence and made in this manner, the auditors should consider the effect in their report.

The auditors should make enquiries of the directors, and examine appropriate available financial and other information. The auditors aim should be to assess the adequacy of the means by which the directors have arrived at their considered view as to whether it is appropriate for them to adopt the going concern basis in preparing the financial statements.

In order to gain sufficient appropriate audit evidence as to the directors' view as to whether it is appropriate for them to adopt the going concern basis in preparing the financial statements, auditors may need to examine some or all of the following matters:

i. The systems, or other means (formal or informal), for timely identification of warnings of future risks and uncertainties the company might face.

ii. Budgets and forecasts information (cash flow information) in particular produced by the company, and the quality of the systems (or other means; formal or informal) in place for producing this information and keeping it up to date.

iii. Whether the key assumption underlying the budgets and for forecasts appear appropriate in the circumstances.

iv. The sensitivity of budgets and or forecasts to variable factors both within the control of the directors and outside their control.

v The existence, adequacy and terms of borrowing facilities and supplier credit; and

vi. The directors' plans for resolving any matters giving rise to the concern (if any) about the appropriateness of the going concern basis. In particular, the auditors may need to consider whether the plans are realistic, whether there is a reasonable expectation that the plans are likely to resolve any problems foreseen and whether the directors are likely to put the plans into practice effectively.

In examining borrowing facilities, the auditors could decide that it is necessary to obtain confirmation of the existence and terms of bank facilities and to make their own assessment of the intentions of the bankers relating thereto. Examples of such situations include cases where:

a. there is a low margin of financial resources available to the company

b. the company is dependent on borrowing facilities shortly due for renewals

c. correspondence between bankers and the company reveals that the last renewal of facilities was agreed with difficulty, or that, since the last renewal of facilities, the bankers have imposed additional conditions as a pre-requisite for continued lending.

d. a significant deterioration in cash flow is projected

e. the value of assets granted as security for the borrowings is declining, or

f. the company has breached the terms of borrowing covenants, or there are indications of potential breaches

Where the auditors have decided that it is necessary to satisfy themselves regarding the existence and terms of borrowing facilities and the intentions of the lender relating thereto, but are unable to do so, the auditors consider whether this inability and for the factors giving rise to it need to be:

i. disclosed in the financial statements in order for them to give a true and fair view, and/or

ii. referred to (by way of an explanatory paragraph or a qualified opinion) in the auditors' report.

The following list sets out examples of situations where, in the circumstances, it may be more likely that the auditors conclude that there is a significant level of concern as to the appropriateness of the going concern basis:

a. an excess of liabilities over assets

b. default on terms of loan agreements, and potential breaches of covenant

c. significant liquidity or cash flow problems

d. major losses or cash flow problems which have arisen since the statement of financial position date and which threatens the company's continued existence.

e. major litigation in which an adverse judgment would imperil the company's continued existence

f. denial of (or reduction in) normal terms of trade credits by suppliers

g. major debts repayments falling due where refinancing is necessary to the company's continued existence

h. issues which involve a range of possible outcomes so wide that an unfavourable results could affect the appropriateness of the going concern basis

i. fundamental changes in the market or technology to which the company is unable to adapt adequately.

However, in situations such as these, the auditors may obtain evidence which causes them to conclude that there is not a significant level of concern as to appropriateness of the going concern basis.

In assessing whether it is appropriate for the directors to prepare the financial statements on the going concern basis, the auditors should take account of any information of which they have become aware which relates to the period beyond one year from the date the directors approve the financial statements. The auditors should discuss the relevance of such information with the directors.

7.8.3 Assessing disclosures in the financial statements

In forming their opinion as to whether the financial statements give a true and fair view, the auditors should consider the adequacy of disclosures in the financial statements relevant to the appropriateness of the going concern basis.

If the going concern basis is inappropriate, this affects the manner in which the other fundamental accounting concepts are applied in the financial statements.

If the financial statements do not include appropriate disclosures relevant to the appropriateness of the going concern basis, the auditors consider very carefully:

i. whether the financial statements give true and fair view, and hence

ii. whether they can justify not issuing an auditors' report including a qualified opinion arising from disagreement with the disclosure of this matter in the financial statements.

7.8.4 Reporting on the financial statements

Where the auditors consider that there is a significant level of concern as to the appropriateness of the going concern basis but the auditors do not disagree with its use, they should include an explanatory paragraph when setting out the basis of their opinion describing the matters giving rise to their concern and should refer to the relevant financial statement disclosures. The auditors should not qualify their report on these grounds alone, provided the disclosures in the financial statements of the matters giving rise to the concern are adequate for the financial statements to give a true and fair view.

In their report on the financial statements, the auditors describe the matters giving rise to their concern so as to identify clearly the nature of the matter. The description is normally identified within the auditor's report through the use of the sub-heading "***Fundamental Uncertainty: going concern".*** The extent of the auditor's concern is one factor affecting the nature and extent of the description in the auditor's report. The auditors use their judgment to decide the extent to which it is necessary for the description in their report to repeat information taken from one or more notes to the financial statements.

Where the auditors disagree with the presumption that the company is a going concern, they should issue a modified audit opinion and should provide in their audit report such additional information as they consider necessary, based on the information of which they have become aware.

Where the going concern presumption is inappropriate, even disclosure in the financial statements of the matters giving rise to this conclusion is not sufficient for them to give a true and fair view.

Where the auditors consider that the disclosures in the financial statements of matter relevant to the appropriateness of the going concern basis are not adequate for the financial statements to give a true and fair view, they should issue an auditor's report including a modified opinion arising from disagreement with the disclosure of these matters in the financial statements.

Where the auditors consider that there is a significant level of concern as to the appropriateness of the going concern basis, they do not normally regard the disclosures as adequate unless the following matters are included in the financial statements (in addition to any disclosures otherwise required):

i. a statement that the financial statements have been prepared on the going concern basis

ii. a statement of the pertinent facts

iii. the nature of the concern

iv. details of the matters giving rise to the concern

v. a statement of the assumptions adopted by the directors, which should be clearly distinguishable from the pertinent facts

vi. (where appropriate and practicable), a statement regarding the directors plans for resolving the matters giving rise to the concern; and

vii. Details of any relevant actions by the directors

In rare circumstances, in order to give a true and fair view, the directors may have prepared financial statements on a basis other than that of a going concern. If the auditors consider this other basis to be appropriate in the specific circumstances, and if the financial statements contain the necessary disclosures, ~~he~~ they should include an explanatory paragraph when setting out the basis of their opinion describing the basis of preparation and referring to the notes to the financial statements concerning this basis.

7.9 QUALITY CONTROL FOR AUDIT WORK

There is the urgent need for auditors to institute internal programmes of quality control with a view to improving their services to clients, improving practice efficiency and profitability and minimizing their exposure to legal liability risks.

All auditors should establish and maintain procedures appropriate to its circumstances and should communicate such procedures to all principals and employees.

An auditor should establish and maintain procedures designed to ensure that

a) any individual who is or will be employed by or associated with it for the purpose of or in connection with audit work is a fit and proper person

b) in making a decision to accept appointment or re-appointment as auditor, consideration is given to its own independence, the availability of the resources required and its ability to properly perform the audit

c) all principals and employees adhere to the principles of independence and confidentiality set out in the ethical statements issued by the professional bodies

d) all principals and employees consult, at the appropriate professional level, on ethical, technical or practical issues as appropriate

e) it maintains an appropriate level of competence in the conduct of audits.

Quality control policies and procedures should be implemented both at the level of the audit firm and on individual audit assignment.

7.9.1 Quality Control at the Audit Firm Level

Audit firms should establish quality control policies and procedures designed to ensure that all audits are conducted in accordance with the appropriate auditing standards and should communicate those policies and procedures to their personnel in a manner designed to provide confidence that the policies and procedures are understood and implemented. Such policies and procedures should include those specifically required under the audit Regulations issued by the relevant recognized supervisory body.

The nature and extent of auditors’ quality control policies and procedures depend on a number of factors such as the size and nature of the practice, geographic dispersion, organization and appropriate cost-benefit considerations. Accordingly, the policies and procedures adopted by different auditors vary as does the extent of their documentation.

The quality control policies to be adopted by auditors ordinarily incorporate the following:

a) **Professional requirements**: personnel to adhere to the principles of independence, integrity, objectivity, confidentiality and professional behaviour;

b) **Skills and competence**: personnel to have attained and maintain the technical standards and professional competence required to enable them to fulfil their responsibilities with care;

c) **Acceptance and retention of clients**: an evaluation of prospective clients and a review on an on-going basis, of existing clients to be conducted. In making a decision to accept or retain a client, the auditors’ independence and ability to serve the client properly and the integrity of the client’s management are to be considered.

d) **Assignment**: audit work to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

e) **Delegation**: sufficient delegation, supervision and review of work at all levels to provide confidence that the work performed meets appropriate quality standards.

f) **Consultation**: consultation, whenever necessary, within or outside the audit firm to occur with those who have appropriate expertise; and

g) **Monitoring**: the continued adequacy and operational efficiency of quality control policies and procedures to be monitored.

7.9.2 Quality Control at the Individual Audit Assignment Level

For each audit, the engagement partner should apply those quality control procedures which are, in the context of the policies and procedures of the audit firm, appropriate to the individual audit assignment.

Any work delegated to assistants should be directed, supervised and reviewed in a manner which provides confidence that such work will be performed competently.

The audit engagement partner and personnel with supervisory responsibilities need to consider the professional competence of assistants performing work delegated to them when deciding the extent of direction, supervision and review appropriate for each assistant. These are further detailed below:

a. **Direction**

Assistants to whom work is delegated need appropriate direction which involves informing them of their responsibilities and the objectives of the procedures they are to perform.

The audit programme is often used to communicate audit directions. Time budgets and the overall audit plan are also helpful in communicating audit directions.

b. **Supervision**

Supervision is closely related to both direction and review and may involve elements of both.

Personnel with supervisory responsibilities perform the following functions during the audit:

(i) monitor the progress of the audit to consider whether

- assistants have the necessary skills and competence to carry out their assigned task
- the work is being carried out in accordance with the overall audit plan and the audit programme

(ii) become informed of, and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit pan and the audit programme as appropriate, and

(iii) resolve any differences of professional judgment between personnel and consider the level of consultation that is appropriate.

c. **Review**

The work performed by each assistant must be reviewed by personnel of at least equal competence to consider whether:

a) the work has been performed in accordance with the audit programme

b) the work performed and the results obtained have been adequately documented

c) any significant audit matters have been resolved or are reflected in audit conclusions; and

d) 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.

The following must be reviewed on a timely basis:-

(i) the overall audit plan and the audit programme

(ii) the assessments of inherent and control risks, including the results of tests of control and the modifications, if any, made to the overall audit plan and the audit programme as a results thereof

(iii) the documentation of the audit evidence obtained from substantive procedures and the conclusions drawn there from, including the results of consultations; and

(iv the financial statements, proposed audit adjustments and the proposed audit report.

The process of reviewing an audit before issuing the audit report may include, particularly in the case of large complex audits, requesting personnel not otherwise involved in the audit to perform certain additional procedures, for example to read the annual report or to consider specific areas of audit judgment.

7.10 CHAPTER SUMMARY

i. The sampling process and practices help the auditors determine and identify the various ways of selecting items for testing.
ii. Sampling enables the auditor to gather sufficient appropriate audit evidence from the population of transaction that occurred during the year.
iii. The effects and differences in the statistical and non-statistical sampling techniques enables the auditor determine the strategy and choice of elements for testing.
iv. Errors in the choice of samples could now be evaluated with the knowledge gained at the stage.
v. Substantive procedures enable the auditor conduct test of details of transactions and relevant analytical procedures.
vi. Analytical procedures are meant to ease the comparison of various indications to establish expectation.
vii. Audit programme enable the auditor establish the procedure for test of details and also assign functions easily to assistants. A knowledge assistant or accountant using audit programme could easily perform audit assignments.
viii. Verification procedures establish the cost, authorisation, valuation, existence beneficial ownership and publication of assets and liabilities.
ix. Entities are evaluated for their survival and continued existence as a going concern. The auditor uses information even after year end to evaluate this.
x. Firms set up procedures to strengthen their operations by instilling measures in their systems to guard against risk and ensure the delivery of desirable quality services.

MULTIPLE-CHOICE ANSWER QUESTIONS

1. All those tests of transactions and balances and other procedures such as analytical review which seeks to obtain audit evidence as to the completeness, accuracy and validity of all records is known as………………….

    A. Substantive test

    B. Compliance test

    C. Walk-through test

    D. Depth test

    E. Random test

2. Those tests which seek to provide audit evidence that internal control procedures are being applied as prescribed is known as

A. Audit evidence

B. Substantive tests

C. Compliance tests

D. Procedural tests

E. Investigating tests

3. Which of the following tends to be most predictable for the purpose of analytical procedures applied as substantive tests?

A Relationship involving statement of financial position accounts

B Transactions subject to management discretion

C Relationship involving income statement accounts

D Data subject to audit testing in the prior year

E Comparison of certificate of balance in prior year

4. An auditor wishes to perform tests of controls on cash disbursement procedures. If the controls leave no audit trail of documentary evidence, the auditor most likely will test the procedures by………………..

A Inquiry and analytical procedures

B Confirmation and observations

C Analytical procedures and confirmation

D Observation and enquiry

E Comparison and confirmation

5. A sample selection method where each item of the population has equal chance of being selected is known as……………………..

A Stratified sampling

B Multistage sampling

C Random sampling

D Discovery sampling

E Judgmental sampling

SHORT ANSWER QUESTIONS

6. State two stages in statistical sampling as an auditing tool

7. The risk that material misstatement could occur in an account balance or class of transactions not be detected by accounting or internal control system is known as………….........................

8. The risk that auditor will draw an invalid conclusion from his audit procedure is called……………............

9. Selecting a sampling of appropriate size on the basis of the auditors judgment of what is desirable is called…………………..

10. A sample technique where each item of the population has equal chance of being selected is called…………………

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. A
2. C
3. C
4. D
5. C

SOLUTIONS TO SHORT-ANSWER QUESTIONS

6. Any two of the following

A Planning the sample

B Selecting the items to be tested

C Testing the items

D Evaluating the result of the test

7. Control risk

8. Audit risk

9. Judgment sampling

10. Random sampling

CHAPTER EIGHT

INTERNAL CONTROL SYSTEM

CHAPTER CONTENTS

a. Definition, objectives, features and importance
b. Types of Internal Controls
c. Scope and components of the Internal Control System
d. Internal Controls and their Inherent limitations
e. Understanding internal control procedures
f. Ascertaining the systems of controls
g. Recording the system of controls
h. Evaluating the systems of controls
i. Control problems associated with small entities
j. Practical application of Control procedures
k. Control system as they apply to small entities
l. Reports to Management on the Control Systems
m. Internal Audit as a control factor

OBJECTIVES

By the time you have finished reading this chapter, the reader should be able to:

a. define internal control system;
b. describe the objectives of internal control systems and the need for effective internal control systems within the context of organizational objectives;
c. describe the different types of control systems that need to be in place to ensure the organization's success;
d. outline internal control considerations relevant to various aspects of business operations;
e. describe the problems associated with internal control systems of small companies;
f. describe the role of internal auditing in ensuring effective internal control system; and
g. explain the relationship between internal and external auditing.

8.1 DEFINITION, OBJECTIVES, FEATURES, AND IMPORTANCE

For systems-based auditing to work effectively, the auditor would rely on internal controls to reduce the volume of substantive testing. It is therefore important for the auditor to examine the internal control practice and procedures that are in place in the client's business. Where weaknesses are revealed, the auditor recommends ways of improving the systems.

8.1.1 Definition of Internal Control

The operational standard (guideline) defines internal control as "The whole system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise, in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records.

The striking thing about the definition is its all-embracing nature and internal control is concerned with the controls operational in every area of the corporate activity as well as with the way in which individual controls inter-relate. The individual components of an internal control system are known as “controls” or “internal controls”.

8.1.2 Objectives of Internal Control

The above definition establishes four objectives of internal controls as:

a) to carry on the business of the organisation in an orderly and efficient manner;
b) to ensure adherence to management policies;
c) to safeguard the asset of the organisation; and
d) to secure completeness and accuracy of the records.

8.1.3 The Essential Features of Internal Control

The detailed nature of the controls operative within any commercial organisation will depend upon:

a) the nature and size of the business conducted;
b) the number of administrative staff employed;
c) the volume of transactions;
d) the materiality of transactions concerned;
e) the importance placed upon internal controls by the organisations own management;
f) the management style of the entity particularly the trust placed in the integrity and honesty of the key personnel and the latter’s ability to supervise and control their own subordinate staff;
g) the geographical distribution of the enterprise; and
h) many other factors.

8.1.4 IMPORTANCE OF INTERNAL CONTROLS TO AUDITORS

a. They prevent errors and frauds or material misstatement
b. They detect errors and frauds or material misstatement.
c. They ensure complete and adequate recording of transactions.
d. They ensure that all recorded transactions are real, properly valued, related to the correct period, properly classified, correctly authorized, and posted.
e. They help to ensure reliable financial reporting and compliance with relevant laws, regulations, and standards.
f. They provide management with reasonable assurance that the goals and objectives it believes are important to the company, which are equally important to the auditor, will be met.

8.2 TYPES OF INTERNAL CONTROL

Internal controls can be categorised as:

Organisational

An enterprise should have a plan of organisation which should:

i) define and allocate responsibilities

ii) identify lines of reporting

In all cases, the delegation of authority and responsibility should be clearly specified. An employee should also know the precise powers delegated to him, the extent of his authority and to whom he should report.

b) **Segregation of duties**

   i) No one person should be responsible for the recording and processing of a complete transaction.

   ii) The involvement of several people reduces the risk of intentional manipulation or accidental error and increases the element of checking of work.

   iii) Functions which for a given transaction should be separated include initiation, authorisation, execution, custody and recording.

c) **Physical**

   i) This concerns physical custody of assets and invoices and procedures designed to limit to which only the authorised personnel have access.

   ii) Access can be direct, e.g., by being able to enter the warehouse or indirect, that is by documentation e.g., personnel knowing the correct procedures, may be able to extract goods by doing the right paper work.

   iii) These controls are especially important in the case of valuable, portable, exchangeable, or desirable assets e.g., locking of securities (share certificates) in a safe with procedures for the custody of the keys, use of passes to restrict access to sensitive places, use of password to restrict access to computer files.

d) **Authorisation and approval**

All transactions should require authorisation or approval by an appropriate person. The limits to these authorisations should be specified e.g.

   i. All credit sales must be approved by the credit control department.

   ii. All individual office stationery purchases limited to a certain amount.

e) **Arithmetical and Accounting**

   i) These are controls in the recording function which check that the transactions have been properly checked and coded, that they are all included and that they are correctly recorded and accurately processed.

   ii) Procedures include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliation, control accounts, trial balances, accounting for documents and previews.

f) **Personnel**

i) Procedures should be designed to ensure that personnel operating a system are competent and motivated to carry out the tasks assigned to them, as the proper functioning of a system depends upon the competence and integrity of the operating personnel.

ii) Measures include selection of people with appropriate personnel characteristics and training; assignment to tasks of the right level of staff; appropriate remuneration and promotion; and career development prospects.

g) **Supervision**

All actions by all level of staff should be supervised. The responsibility for supervision should be clearly laid down and communicated to the person being supervised.

h) **Management**

i) These are controls, exercised by management which are outside and over and above the day-to-day routine of the system.

ii) They include overall supervisory control, review of management accounts, comparison with budgets, internal audit, and any other special review procedures.

i) **Acknowledgement of performance**

Persons performing data processing operations and other sensitive activities should acknowledge their activities by means of signatures, initials, rubber stamps, etc. For example, if invoice calculations must be checked, the checker should initial each invoice. This mitigates against the following:

i. Inherent limitations of internal controls
ii. Fraud perpetuated within and/or outside the system
iii. Hacking of computer code through human cleverness

8.3 SCOPE AND COMPONENTS OF INTERNAL CONTROL SYSTEM

The scope of internal control systems extends beyond control of accounting procedures, it further encompasses the control environment, the entity's work assessment process, control procedures, information and communication system and monitoring.

a) **The Control Environment**

This is the foundation of all other components of internal control. This refers to all the overall attitude, awareness and actions of directors and management regarding the internal control systems and its importance in the entity i.e. a strong control environment can complement specific control procedures but does not in itself ensure the effectiveness of the internal control system.

b) **Risk Assessment**

Managers need to assess business risk as part of designing and operating the internal control system to minimise errors and irregularities. Business risk represents factors, events and conditions that can prevent an organisation from achieving its business objectives. If management assesses and responds to risk in an effective manner, the auditor will need to accumulate less evidence, as this lowers the control risk. Conditions that may increase business risk include new personnel, new technology, corporate restructuring, and foreign operations.

c) **Control procedures**

Control procedures sometimes called control activities represents policies and procedures and specific actions taken by a client's management and employees that help ensure management's directives are carried out. Control procedures involve establishing a policy of control and defining procedures to effect the policy. All control procedures should be analysed for risk.

d) **Information and Communication system**

The information and communication component of internal control is a prerequisite for achieving management objective. Every organisation is expected to capture pertinent information relating to both internal and external events and both financial and non-financial activities of the organisation. Communication includes report production and distribution. For an audit, the auditor should obtain an understanding of the information system and the related business process relevant to financial reporting.

e) **Monitoring**

Internal controls need to be monitored. Management should assess the quality of control performance on a timely basis. Monitoring involves the process of assessing the design of controls and their operation on a timely basis and taking necessary corrective actions. Example of monitoring controls include: Company Operating Manager's Report and Published Financial Statement, analysis of customers' complaints, periodic comparison of recorded amounts to actual assets, and examining internal auditors reports on control performance

8.4 INTERNAL CONTROLS AND THEIR INHERENT LIMITATIONS

Directors of corporate bodies set up internal controls in the accounting system to ensure that:

a. transactions are executed in accordance with proper authorization,
b. all transactions are promptly recorded at the correct values in the appropriate accounts and in accordance with relevant regulatory frameworks,
c. access to assets is permitted in accordance with authorized procedures, and
d. recorded assets are compared with physically existing assets at reasonable intervals and the differences reconciled.

However, any instituted internal control system provides management with only **reasonable** but not **absolute** assurance that their objectives are accomplished because of the inherent limitations such as the following:

i) The requirement that the cost of an internal control does not outweigh the potential loss which may result from its absence.
ii) Most systematic internal controls tend to be directed at routine transactions rather than non-routine transactions.
iii) The potential for human error in the operation of internal controls due to carelessness, distraction, mistakes of judgment and the understanding of instructions.

iv) The possibility that a person responsible for exercising an internal control could abuse that responsibility by overriding an internal control.
v) The possibility of controls being by-passed because two or more people colluded. Collusion may be between people inside the organization, but may involve outsiders as well.
vi) The possibility that procedures may become inadequate due to changes in conditions or that compliance with procedures may deteriorate over time. This may particularly apply if a business is expanding.

Factors that determine the success of an Internal Control System include:

a. The nature, size, and volume of transactions
b. The geographical distribution of the enterprise
c. The controls exercised personally by individual members of management
d. The cost of setting up controls and the benefit obtainable therefrom
e. Management's attitude to controls

8.5 UNDERSTANDING THE INTERNAL CONTROL SYSTEM

In planning the audit, auditors should obtain and document an understanding of the accounting system and the control environment sufficient to determine their audit approach.

a. An understanding of the accounting system will enable the auditor to identify and understand:
   i. major classes of transactions in the entity's operations;
   ii. how such transactions are initiated;
   iii. significant accounting records, supporting documents and the accounts in the financial statements; and
   iv. the accounting and financial reporting process, from the initiation of significant transactions and other events to the inclusion in the financial statements.

b. The factors affecting the nature, timing and extent of the procedures performed in order to understand the systems include:
   i. materiality considerations;
   ii. the size and complexity of the entity and its operations
   iii. their assessment of inherent risk
   iv. the complexity of the entity's computer systems
   v. the type of internal controls involved, and
   vi. the nature of the entity's documentation of specific transactions
   vii. the entity's reporting requirements.

c. The auditor updates previous knowledge of the accounting systems in the following ways:
   i. Enquiries of appropriate supervisory and other personnel at various organizational levels within the entity, together with references to documentation such as procedure manuals, job descriptions and systems descriptions.
   ii. Inspection of relevant documents and records produced by the systems.

iii. Observation of the entity's activities and operations, including the information technology functions, organization, personnel performing control procedures and the nature of transactions processing.

8.6 ASCERTAINING THE SYSTEM OF CONTROLS

Methods of ascertaining the control system are summarized as follows:

a. Examining previous audit work
b. Examining the client's documentation of the system
c. Interviews with client's staff.
d. Tracing transactions
e. Reviewing the client's documents and records
f. Observation of procedures

a. **Examining previous audit work**

Apart from the first audit, the audit files should provide a record of the system as it operated at the last date. Unless there has been no major change, this requires updating.

b. **Examining the client's documentation of the system**

Some entities have manuals of procedures. These provide source of information to the existing control systems. It is important to check whether the system as described in the manual is what is actually practised.

c **Interviews with client's staff**

During various stages of the audit, the auditor will need to sit down with some members of the staff of the client and find out how they carry out the functions. This procedure will reveal existing controls and give indications of potential problems.

d **Tracing transactions**

The walk through tests allow auditors to identify any actual procedures that vary from intended procedures. It also helps the understanding of the entire process as well as identification of risks.

e **Reviewing client's documents and records**

The auditor can also ascertain the client's control systems by examining some available documents provided by the client. For example, minutes of management meeting may reveal control issues that require further investigations. Implementation or steering group meetings should be held for significant systems changes and documentations of these will be useful sources of information.

f **Observation of procedure**

It is sometimes useful to watch staff carrying out procedures (such as wages pay-out, receiving materials into stores, etc.) to be able to ascertain the existing and practised control procedures.

8.7 RECORDING THE SYSTEM OF CONTROLS

Methods of recording the system may include

- Narrative Notes
- Organization Chart
- Internal Control Questionnaire
- Flow Charts and other Diagrammatic Presentation

a. **Narrative Notes**

This method is where words are used to describe the systems.

Narrative notes are normally appropriate for simple systems where all paper work are handled by only one or few people. For each system, narrative notes need to describe the following:

i. Functions to be performed and those responsible for performing them
ii. Documents used
iii. Source and destination of documents
iv. Sequence of filing documents
v. Types of accounting books kept

It has the advantages of being simple to record and easy to understand.

However, it has several practical application difficulties which include the following:

- It is difficult to make a note of changes in the system
- Preparation of narrative notes for a complex system may take up a disproportionate amount of space.
- It may be difficult to see if part of the system has been missed out altogether.

b. **Organization Chart**

This provides a convenient way of describing the authority, responsibility, approval and reporting relationships that exist in the organization. It outlines the formal relationships that exist in the organization. It however does not specify the precise duties of the individuals concerned.

c. **Internal Control Questionnaire (ICQ)**

ICQ remains the longest used internal control assessment and recording technique. Its function is to highlight precisely the areas of strength and weakness in the internal control system.

The questionnaire is a standardized pre-printed document designed by the audit firm using it, and comprises a series of questions designed to determine whether desirable controls are present. They are formulated so that there is one to cover each of the major transaction cycles.

The following points are worth-noting about the use of ICQ.

i) An ICQ will normally be used if the size and complexity of the client organization justifies it.

ii) A complete ICQ should have an effective life of approximately three years during which only updating would be necessary. The completion of new ICQ would be necessary if a major change in the system had taken place (e.g. a change over from manual to computerised system).

iii) The ICQ should be completed by a senior member of the audit staff after putting the questions to the responsible officers of the client company.

iv) Observation and selected tests will ensure that the ICQ accurately reflects the strengths and weaknesses within the procedures that operate from day to day.

v) The auditor should not place reliance on controls on the basis of this preliminary evaluation. He should conduct further compliance tests designed to give a reasonable assurance that the controls are functioning properly.

vi) The questions should be formulated in such a way that the relevant internal control criteria are implicit, so that no more than a Yes/No answer is required to indicate compliance or non-compliance. This degree of simplicity is not possible for every question, for example cases where it is necessary to know the names of executive officer authorized to sign cheques, or the limit on the authority of a particular officer to authorise expenditure.

Specimen Internal Control Questionnaire

i. **Purchases and Trade Creditors** -Are official orders issued showing names of suppliers, quantities ordered and prices? -Are copies of orders retained on files? -Are orders authorized based on authority limits? -Is a record kept of orders placed but not executed? If the answer to question above is „Yes" how is this record complied? (Specify)	Yes	No	N/A	Date of Answer
-Are goods from suppliers inspected on arrival as to quantity and quality? -Are all invoices received compared with copy orders? -Are the invoices checked for calculations, extensions, and additions? -Is the purchases ledger personnel independent of those responsible for approving invoices and credit notes? -Is the control account function independent of purchases ledger function?				

	Yes	No	N/A	Date of Answer
ii. **<u>Cheque Payments</u>** -Is the signing of blank cheques prohibited? -Is the signing of cheques restricted to directors/Secretaries/other senior officials? -Is the duly authorized invoice produced in respect of each payment before cheques are signed? -Are all cheques (other than those for cash) suitably crossed? -Are "paid" cheques returned by the bank monthly? -Are these cheques filed in the order in which they appear in the cash book?				
iii. **<u>Cash Payments</u>** -Apart from salaries and wages, are all payments made from an imprest? -Are supporting vouchers examined and authorized by a party other than the cashier or accountant? -Are expenditures appropriately analysed? -Is the amount of the claim enclosed on specially designed petty cash or other voucher? -Are checks made on the balance of cash in hand at random intervals by an independent official?	Yes	No	N/A	Date of Answer

Advantages and disadvantages of ICQ

Advantages include the following:

- If drafted thoroughly, they can ensure that all controls are considered - They are quick to prepare.
- They are easy to use and control. A manager or partner reviewing the work can easily see what has been done.

Disadvantages include the following:

- The client may overstate controls.
- ICQ may contain a large number of irrelevant controls.
- They can give the impression that all controls are of equal weight.
- They may not include unusual controls, which are nevertheless effective in particular circumstances.

d. **Flowcharts**

The auditor, in establishing the nature of the system in operation, may include flow charts of the system, supplemented by narrative notes in the permanent audit files. These are updated on the basis of regular periodic reviews.

The auditor's flow charts may be adapted from those already prepared by the client, or produced from scratch by the auditor.

The preparation of the flowcharts, will of itself teach the auditor a good deal more about the detailed functioning of the system at work in each department.

The auditor should not commit the flowchart to his files until he has, as a result of questioning and observation, reasonably ascertained that it represents what actually takes place. This precaution is important because the nature of the audit tests subsequently carried out will, to a large degree, follow the pattern reflected in the chart and much time will be wasted if the flowcharts are incomplete or inaccurate.

Generally, there are two methods of flowcharting, namely*: Document Flowcharts* and *Information Flowcharts.*

Document Flowcharts are more commonly used because they are relatively easy to prepare. They show that:

- All documents are followed through from beginning to the end
- All operations and controls are shown.

Information Flowcharts are prepared in the reverse direction from the flow. They start with the entry into the accounting records and work back to the actual transaction. They concentrate on significant information flows and ignore any unimportant or copies of document. They are easy to understand but require skill and experience to compile them.

Rules of Flowcharting

The following rules are generally observed in flowcharting:

i. A flowchart should only be used when the system being reviewed cannot be readily understood in words

ii) Flowcharts should be kept simple so that the overall structure or flow is clear at first sight. This means that:
   - There must be conformity of symbols, with each symbol representing one and only one thing
   - The direction of the flowchart should be from top to bottom and from left to right
   - There must be no loose ends
   - The main flow should finish at the bottom right-hand corner, not in the middle of the page

- Connecting lines should cross only where absolutely necessary to preserve the chart's simplicity

iii) Unless BSI (British Standard Institution) symbols are used, a key should always be provided.

iv) A specially designed template should always be used; freehand flowcharting is rarely acceptable.

v) The chart must reflect the system, weaknesses included.

vi) Marginal comments should be included in the chart where appropriate, using a dotted flow line and marginal bracket.

Advantages of Flowcharts

i. The system or any part of it may be presented as a totality without any loss of detail.
ii. The relationship between procedures in different areas can be depicted simply.
iii. Control features (or their absence in cases where they might be expected) may be highlighted by the use of designated symbols.
iv. References to the other related audit documents may be easily incorporated.
v. Diagrammatic representation facilitates subsequent references to particular features in the system more readily than pure narrative.
vi. New members of the audit team are able to participate in the audit work after a short induction period and as a result, it results in considerable saving of time.
vii. As the information is presented in a standard form, they are fairly easy to follow and to review.
viii. They generally ensure that the system is recorded in its entirety, as all document flows have to be traced from beginning to end. Any "loose end" will be apparent from a quick examination.
ix. They eliminate the need for extensive narrative notes and can be of considerable help in highlighting the salient points of control and any weakness in the system.

Disadvantages of Flowcharts

i. They are only suitable for describing standard systems. Procedures for dealing with unusual transactions will normally have to be recorded using narrative notes.
ii. They are useful for recording the flow of documents, but once the records or the assets to which they relate have become static, they can no longer be used for describing the control (for example over non-current assets).
iii. Major amendment is difficult without redrawing.
iv. Time can be wasted by charting areas that are of no audit significance.

8.8 EVALUATING THE INTERNAL CONTROL SYSTEM

After ascertaining and recording the system, the auditor has to conduct some preliminary evaluation of the control system in order to form opinion as to whether he can rely on the system to reduce substantive testing or he should disregard the control system (because they are inefficient) and to conduct in-depth testing. This is generally done using Internal Control Evaluation Questionnaire.

a. ***Internal Control Evaluation Questionnaire (ICEQs)***
These are designed to determine whether appropriate control systems exist to prevent specific errors or omissions. They are answered using knowledge of the system obtained from the flowchart or the internal control questions (ICQ). The characteristic of these questions is that they concentrate on the criteria that the existing controls should meet.

b. The nature of an ICEQ can be illustrated with the examples below:
   i. ***The sales (revenue) cycle***
   Is there reasonable assurance:
   - that sales are properly authorized?
   - that sales are made to reliable payers?
   - that all goods dispatched are invoiced?
   - that all invoices are properly prepared?
   - that all invoices are recorded?
   - that invoices are properly supported?
   - that all credits to customers" accounts are valid?
   - that cash and cheques received are properly recorded and deposited?
   - that slow payers will be chased and that bad and doubtful debts will be provided against?
   - that all transactions are properly accounted for?
   - that cash sales are properly dealt with?
   - that sundry sales are controlled?
   - that at the period end the system will neither overstate nor understate debtors?

ii. ***The purchases (expenditure) cycle***
Is there reasonable assurance:
- that goods or services could not be received without a liability being recorded?
- that receipt of goods or services is required in order to establish a liability?
- that a liability will be recorded:
  i. only for authorized items; and
  ii. at the proper amount?
- that all payments are properly authorized?
- that all credits due from suppliers are received?
- that all transactions are properly accounted for?
- that at the period end liabilities are neither overstated nor understated by the system?
- that the balance at the bank is properly recorded at all times?
- that unauthorized cash payments could not be made and that the balance of petty cash is correctly stated at all times?

iii. ***Wages and Salaries***

Is there reasonable assurance:

- that employees are only paid for work done?
- that employees are paid the correct amount (gross and net)?
- that the right employees actually receive the right amount?
- that accounting for payroll costs and deductions is accurate?

iv. ***Inventories***

Is there reasonable assurance:

- that inventory is safeguarded from physical loss (e.g. fire, theft, deterioration)?
- that inventory records are accurate and up to date?
- that the recorded inventory exists?
- that the recorded inventory is owned by the company?
- that the cut off is reliable?
- that the costing system is reliable?
- that the inventory sheets are accurately complied?
- that the inventory valuation is fair?

v. ***Non-current assets***

Is there reasonable assurance:

- that recorded assets actually exist and belong to the company?
- that capital expenditure is authorized and reported?
- that disposals of non-current assets are authorized and reported?
- that depreciation is realistic?
- that non-current assets are correctly accounted for?
- that income derived from non-current assets is accounted for?

i. That the carrying values reflect the fair values.

vi. ***Investments***

Is there reasonable assurance:

- that recorded investments belong to the company and are safeguarded from loss?
- that all income, rights or bonus issues are properly received and accounted for?
- That investment transaction is made only in accordance with company policy and are appropriately authorized and documented?
- that the carrying values of investments are reasonably settled?

vii ***Management information and general controls***

- Is the nominal ledger satisfactorily controlled?
- Are journal entries adequately controlled?
- Does the organization structure provide a clear definition of the extent and limitation of authority?

- Are the systems operated by competent employees, who are adequately supported?
- If there is an internal audit function, and is it adequate?
- Are financial planning procedures adequate?
- Are periodic management reporting procedures adequate?

c. ***Advantages of ICEQs***

i. ICEQs highlight areas of weakness where extensive substantive testing will be required.

ii. Answering ICEQs enables auditors to identify the important controls which they are most likely to test during control testing.

d. ***Disadvantages of ICEQs***

The main disadvantage of ICEQs is that they can be drafted vaguely, hence misunderstood and important controls not identified.

8.9 PRACTICAL APPLICATION OF INTERNAL CONTROL

a. **Key Control Risk Areas**

The following is a summary of the Internal Control considerations appropriate to each of the following areas:

i. General financial arrangements
ii. Cash and cheques (received and paid)
iii. Wages and salaries
iv. Purchases and trade creditors
v. Sales and trade debtors
vi. Inventories and Work-in-progress
vii. Non-Current assets and investments.

b. **General Financial Arrangements**

Internal control considerations include the following:

i. Devising an appropriate and properly integrated system of accounts and records.

ii. Determining the form of general financial supervisory budgetary control, regular interim accounts of suitable frequency and special reports.

iii. Ensuring that adequate precautions are taken to safeguard (and if necessary, to duplicate and store separately) important records.

iv. Engaging training and allocating to specific duties, management, and staff competent to fulfil their responsibilities and getting replacements during staff absence.

c. **Cash Sales and Cheques Received by Post**

Considerations involved in dealing with cash and cheques received by post include:

i. Instituting safeguards to minimize the risk of interception of mail between its receipt and opening.

ii. Whenever possible, appointing a responsible person, independent of the cashier, to open or supervise the opening of mails.

iii. Ensuring that cash and cheques received are adequately protected (for instance by restrictive crossing) and properly accounted for (for instance by the preparation of post-lists of moneys received for independent comparison with subsequent records and book entries).

d. **Custody and Control of Money Received**

Internal Control considerations include the following:

i. The appointment of suitable person to be responsible at different stages for the collection and handling of money received, with clearly defined responsibilities.

ii. How, by whom, and at what frequency cash offices and registers are to be cleared?

iii. What arrangements are to be made for agreeing cash collections with cash and sales records (preferably, this should be carried out by a person independent of the receiving cashier or employee)?

iv What arrangements are to be made for dealing with recording and investigating any cash shortage or surpluses?

e. **Recording of Cash Received**

Internal Control considerations include:

i. Determining the person responsible for maintaining records of money received.

ii. Establishing the practical limitations to be put on the duties and responsibilities of the receiving cashier, particularly as regards dealing with such matters as other books of accounts, other funds, securities and negotiable instruments, sales invoices, credit notes and cash payments.

iii. Identifying the persons to deputise for the receiving cashier during his absence at lunch, on holiday, or through sickness.

iv. Determining the circumstances under which receipts are to be given, whether copies are to be retained, the serial numbering of receipt books and forms; how their issues and use are to be controlled, what arrangements are to be made, and who is to be responsible for checking receipt counterfoils against cash records and bank paying-in-slips.

f. **Payment into Banks**

Internal control considerations include the following:

i. How frequently payments are to be made into the bank (preferably daily)

ii. Who is to make up the bank-paying-in-slips (preferably this is to be done by a person independent of the receiving and recording cashier).

iii. Who is to make payments into the bank (preferably not the person responsible for preparing pay-in-slips).

iv. Whether all receipts are to be banked intact; if not, how disbursements are to be controlled.

g. **Cash Balances**

Considerations in connection with the control of cash balances include:

i. What amounts are to be retained as cash floats at cash desks, and whether payments out of cash received are to be permitted?

ii. What restrictions are to be imposed as to access to cash registers and officers.
iii. Rules regarding the size of cash floats (i.e., the imprest system) to meet expenses, and their methods of reimbursement.
iv. The frequency with which cash floats are to be checked by independent officials.
v. What arrangements are to be made for safeguarding cash left on the premises outside business hours.
vi. Whether any special insurance arrangement (such as fidelity guarantee and cash insurance) are judged desirable having regard to the nature of the business, the sums handled, and the length of time they are kept on the premises.
vii. What arrangements are to be made for the control of funds held in trust for employees, especially those which are held by nominated employees independent of the company's authority (for instance, sickness funds or holiday clubs).

h. **Cheque Payments**

Among the points to be decided in settling the system for payments by cheque are the following:

i. What procedure is to be adopted for controlling the supply and issue of cheques for use, and who is to be responsible for issue of cheques for use, and who is to be responsible for their safe-keeping
ii. Who is to be responsible for preparing cheques.
iii. What documents are to be used as authorization for preparing cheques, rules as to their presentation to cheques signatories as evidence in support of payments, and the steps to be taken to ensure that payments cannot be made twice on the strength of the same documents.
iv. The names and status of persons authorized to sign cheques, limitations as to their authority. The minimum number of signatories required for each cheque etc.
v. Safeguards to be adopted if cheques are signed mechanically or carry printed signatures.
vi The extent to which cheques issued should be restrictively crossed, and the circumstances, if any, in which blank or bearer cheques may be issued.
vii. Arrangements for obtaining paid cheques, whether they are to be required; and the procedure to be followed in dealing with paid cheques returned.
viii. The arrangements to be made to ensure that payments are made within discount periods.

i. **Cash Payments**

Factors to be considered include the following:

i. Nomination of a responsible person to authorize expenditure, the means of indicating authorization and the documentation to be presented and preserved as evidence.
ii. Arrangements to ensure that the vouchers supporting payments cannot be presented for payment twice.
iii. Whether any limit is to be imposed as regards amounts disbursed in respect of individual payments.
iv. Rules as to cash advances to employees and official, IOUs, and the cashing of cheques.

j. **Wages and Salaries**

Internal control considerations include the following:

i. Who may authorize the engagement and discharge of employees.
ii. Who may authorize general and individual changes in rates of pay.
iii. How notifications of changes in personnel and rates of pay are to be recorded and controlled to prevent irregularities and errors in the preparation and payment of wages and salaries.
iv. How deduction from employees pay other than statutory deductions (income tax and Social Security deductions) are to be authorized.
v. What arrangements are to be made for recording hours worked (in the case of hourly paid workers) or work done (in case of piece workers), and for ensuring that the records are subject to scrutiny and approval by a responsible official before being passed to the wages department.
vi. Whether advances of pay are to be permitted; if so, how they are to be notified to and dealt with by wages and salaries department and how they are to be recovered
vii. How holiday pay is to be dealt with.
viii. Who is to deal with pay queries?

k. **Preparation of Payroll**

The procedures for preparing the payroll should be clearly established. Principal matters for consideration include the following:

i. What records are to be used as bases for compilation of the payroll and how they are to be authorized?
ii. Who is to be responsible for preparing pay sheets, for checking them, for approving them, and by what means individual responsibility at each stage is to be indicated.
iii. What procedures are to be laid down for notifying and dealing with non-routine circumstances such as an employee's absence from work, or employee's leaving at short notice in the middle of a pay period.

l. **Payment of Wages and Salaries**

Where employees are paid in cash, the following matters are among those that require decisions:

i. What arrangements are to be made to provide the requisite cash for paying out (example, by encashment of a cheque for the total amount of wages) and what steps are to be taken to safeguard such moneys during collection and transit and until distribution.
ii. What safeguard against irregularities are to be adopted and what particulars are to be given to the payees.
iii. Who is to pay cash wages over to employees (preferably a person independent of those engaged in the preparation of pay sheets and pay packets). How payees" identities are to be verified and how distribution is to be recorded (e.g. by recipient's signature or by checking off names in the pay list).
iv. What arrangements are to be made for dealing with unclaimed wages.

Where wages and salaries are paid by cheque or bank transfer, the matters to be decided include:

v. Which persons are to prepare, and to sign cheques and bank transfer lists (preferably these persons should be independent of each other and of those responsible for preparing pay sheets?
vi. Whether a separate wages and salaries bank account is to be maintained what amounts are to be transferred to it from time to time and who is to be responsible for its regular reconciliation.

m. **Purchases**

Factors to be considered include:

i. The procedure to be followed when issuing requisitions for additions to and replacements of inventories, and the persons to be responsible for such requisitions.
ii. The preparation and authorisation of purchase orders (including procedures for authorizing acceptance where tenders have been submitted for prices quoted).
iii. As regard capital items, any special arrangements as to authorizations required.
iv. Arrangements for examining goods inwards as to quantity, quality, and condition, and for recording the evidence of such examination.
v. The appointment of a person responsible for accepting goods and procedure for recording and evidencing their arrival and acceptance.
vi. The procedure to be instituted for checking goods inwards records against authorized purchase orders.

n. **Accounting for Purchases**

Factors to be considered include:

i. The appointment of persons (as far as possible), separately responsible for checking suppliers invoices, recording purchases and purchase returns; maintaining suppliers ledger accounts or similar records; checking suppliers statements; and authorizing payments.
ii. Arrangements to ensure that before goods are paid for;
iii. The goods concerned have been received, accord with the purchase order, and properly priced and invoiced.
iv. The expenditure has been properly allocated; and
v. Payments have been duly authorized by the official responsible.

o. **Sales**

Considerations include the following:

i. What arrangements are to be made to ensure that goods are sold at their current prices and how to deal with cheque exchange, discounts and special reductions.
ii. Who is to be responsible for, and how control is to be maintained over, the granting of credit terms to customers.
iii. Who is to be responsible for accepting customers‘ orders and what procedures is to be adopted for issuing production orders and dispatch notes.
iv. Who is to be responsible for the preparation of invoices and credit notes and what controls are to be instituted to prevent errors and irregularities (for instance, how selling prices are to be ascertained and authorised, how the issue of credit notes are to be controlled and checked, etc.).
v. What special controls are to be exercised over the dispatch of goods free of charge or on special terms.
vi. Who may authorize the dispatch of goods and how such authority is to be evidenced.

vii. What arrangements are to be made to examine and record goods outwards (preferably, this should be done by a person who has no access to inventories and has no accounting or invoicing duties).
viii. The procedures to be instituted for agreeing goods outwards with customers' orders, dispatch notes and invoices.

p. **Accounting for Sales**

The following are among matters to be considered:

i. The appointment of persons, as far as possible, separately responsible for recording of sales returns, maintaining customers' accounts, and preparing debtors statements.
ii. The establishment of appropriate control procedures in connection with sales returns, price adjustments and similar matters.
iii. Arrangements to ensure that goods dispatched but not invoiced (or vice versa) during an accounting period are properly dealt with in the account of the period concerned (i.e., cut-off procedure).
iv. The establishment of arrangements to deal with sales to companies or branches forming part of the same group, or other related parties.
v. What procedures are to be adopted for the preparation, checking and dispatch of debtors' statements and for ensuring that they are not subject to interference before dispatch.
vi. How discounts granted and special terms are to be authorized and evidenced
vii. Who is to deal with customers queries connected with statements of accounts?
viii. What procedure is to be adopted for reviewing and following up overdue accounts.
ix. Who is to authorize the writing off of bad debts and how such authority is to be evidenced.
x. The institution of a sales control accounts and its regular checking preferably by an independent official against customers' balances on the sales ledger.

q. **Inventories and Work in Progress**

Among the main considerations are the following:

i. What arrangements are to be made for receiving, checking and recording goods inwards?
ii. Who is to be responsible for the safeguarding of inventories and what precautions are to be taken against theft, misuse and deterioration?
iii. What arrangements are to be made for controlling (through establishing inventory levels) and recording inventories (e.g. by inventory ledgers, independent control accounts, bin card etc.).
iv. Who is to be responsible for keeping inventory records (preferably persons who have no access to inventories and are not responsible for sales and purchases records), and what procedure is to be followed as to the periodic reconciliation of inventory record with the financial accounts.
v. How movement of inventories out of store (or from one process or department to another) are to be authorized, evidenced and recorded and what steps are to be taken to guard against irregularities.
vi. What arrangements are to be made for dealing with returnable containers?
vii. What arrangements are to be made for dealing with maintaining control over

company's inventories held by others (for instance goods in warehouse, on consignment, or in course of processing) and goods belonging to others held by the company (e.g. how withdrawals are to be authorized and evidenced, and how goods belonging to others are to be distinguished from own goods).

viii. What persons are to be responsible for physical checking of inventories, at what intervals such checks are to be carried out and what procedures are to be followed (e.g. if continuous inventory-taking procedures are in use, arrangement should ensure that all categories of inventories are counted at appropriate intervals, normally at least once a year). Counts should preferably be conducted by persons independent of storekeepers; how inventory counts are to be recorded and evidenced and what cut-off procedures are to be operated to ensure that inventories are adjusted to take proper accounts of year-end sales and purchases.

ix. What bases are to be adopted for computing the amount at which inventories are to be stated in the accounts?

x. What arrangements are to be made for the periodic review of the condition of inventories, how damaged, slow moving and obsolete inventories are to be dealt with and the write off are to be authorized.

xi. What steps are to be taken to control and account for scrap and waste, and receipts from the disposal of cash items?

r. **Non-Current Assets**

Some of the principal issues to be decided in connection with controls relating to non-current assets are as follows:

i. Who is to authorize capital expenditure and how such authorization is to be evidenced.

ii. Who is to authorize the sale, scrapping or transfer of non-current assets, how such authorization is to be evidenced, and what arrangements are to be made for controlling and dealing with receipts from disposals.

iii. Who is to maintain accounting records in respect of assets register and how frequently they are to be agreed with the relevant accounts and physically verified.

iv. What arrangements are to be made to ensure that non-current assets are properly maintained and applied in the service of the company (e.g. by periodic physical checks as to their location, operation and condition).

v. Where non-current assets are transferred between branches or companies within a group, what arrangements in respect of depreciation accounting are made.

vi. How depreciation rates are to be authorised and evidenced and who is to be responsible for carrying out and checking the necessary calculations.

s. **Investments**

Internal control considerations include the following:

i. Who is to be responsible for authorising purchases and sales of investments and how such authorizations are to be evidenced (those responsible should preferably have no concern with cash or the custody of documents of title).

ii. What arrangements should be made for maintaining a detailed investment register, and who should be responsible for agreeing it periodically with the investment control account and physically verifying the documents of title.

iii. What arrangements are to be made for checking contract notes against authorised purchases or sale instructions and for ensuring that charges for dealing with share transfers are currently calculated and for ensuring that business rights, dividends interest and/or capital repayments are received and properly accounted for.

8.10 CONTROL SYSTEMS AS THEY APPLY TO SMALL ENTITIES

a. **Control Environments**

Small entities may implement the control environment elements in a manner different from that of the larger entities. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Similarly, those charged with governance in small entities may not include an independent or outside member.

b. **Risk assessment Process**

The basic concepts of the entity's risk assessment process are relevant to every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognized implicitly rather than explicitly in small entities. Management may be aware of risks related to these objectives without the use of a formal process but through direct personal involvement with employees and outside parties.

c. **Information Systems**

Information systems and related business processes relevant to financial reporting in small entities are likely to be less formal than in larger entities. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Communication may be less formal and easier to achieve in a small entity than a larger entity due to the small entity's size and fewer levels as well as management's greater visibility and availability.

d. **Control Activities**

The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate varies. Small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities. An appropriate segregation of duties often appears to present difficulties in small entities. Companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

e. **Monitoring of Controls**

On-going monitoring activities of small entities are more likely to be informal and are typically performed as a part of the overall management of the entity's operations. Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

8.11 REPORTING ON INTERNAL CONTROL TO MANAGEMENT

a. **Introduction**

This section outlines the need for auditors to communicate weaknesses identified in the accounting and internal control systems to management and describe the nature and contents of such reports.

At the conclusion of the internal control assessment stage of the audit, there is the need for the auditors to communicate any weaknesses discovered in the internal control systems to the management of the client company.

This report usually takes the form of a Management Letter, Letter of Weakness, or Internal Control Letter. However other forms of reports are acceptable.

The precise stage of the audit at which the letter should be sent, how far the content of the report should extend and the action the auditor should take if his observations on major weaknesses are ignored by the client are matters of professional judgement and based on the type of audit and the client company.

Where the audit work is performed on more than one visit, the auditors normally report to management after the interim audit work has been completed as well as after the final visit, particularly if there are procedures that need to be improved before the financial year end.

b. **Principal purposes of reports to management**

The principal purposes of reports to management are as follows:

i. To enable the auditors to comment on the design and operation of the accounting and internal control systems examined during the audit and to make suggestion for their improvement;

ii. To provide other constructive advice, for example, comments on potential economies or improvements in efficiency identified during the audit; and

iii. To communicate other matters that have come to the auditors' attention during the audit, for example comments on adjusted and unadjusted errors in the financial statements or on particular accounting policies and practices.

c. **Material weaknesses in accounting and internal control systems**

When material weaknesses in the accounting and internal control systems are identified during the audit, the auditors should report them in writing to the directors, the audit committee or to an appropriate level of management on a timely basis.

A material weakness (within this context) is a condition which may result in a material misstatement in the financial statements. If the directors or management have detected a material weakness, and in the view of the auditors, have taken the appropriate corrective actions, the auditors do not need to report to directors or management on the matter. In this circumstance, the auditors normally document, in their working papers, the considerations which resulted in their conclusion that no report to directors or management in respect of this matter is needed.

Ordinarily, material weaknesses in the accounting and internal control systems are communicated to directors or management in a written report issued by the auditors. However, in some circumstances it may be sufficient for the relevant matters to be raised orally with directors or management, followed by a file note circulated to those attending the meeting to provide a record of the auditors' observations and the responses of the directors or management.

When no material weaknesses are identified during the audit, the auditors may choose not to issue a report to directors or management. They may however need to inform them that no report is to be issued.

d. **Addressee of report to management**

When submitting a management report, the auditors need to consider which directors or members of management have the power to act on their findings. Ordinarily, it is appropriate to address the report to the board of directors, audit committee or similar body. The report may contain matters of varying levels of significance which may make it appropriate for a tiered report to be issued so that the board can consider any major points and the receipt of a report of less important matters can be delegated to other levels of management.

Ordinarily, the auditors request a reply to the points raised in a report to management, indicating the actions that the directors or management intend to take as a result of the comments made in the report.

In any report to directors or management, the auditors need to explain that the report is not a comprehensive statement of all weaknesses which exist or of all improvements which may be made, but that it documents only those matters which have come to their attention as a result of the audit procedures performed. The auditors may wish to refer to their audit approach in the report to directors or management, particularly in the work undertaken on the accounting and internal control system, to help directors or management appreciate the nature, time and extent of the audit procedures which have resulted in the identification of the matters included in the report.

e. **Other matters regarding reports to management**

If the auditors identify weakness (other than material weakness) and other matters which they consider appropriate to bring to the attention of directors, they may include them in the report (together with the material weaknesses), although they may be issued in a separate report.

The auditors may consider it appropriate to raise these matters orally with management and under these circumstances, the auditors normally prepare a file note to provide a record of their observations.

To be effective, a report to directors or management is issued immediately after the completion of the audit procedures giving rise to the observations.

Where the audit work is performed in more than one visit, it is appropriate to report to directors or management after the interim visit as well as after the final audit visit. However, an interim audit report needs to make it clear that the overall audit work is only partially complete and further matters may still arise.

Matters raised in previous reports to directors or management need to be considered by the auditors. Where they have not been dealt with effectively, the auditors need to enquire why appropriate action has not been taken. If the auditors consider that a point is still significant, consideration needs to be given to repeating the point in the current report, otherwise there is a risk that the auditors may give an impression that they are satisfied that the weakness has been corrected.

f. **Third parties interested in reports to directors or management**

Any report to directors or management is a confidential communication. Thus the auditors need to obtain the prior consent of the directors or management if they are to provide a copy of the report to a third party.

In practice, the auditors have little control over what happens to the report once it has been dispatched. Occasionally, management may provide third parties with copies of the report, e.g., their banks or certain regulatory authorities.

It is therefore appropriate to ensure that third parties who see the report understand that it was not prepared for their benefit. Accordingly, care needs to be taken to protect the auditor's position from exposure to liability to any third parties who may seek to rely on a report which was not intended for their use.

Thus, auditors ordinarily state in their report to management that:

i. the report has been prepared for the sole use of the entity;
ii. it must not be disclosed to a third party without the written consent of the auditors; and
iii. no responsibility is assumed by the auditors to any other person.

As a rule, a liability in negligence to a third party may only arise in circumstances where the auditors carry out work for an entity knowing that their work is to be relied upon by a third party and that the third party may suffer financial loss as a result. An expressed disclaimer of liability normally provides a high degree of protection against an unforeseen liability to a third party.

Specimen management letter

6th February 2022
The Board of Directors
Seekfirst Plc
290 Abeka Rd Ext
Lagos

Members of the Board,

Financial Statements for the year ended 31 December 2021

Following the conduct of our interim audit, we set out below certain points which arose as a result of our review of the accounting systems and procedures operated by your company.

We wish to point out, however, that our audit testing was undertaken in accordance with the scope of our audit engagement, and therefore, will not necessarily identify all weaknesses that may exist. As you are aware, it is the responsibility of the directors to ensure that satisfactory internal controls are maintained at all times.

1. **<u>Purchase order Procedure</u>**

Present system

During the audit we found out that some departments order some goods from suppliers orally without the support of any purchase requisition or purchase order.

Implication

Actions against suppliers' non-performance would become unenforceable in the absence of a written purchase order.

Recommendation

We recommend that the Logistic Department be made responsible for all procurements and when orders are made orally, they should be subsequently confirmed by raising official purchase order.

2. **Purchase Ledger Reconciliation**

Present System:

Although it is the practice of your company to reconcile the purchase ledger with statements received from various suppliers at the end of every month, this was not done in August and September.

Implication

Unexplained differences exist between suppliers‘ statements balance and purchase ledger balances. This implies a breakdown of purchases invoice and or cheque payment batching and posting procedures.

Recommendation

It is important that this reconciliation is performed regularly by a responsible official independent of day-to-day purchase ledger, cashier and nominal ledger functions.

3 Credit Control

Present System

As at 30 October 2021, total debtors figure approximates three months sales although the company's trade terms allow four weeks credit to customers.

Implication

This has resulted in high overdraft level with the resultant high interest charges and difficulty in settling the accounts of some key suppliers on time.

Recommendations

We recommend that a more structured system of debt collection be considered using standard letters and that account statements should be sent out a week earlier than it is now.

Yours faithfully,

ABC & Co.

Chartered Accountants

8.12 INTERNAL AUDIT AS A CONTROL FACTOR

The external auditor should consider the activities of internal auditing and their effect, if any, on external audit procedures.

"Internal auditing" is an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, the monitoring of the internal control system.

While the external auditor has sole responsibility for the audit opinion expressed and for determining the nature, timing and extent of external audit procedures, certain parts of internal auditing work may be useful to the external auditor.

a. **Scope and Objectives of Internal Auditing**

The scope and objectives of internal auditing vary widely and depend on the size and structure of the entity and the requirements of its management. Ordinarily, internal auditing activities include one or more of the following.

i. ***Monitoring of internal control*:**

The establishment of adequate internal control is the responsibility of management which demands proper attention on a continuous basis. Internal auditing is ordinarily assigned specific responsibility by management for reviewing controls, monitoring their operation, and recommending improvements.

ii. ***Examination of financial and operating information*:**
This may include review of the means used to identify measure, classify, and report such information and specify inquiry into individual items including detailed testing of transactions, balances and procedures.

iii. ***Review of the economy*:**
Efficiency and effectiveness of operations including non-financial controls of an entity:
Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements.

b. **Relationship Between Internal Auditing and The External Auditor**

The role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report independently on the financial statements. The internal audit function's objectives vary according to management's requirements. The external auditor's primary concern is whether the financial statements are free of material misstatements.

Nevertheless, some of the means of achieving their respective objectives are often similar and thus certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures.

Internal auditing is part of the entity. Irrespective of the degree of autonomy and objectives of internal auditing, it cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on the financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by any use made of internal auditing. All judgments relating to the audit of the financial statements are those of the external auditor.

c. **Understanding and Preliminary Assessment of Internal Auditing**

The external auditor should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures.

Effective internal auditing will often allow a modification in the nature and timing, and a reduction in the extent of audit procedures performed by the external auditor but cannot eliminate them entirely. In some cases, however, having considered the activities of internal auditing, the external auditor may decide that internal auditing will have no effect on external audit procedures.

The external auditor should perform an assessment of the internal audit function when internal auditing is relevant to the external auditor's risk assessment.

The external auditor's assessment of the internal auditor's function will influence the external auditor's judgment about the use which may be made of internal auditing in making risk assessments and thereby modifying the nature, timing and extent of further external audit procedures.

When obtaining an understanding and performing an assessment of the internal audit function, the important criteria are the following:

i) ***Organizational status:*** Specific status of internal auditing in the entity and the effect this has on its ability to be objective. In the ideal situation, internal auditing will report to the highest level of management and be free of any other operating responsibility. Any constraints or restrictions placed on internal auditing by management would need to be carefully considered. In particular, the internal auditors will need to be free to communicate fully with the external auditor.

ii) ***Scope of function:*** The nature and extent of internal auditing assignments performed. The external auditor would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

iii) ***Technical Competence:*** Whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors. The external auditor may, for example, review the policies for hiring and training the internal auditing staff and their experience and professional qualifications.

iv) ***Due professional care:*** Whether internal auditing is properly planned, supervised, reviewed, and documented. The existence of adequate audit manuals, work programmes and working papers would be considered.

d. Timing for Liaison and Coordination

When planning to use the work of internal auditing, the external auditor will need to consider internal auditor's tentative plan for the period and discuss it as early as possible. Where the work of internal auditing is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to agree in advance the timing of such work, the extent of audit coverage, materiality levels and proposed methods of sample selection, documentation of the work performed and review and reporting procedures.

Liaison with internal auditing is more effective when meetings are held at appropriate intervals during the period. The external auditor would need to be advised of and have access to relevant internal reports and be kept informed of any significant matter that comes to the internal auditor. Similarly, the external auditor would ordinarily inform the internal auditor of any significant matters which may affect internal auditing.

e. **Evaluating the Work of Internal Auditing**

When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.

The evaluation of specific work of internal auditing involves consideration of the adequacy of the scope of work and related programmes and whether the assessment of the internal auditing remains appropriate. This evaluation may include consideration of whether:

i) The work is performed by persons having adequate technical training and proficiency as internal auditors and the work of assistants is properly supervised, reviewed and documented;
ii) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;
iii) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
iv) Any exceptions or unusual matters disclosed by internal auditing are properly resolved.

The nature, timing and extent of the audit procedures performed on the specific work of internal auditing will depend on the external auditor's judgment as to the risk of material misstatement of the area concerned, the assessment of internal auditing and the evaluation of the specific work by internal auditing. Such audit procedures may include examination of items already examined by internal auditing, examination of other similar items and observation of internal auditing procedures.

The external auditor would record conclusions regarding the specific internal auditing work that has been evaluated and the audit procedures performed on the internal auditor's work.

8.13 CHAPTER SUMMARY

i. It is the responsibility of management of every entity to ensure the existence and operation of an efficient internal control system. The auditor's role is to examine the systems and to determine the extent to which the system can be relied upon.
ii. There are several ways of ascertaining and recording internal control systems.
iii. Control environment means the overall attitude, awareness and actions of management regarding internal controls
iv. Control procedures are those established to achieve the entity's specific objectives
v. Internal controls are meant to prevent risks from occurring or to minimize the impact of such risks
vi. Generally, the larger the entity the more comprehensive the controls would have to be.

vii. Auditors rely on internal control\to reduce the amount of substantive testing required.

viii. Internal Auditing is instituted in an entity to serve as a control factor and that internal audit department should be able to provide management (Board) with assurance regarding the effectiveness of the system of internal controls.

MULTIPLE-CHOICE QUESTIONS ON INTERNAL CONTROL

1. Auditors obtain an understanding of the accounting system sufficient to enable them to identify and understand by documenting the following **EXCEPT**

   A Major class of transactions in the entity's operation.
   B How such transactions are initiated
   C Significant accounting records, supporting documents and accounts in the financial statements
   D The accounting and financial reporting process from the initiation of significant transactions and other events to their inclusion in the financial statement
   E Their knowledge of any significant change in the composition of the board.

2. The nature, timing and extent of the procedures performed by auditors to obtain an understanding of the systems vary because of the following factors **EXCEPT**

   A Materiality consideration
   B The size and complexity of the entity
   C The type of products and/or services rendered by the entity
   D Their assessment of inherent risk
   E The type of internal controls involved

3. Specific criteria for assessing the internal audit functions **EXCLUDES**

   A Resources available
   B Due professional care
   C Scope of function
   D Technical competence
   E Number of staff in the internal audit section

4. Which of the following is **NOT** a component of an internal control system?

   A. Control environment
   B. Risk assessment
   C. Control activities
   D. Monitoring
   E. Management perspective

5. Which of the following does **NOT** represent an inherent limitation of internal control system?

   A Fraud
   B Abuse of responsibility

C Fatigue
D Accountability
E Poor working conditions

SHORT-ANSWER QUESTIONS

6. The overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity is referred to as……………………….....................
7. Those policies and procedures in addition to the control environment which are established by management to achieve the entity's specific objectives are known as …………………
8. The type of audit tests performed to obtain audit evidence about the effective operation of the accounting and internal control systems within an entity is called………………
9. State any **TWO** features of Internal Control.
10. List any **TWO** factors which management will consider in order to determine the extent to which internal controls are to be applied within an organisation.

SOLUTIONS TO MULTIPLE CHOICE QUESTIONS

1. **E**
2. **C**
3. **E**
4. **E**
5. **D**

SOLUTIONS TO SHORT-ANSWER QUESTIONS

6. Control environment

7. Control procedures

8. Test of controls

9. Any TWO of
   (a) Segregation of duties
   (b) Custody and control of assets
   (c) Authorisation and approval
   (d) Review of management accounts and comparison with budget
   (e) Supervision of day to day transactions by responsible official
   (f) Allocation of responsibilities
   (g) Checking of arithmetical accuracy of the records

10. Any TWO of
   (a) The nature size and volume of transactions
   (b) The geographical distribution of the enterprise
   (c) The controls exercised personally by individual members of management
   (d) The cost of setting up controls and the benefits obtained thereby

CHAPTER NINE
PUBLIC SECTOR ASSURANCE

CHAPTER CONTENTS

a. Appointment, Powers and Functions of the Auditor-General
b. Functions of the Office of the Auditor-General
c. Role of Public Accounts Committee (PAC) in the Audit Process
d. Internal Audit in the Public Sector
e. Due process and the Procurement Act
f. Establishment of the Bureau of Public Procurement

OBJECTIVES

After studying this chapter, readers should be able to understand:

a. Appointment, powers and functions of the Auditor-General for the Federation, States and Local Government.
b. Auditing for compliance with legislative and related authorities
c. The role of Public Accounts Committee (PAC) in the Audit process
d. Internal audit in the public sector
e. Due process and Public Procurement Act

9.1 APPOINTMENT, POWERS, AND FUNCTIONS OF THE AUDITOR-GENERAL

9.1.1 Appointment of Auditor-General

The Auditor-General for the Federation is appointed by the President on the recommendation of the Federal Civil Service Commission, subject to confirmation by the Senate. He is appointed in accordance with the provision of Sec. 86 of the 1999 Constitution of the Federal Republic of Nigeria (as amended to 2011). The power to appoint a person to act in the office of the Auditor-General is vested in the President.

At the level of a State, a similar dispensation is put in place under the 1999 Constitution, for the Governor to appoint the Auditor-General of the State on the recommendation of the State Civil Commission, subject, however, to the confirmation of the relevant House of Assembly. The appointment of the Auditor-General for Local Government of a State undergoes the same process outlined above.

9.1.2 Acting Capacity

No person acts in the office of the Auditor-General for a period exceeding six months, except with the sanction of a resolution duly passed by the Senate.

9.1.3 Tenure of office of Auditor-General (Section 87)

a) a person holding the office of the Auditor-General for the Federation can be removed from office by the President acting on an advice supported by two thirds majority of the Senate, praying that he be so removed for inability to discharge the functions of his office. Auditor-General shall be so removed only on account of:
   i) Infirmity of mind, body, or any other cause, or
   ii) Misconduct

b) The Auditor-General cannot be removed from office before such retiring age as may be prescribed by law, save in accordance with the provisions of aforementioned paragraph.

9.1.4 Powers and Functions of Auditor-General

According to the Financial Regulations No 108 (December 2009), the Officer responsible under the Constitution of the Federation for the audit and report on the public accounts of the Federation, including all persons and bodies established by law entrusted with the collection, receipt, custody, issue, sale, transfer or delivery of any stamps, securities, stores or other property of Government of the Federation and for the certification of the Annual Accounts of that Government is the Auditor-General for the Federation. The Auditor-General shall examine and ascertain in such manner as he may think from the accounts relating to public funds and property and shall ascertain whether in his opinion:

a) The accounts have been properly kept;
b) All public monies have been fully accounted for, and the rules and procedures applied are sufficient to secure effective checks on the assessment, collection and proper allocation of revenue;
c) Monies have been expended for the purposes for which they were appropriated and the expenditure have been made as authorised; and
d) Essential records are maintained and the rules and procedures applied sufficient to safeguard and control public property and funds.

9.1.5 Free Access to Books and Accounts

By virtue of the responsibilities and functions of the Auditor-General for the Federation, the officer and/or his/her representatives are permitted free access, at all reasonable times, to all files, safes, documents, books and other records relating to the accounts of all Federal Ministries/Extra-Ministerial Departments or units. They are also entitled to require and receive from members of the public services such information, reports and explanations as they may deem necessary for the proper performance of their functions.

The Auditor-General is empowered to conduct periodic checks of all government statutory corporations, commissions, authorities, agencies, including all persons and bodies established by an Act of the National Assembly.

The Auditor-General shall, within ninety days of receipt of the Accountants-General's financial statements, submit his reports to each House of the National Assembly and each House shall cause the reports to be considered by a Committee of the House of the National Assembly responsible for public accounts.

In the exercise of his functions under the Constitution, the Auditor-General is not subjected to the direction or control of any other authority or person.

9.1.6 Audit of Public Accounts

a. The Auditor-General for the Federation shall be appointed in accordance with provisions of section 86 of the Constitution of Federal Republic of Nigeria

b. The Public accounts of the Federation and of all offices and courts of Federation shall be audited and reported on, by the Auditor-General who shall submit his reports to the National Assembly.

c. Nothing in section 85 (2) shall be constructed as authorizing the Auditor-General to audit the account of (or appoint auditors for) government statutory corporations, commission, authorities, agencies including all persons and bodies established by an Act of the National Assembly.

   Nonetheless the Auditor-General shall:

   i) Provide such bodies with:
      - A list of auditors qualified to be appointed by them as external auditors and from which the bodies shall appoint their external auditors
      - Guidelines on the level of fees to be paid to external auditors and

   ii) Comment on their annual accounts and auditor's reports thereon.

d. The Auditor-General shall have power to conduct periodic checks of all government statutory corporations, commission, authorities, agencies, including all persons and bodies established by an Act of the National Assembly.

e. The Auditor-General shall, within ninety days of receipt of the Accountant-General's financial statements, submit his report under this section to each House of the National assembly and each House shall cause the report to be considered by a Committee of the National assembly responsible for public accounts.

f. In the exercise of his functions under the Constitution, the Auditor-General shall not be subject to the direction or control of any other authority or person.

9.1.7 Auditing for Compliance with Legislative and Related Authorities

The Auditor-General performs the external audit function of the examination of financial statements of the government and its allied activities in a financial year. The Auditor-General performs pre-audit and post-audit functions. The post-audit refers to the audit performed after the close of transactions in a particular period; it is a post-mortem audit. The audit takes place after the end of the financial year.

The appointment, termination, and mode of operation of the Auditor-General are governed by the provisions of the Audit Act of 1956, the Nigerian Constitution and Financial Regulations of 2009 as amended.

9.2 THE OFFICE OF THE AUDITOR GENERAL

9.2.1 Functions of the Office of the Auditor General

The "green paper" on the Role of the Comptroller and Auditor-General lists the following as the functions of the Auditor-General:

a. **Financial and Regularity Audit.** A financial audit is undertaken to ensure that:

   i) Systems of accounting and financial control are efficient and operating properly, and

   ii) Financial transactions have been correctly controlled, authorised and accounted for.

A regularity audit (sometimes called Compliance Audit) is that which verifies that expenditure has been incurred on approved services and in accordance with statutory and other regulations and authorities governing them.

b. **Economy and efficiency audit (also called Value for Money Audit):** This is a measurement of how economic resources are efficiently employed. It is also to highlight areas of wastes and extravagant or unrewarding expenditure. It looks into failures to maximize receipts; financial arrangements that are detrimental to the treasury; and weaknesses leading to them.

c. **Effectiveness audit (**also called Programme Results Audit)**.** This is an examination to assess whether programmes or projects undertaken to meet established policy goals or objectives have met their respective aims. It aims at focussing on comprehensive audit in government.

d. **Value-for-Money Audit.**

This is variously called Performance Audit, or Economy and Efficiency audit. The essence is to determine whether an entity is acquiring, managing, or utilizing its resources in the most economical and efficient manner. It traces the causes of inefficiencies or uneconomical practices. Value-for-money Audit is defined as an objective professional and systematic assessment of:

i. The nature and function of an authority's managerial systems and procedures;
ii. The economy and efficiency with which its services are processed; and
iii. The effectiveness of its performance in achieving objectives

Phases of value-for-money audit are:

- **Proposal phase:** aims at justifying the study of a particular area, authorise initial resources and determine further the initial analysis of financial statistics, audit costs and other performance indicators.
- **The Scooping phase:** aims at gathering sufficient details. It embraces gathering working information, studying related legislations and testing controls. At this stage there will be comprehensive management systems and objective review.
- **Planning phase:** aims at planning to fully develop identified potentials. The planning and control processes are properly analysed and methods of reviewing operating results are examined through analysis of control and reporting systems.
- **Implementation phase:** aims at reporting the audit results to those responsible for receiving or acting on them.
- **Evaluation phase:** is to evaluate the audit result, methodology and performance of the audit staff. The focus here will be assessment of efficiency and effectiveness review. Value-for-money audit aims to identify ineffectiveness in the system and under-utilisation of resources.

9.2.2 Directorates in the Office of Auditor-General

The office of the Auditor-General comprises some of the following directorates:

a. Treasury Accounts, which handles the audit of accounts and financial statements;

b. State Accounts, which audit the transactions of pay officers operating in various States;
c. Public Enterprises, which oversees the audit of parastatals;
d. Project Audit which investigates justifications to pay officers operating in various States;
e. Pension which conducts pre-audit of gratuities and pensions;
f. Losses and Investigations that handles all cases of loss of funds; and
g. Annual report and Public Accounts Committee (PAC) which handles all reports and links with PAC deliberations.

9.2.3 Audit Queries and Alarms

Audit queries are observations or points raised by the audit in particular transactions seeking further clarifications. Such queries raised by Internal Audit are pre-audit queries while those raised by the Auditor-General are termed post-audit queries.

Queries serve as an important part of the mechanism of financial control as well as valuable means of detecting and preventing errors, frauds, etc.

The guidelines on Civil Service Reforms gave prominence to queries by specifying time limit for replying audit queries and possible sanctions for failure to respond. Matters on which queries may be raised can be classified as:

a. Irregularities resulting in losses to the government due to either fraudulent activity of the functionaries or their negligence or incompetence;
b. Irregularities not directly or immediately resulting in losses to government but which infringe upon budgetary and proper financial management; and
c. Irregularities arising through poor or inefficient management and accounting, which may lead to losses to the government.

9.3 ROLE OF PUBLIC ACCOUNTS COMMITTEE (PAC) IN THE AUDIT PROCESS

9.3.1 Power to Conduct Investigation

In line with the provisions of the Constitution, each House of the National Assembly shall have power by resolution published in its journal or in the Official Gazette of the Government of the Federation to direct or causes to be directed an investigation into:

a) Any matter or thing with respect to which it has power to make laws; and
b) The conduct of affairs of any person, authority, ministry, or government department charged, with the duty of or responsibility for:
    i. Executing or administering laws enacted by the National Assembly; and
    ii. Disbursing or administering moneys appropriated or to be appropriated by the National Assembly.

The power conferred on the National Assembly under the provisions of this section is exercisable only for the purpose of enabling it to:

- Make laws with respect to any matter within its legislative competence and correct any defects in existing laws and

- Expose corruption, inefficiency or wastes in the execution and administration of laws within its legislative competence and in the disbursement or administration of funds appropriated by it.

9.3.2 Power as to Matters of Evidence

For the purpose of any investigation under section 88 of the Nigerian Constitution and subject to the provisions thereof, the Senate or House of Representatives or a Committee appointed in accordance with section 62 of the Constitution shall have power to:

a. Produce all such evidence, written or oral, direct or circumstantial, as it may think necessary or desirable, and examine all persons as witnesses whose evidence may be material or relevant to the subject matter; and
b. Require such evidence to be given on oath.

This Committee is invariably known as Public Accounts Committee. The purpose of the provision of the Constitution and the establishment of the PAC is to expose corruption, inefficiency or wastages in the execution or disbursement of administration of funds appropriated by it.

The Public Accounts Committee is empowered to:

i. Examine such audited accounts of the Federation and of all offices and courts of the Federation and the Auditor-General report thereon as may be referred to it.
ii. Examine:
    - The accounts and reports of Ministries, Departments and Agencies of the Government of the Federation;
    - The Audited-Accounts of statutory corporations, boards and such other government bodies; and
    - The causes which led to, or might have led to, any excess over approved appropriations.

    In the performance of its functions, the PAC is further empowered to:
    - Procure all such evidence, oral or written and examine such persons at it may deem necessary or desirable; and
    - Require any person to produce any books, documents, or records, as it may deem necessary and desirable.

The composition of PAC is geared towards functioning like a court or enquiry empowered to look into civil and criminal cases as regards allocation and disbursement and use of public funds by public officers who have been entrusted with the responsibility of judiciously using the funds, carrying out government programmes and recommending appropriate actions against officers found wanting in carrying out their duties.

9.3.3 Basis of Public Accounts Committee Activities

The major basis of the PAC activities are the reports of the Auditor-General. In these reports, statement of how the accounts of the government departments, agencies and ministries are examined is stated and queries raised and the response to these queries is also stated.

Consequently, all cases that are of prime importance or which the Committee feels should be properly examined are then picked out of the report. Other bases of PAC activities are the cases referred to the Committee by the House in respect of issues examined by it during deliberation.

9.3.4 Problems of Public Accounts Committee

These include:

a. Political instability (either through violent change as in the military regimes or change of political party) leading to continuous changes in the composition of the committee;
b. Financial statements to be examined are often in arrears;
c. Members are not knowledgeable in accounting and financial reporting;
d. Lack of co-operation and information from the expected facilitators; and
e. Resolutions are not always implemented.

9.4 INTERNAL AUDIT IN THE PUBLIC SECTOR

The Institute of Internal Auditors defined internal auditing as "the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as a basis for protective and constructive service to management".

9.4.1 Objectives and Scope of Internal Audit in the Public Sector

The basic objectives of internal auditing are to assist the management in the effective discharge of its responsibilities. The internal audit department provides this assistance by furnishing management with analysis, appraisals, recommendations and comments regarding the activities reviewed. Internal auditors can be concerned with any phase of the operations of the department/ministry. This may involve going beyond accounting and financial records to obtain a full understanding of the operation under review. Internal auditing is a managerial control in itself and a duty performed by personnel employed for such specific purpose. Internal audit exists in every Ministry/Department/Agency to carry out pre-audit. Pre-audit is the audit performed with the main objective of checking transactions before payment takes place in order to ensure compliance with the rules governing each transaction.

In order to attain the overall objective, internal audit activities should include:

a. Reviewing and appraising the soundness, adequacy and application of accounting, financial and other administration controls and promoting effective controls at reasonable cost;
b. Ascertaining the extent of compliance with established policies, plans and procedures;
c. Ascertaining the extent to which the assets of the department/ministry/agency are accounted for and safeguarded against losses of all kinds;
d. Ascertain the reliability of data developed or produced;
e. Preserving the integrity of files on which those transactions and related data are stored; and
f. Appraising the quality of performance in carrying out assigned responsibilities.

9.4.2 Operation of the Internal Audit in the Public Sector

Internal audit derives his powers from the power as delegated by the Auditor-General. The internal auditor has full access to all the department/ministry/agency`s record, properties and personnel that could be relevant to the subject under review. The internal auditor fall within the following responsibilities executed by him in the establishment:

a. **Operational Audit:** This focuses on a particular activity within the establishment e.g. audit of Agricultural and Rural Development in a local government
b. **Functional Audit:** This focuses on a particular function e.g., audit of salary preparation.
c. **Organisational Audit:** This focuses on all the activities within an establishment. It includes (a) and (b) above.
d. **Investigation:** This focuses on ad-hoc assignments
e. **Management Audit:** This focuses on advising on policies introduced from time to time by the establishment.

9.4.3 Responsibilities of the Internal Audit in the Public Sector

The internal audit is responsible for:

a. Reviewing, evaluating and reporting on the adequacy or otherwise of the controls installed and operated and the extent to which they assure propriety, security, completeness and accuracy of operations of the establishment.
b. Performing the responsibility imposed by the Civil Service Reforms. The reforms state that he shall carry out complete and continuous audit of accounts and records of revenue and expenditure, plant stores and assume the duty of inventory verifier where none exists in an establishment and
c. Confirmation of reliability and accuracy of extracted financial information to management.
d. Matters influencing setting up of internal audit unit include:
    i. The necessity of the internal audit unit in the circumstances of the government, bearing in mind the provisions of Civil Service Reforms. Guidelines and relevant extant laws;
    ii. Determining the size and structure of the unit;
    iii. Preparing of audit manual;
    iv. Recruitment of appropriate staff for respective office; and
    v. Training and inducting the staff.

The above stated procedures are of equal application to the audit of other tiers of government – the state and local government

9.5 DUE PROCESS AND PUBLIC PROCUREMENT

9.5.1 Due Process

The Federal Government of Nigeria set up the Budget Monitoring and Price Intelligence Unit (BMPIU) otherwise called ‘The Due Process’ office. The Due Process office is run as an operationally independent body under the leadership of the Senior Special Assistant to the President on the Unit. Its staff comprises experts with biases for project management, construction, and procurement. The unit was designed to act as the clearinghouse for all government contracts and procurement of goods and services and functions under three major strategies namely: goals, objectives, and implementation. The goal is to ensure full compliance with laid down guidelines and procedures for the procurement of capital and minor capital projects, as well as associated goods and services.

The due process is the application of bureaucratic rules and regulations to the management of economic resource of a nation. Due process allows approved official protocols to take place in the spending of government funds and resources and in the handling of government business. The procedures required in specific situations depend on several factors and the cost to the government, in time and money, in carrying out the procedures.

It can be defined as:

- a mechanism that attests to the public funding of only those projects that have passed the test of proper implementation packaging and that adheres strictly to the international competitive bid approach in the award process.
- the firm adherence to laid down rules and regulations in the conduct of the nation's business with the aim of ensuring probity, accountability, transparency, effectiveness, and efficiency.
- the means by which ethical constraints are placed on administrative procedures and decision-making, to prevent inhuman treatment, intoxication and abuse of powers, and excesses; and to assure financers that any money budgeted and spent on any project would be well utilized and judiciously managed.

Objectives of the Due Process

Due process implies that governmental activities and businesses can be carried out openly, economically and transparently. The essence is to ensure that rules and procedures for procurement are made in such a way that it would be implementable and enforceable.

The objectives of due process are:

- To harmonize and update the policies and practice in public procurement;
- To ensure that project conceptualization, packaging and execution are in tandem with targets as contained in approved budgets;
- To strictly enforce the Due Process principles of transparency, competition, efficiency and value for money in the procurement of public goods, works and services;
- To ensure that the execution of contract is monitored; and
- To prevent extra-budgetary spending and inflation of contract prices.

Scope and Coverage of Due Process

- Coverage of Entities: Entities at all levels of government, including enterprises owned or influenced by government.
- Coverage of Products: All goods and services and any combination of goods and services.
- Threshold Values: The coverage should not be limited to contracts above a certain threshold level, but certain provisions might equally be more flexible in relation to smaller contracts.

- Coverage of Transaction: Acquisition of any contracted items, including leases and rentals.

Documents of Importance to the Auditor

The following documents are necessary to ascertain that due process has been adhered to in the spending of public money:

i. Substantial and appropriate evidence of advertisement
ii. Tender Evaluation report
iii. Contract award letter and agreement, and
iv. Tender Returns.

9.5.2 The Public Procurement Act

The Public Procurement Act was enacted by the National Assembly by Act No. 14 of 2007. The National Council on Public Procurement which is referred to as "the Council" in the Act consist of:

a. the Minister of Finance as Chairman
b. the Attorney-General and Minister of Justice of the Federation
c. the Secretary to the Government of the Federation
d. the Head of Service of the Federation
e. Economic Adviser to the President
f. Six part-time members to represent:
    i. Nigerian Institute of Purchasing and Supply Management;
    ii. Nigerian Bar Association;
    iii. Nigerian Association of Chambers of Commerce, Industry, Mines and Agriculture;
    iv. Nigerian society of Engineers;
    v. Civil society;
    vi. The Media; and
g. The Director-General of the Bureau who shall be the Secretary of the Council.

The Council may co-opt any person to attend its meeting, but the person so co-opted shall not have a casting vote or be counted towards quorum.

Functions of the National Council on Procurement

The Council shall

a. Consider, approve, and amend the monetary and prior review thresholds for the application of the provisions of this Act by procuring entities;
b. Consider and approve policies on public procurement;
c. Approve the appointment of the Directors of the Bureau;
d. Receive and consider for approval, the audited accounts of the Bureau of public procurement;
e. approve changes in the procurement process to adapt to improvement in modern technology; and
f. give such order directives and perform such other functions as may be necessary to achieve the objective of this Act.

9.6 ESTABLISHMENT OF THE BUREAU OF PUBLIC PROCUREMENT (BPP)

This is established as an agency to be known as the Bureau of Public Procurement. The Public Procurement Act referred to it as "the Bureau".

The Bureau

a. shall be a body corporate with perpetual succession and a common seal;
b. may sue and be sued in its corporate name; and
c. may acquire, hold, or dispose of any property, moveable, or immovable for the purpose of carrying out any of its function under this Act

9.6.1 The objectives of the Bureau are:

a. The harmonisation of existing government policies and practices on public procurement and ensuring probity, accountability, and transparency in the procurement process.
b. The establishment of pricing standards and benchmarks;
c. Ensuring the application of fair, competitive, transparent, value-for money standard and practices for the procurement and disposal of public assets and services; and
d. The attainment of transparency, competitiveness, and professionalism in the public sector procurement system.

9.6.2 Functions of the Bureau

a. Formulate the general policies and guidelines relating to public sector procurement for the approval of the Council;
b. Publicize and explain the provisions of this Act;
c. Subject to thresholds as may be set by the Council, and certify Federal Procurement prior to the award of contract;
d. Supervise the implementation of established procurement policies;
e. Monitor the prices of tendered items and keep a national data base of standard prices;
f. Publish the details of major contracts in the procurement journal;
g. Publish paper and electronic editions of the procurement journal and maintain an archival system for the procurement journal;
i. Maintain a national database of the particulars and classification and categorization of federal contractors and service providers;
i. Collate and maintain in an archival system, all federal procurement plans and information;
j. Undertake procurement research and surveys;
k. Organise training and development programme for procurement professionals;
l. Periodically review the socio-economic effect of the policies on procurement and advise the council accordingly;
m. Prepare and update standard biding and contract documents;
n. Prevent fraudulent and unfair procurement and where necessary apply administrative sanctions;
o. Review the procurement and award of contract procedures of every entity to which this Act applies;
p. Perform procurement audits and submit such reports to the National Assembly bi-annually;

q. Introduce, develop, update, and maintain related database and technology;
r. Establish a single internet portal that shall, subject to section 16(2) to this Act serve as a primary and definitive source of all information on government procurement, containing all public sector procurement information; and
s. Co-ordinate relevant training programme to build institutional capacity.

9.7 CHAPTER SUMMARY

i. This chapter has provided full coverage of the statutory as well as the constitutional provisions regarding the appointment and functions of the Auditor-General for the Federation.
ii. Similarly, functions of the Public Accounts Committee which is a unit of the National Assembly were also detailed.
iii. The information provided in this chapter will enable readers to have full understanding of the workings of the office of the Auditor-General for the Federation, as well as of the States and equivalent officers in the local governments, together with requirement for the audit of Public Accounts and the supervisory powers of the National Assembly.
iv. The procurement process and the Bureau of Public Procurement were also discussed.

MULTIPLE-CHOICE QUESTIONS

1. Due process in the public sector involves which of the following?
   A. Transparency in accounting for contracts
   B. Making use of committee in approving contracts
   C. Making adequate arrangements in treating all audit queries into decision making process
   D. Allowing interested parties to provide input into the decision making process
   E. Report over inflated contract to National Assembly

2. The following are documents necessary to ascertain due process that has been adhered to in the spending of public money **EXCEPT**
   A. Substantial and appropriate evidence of advertisement
   B. Tender Evaluation report
   C. Contract award letter and agreement
   D. Driving Licence of the person quoting for the tender
   E. Tender Returns.

3. The following matters are to be considered in designing an audit programme for government parastatals, corporations, or ministries **EXCEPT**
   A. General and service rules
   B. Organisational reporting structure
   C. Statutory law establishing the corporation, ministry, or parastatals
   D. International passport of the parastatals` general manager or permanent secretary of the Ministry
   E. Internal control system in operation

4. The National Council on Public Procurement has a board made up of the following **EXCEPT**
   A. The minister of finance
   B. The Attorney-General and minister of justice of the federation
   C. The Auditor-General for the Federation
   D. The Secretary to the Government of the federation
   E. The Head of Service of the Federation

5. Which of the following is **NOT** a major audit guide document the auditor will use in his compliance audit of a government parastatals/ministries?
   A. The Nigerian Constitution
   B. Civil service rule
   C. Gazettes
   D. CAMA 2020
   E. Treasury circulars

SHORT-ANSWERS QUESTIONS

6. In carrying out the audit of government parastatals, there are two main checks which the auditor must adopt in his compliance tests. List them.
7. Who has the power to conduct periodic checks of all government statutory corporations, commissions, agencies, including all persons and bodies established by an Act of the National Assembly?
8. The power to appoint persons to act in the office of the Auditor-General for the Federation shall rest in...
9. Who is the chairman of the National Council on public procurement?
10. An Act or Law passed by the National or State Assembly or Local Government authorising spending from the Consolidated Revenue Fund is called.....................

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. D
2. D
3. D
4. C
5. D

SOLUTIONS TO SHORT-ANSWERS QUESTIONS

6. (a) Basic check and
   (b) Special checks concerning legislative authorization
7. The Auditor-General for the Federation
8. The president
9. The Minister of Finance
10. Appropriation Act

CHAPTER TEN
IT BASED ASSURANCE

CHAPTER CONTENTS

a. Information Technology (IT) Systems
b. Challenges faced in Small IT-Based Audits
c. Documentation Procedures in IT-Based Systems
d. Audit Approach in IT-Based Systems
e. Business Systems and Associated IT Risks
f. Current Trends in IT Audits

OBJECTIVES

On completion of this chapter, the reader should be able to:

a. Explain types of information technology systems that auditors encounter.
b. State typical control challenges faced in the assurance of small IT-based systems.
c. Explain documentation procedures used in the assurance of manual and IT-based systems.
d. Explain the approach to the audit of IT-based systems with attention to audit trail and controls.
e. Explain business systems and associated IT risks
f. Explain the concepts of IT audit activities and current trends in Information Technology relating to:
   i. Big data analytics;
   ii. Audit of electronic transactions;
   iii. Artificial intelligence; and
   iv. Machine learning.

10.1 INFORMATION TECHNOLOGY SYSTEMS

There are six information technology systems.

- Transaction Processing System (TPS). This is a system that turns transactions inputs into outputs in an organization. A transaction includes all the purchases and sales of goods and services, and all business activities required to run the entity. At its inception, it was called data processing. It is a system established to handle the processing of transactions, as an improvement over manual handling.

- Office Automation System (OAS). This is a web of various tools and technologies required to conduct clerical and managerial tasks, e.g., recording, printing, and mailing.

- Knowledge Management System (KMS). This system stores and extracts information to help employees, customers, and management enhance their knowledge and optimize collaboration efforts to complete organizational tasks. The information to be shared is usually the product (e.g., in educational institutions) or about the product (e.g., in commercial and industrial establishments).
- Management Information System (MIS). This is the system that enables the middle level managers to extract various transaction data from a TPS, analyse them, and produce reports that help top management to optimize planning and decision-

making. This includes summarization in producing the financial statements of the entity.

- Decision Support System (DSS). This is a set of software tools (e.g., Microsoft Office) that assist management in decision making. It helps in spelling and grammar correction during the preparation of letters and reports (e.g., MS Word) and in doing calculations for larger volumes, in analysing variance, and in scenario mapping (e.g., MS Excel). These tools help middle managers to make informed decisions and proffer solutions to problems.

- Executive Support System (ESS). This is also called an Expert system in that it proffers solutions to non-routine problems. Enterprise systems that provide information on taxation, investments, shareholding, etc., fall into this category. They help directors and owners to monitor the performance of an entity.

An understanding of these systems will help the auditor in identifying what type of information system is of particular importance to the audit and which is secondary. Nevertheless, all IT systems in use in the client environment is important to the auditor's knowledge of the client's business.

10.2 CHALLENGES FACED BY SMALL IT-BASED SYSTEMS

In this section, we look at the control and audit problems peculiar to small computer systems, concentrating on personal computers (PCs).
Most of the potential problems arise due to the departure from the formal structure of the traditional data processing department, where a controlled environment was provided over the acquisition, maintenance, and distribution of computer information. In the world of the PC, this controlled structure does not exist and the environment is more informal.

The problems surrounding PCs can be grouped under three headings:

i. lack of planning over the acquisition and use of PCs;
ii. lack of documentary evidence; and
iii. lack of security and confidentiality.

All these areas could produce problems for the auditors, giving them difficulties when attempting to assess the documentation, the adequacy of design processes and testing the completeness, accuracy, and authority of data and, of course, audit trails. Each of the three problem areas is now considered in more details.

10.2.1 Lack of Planning Over the Acquisition and Use of PCs

When an organization sets out to acquire a computer system, a series of steps should be undertaken before making the decision to purchase.

a. ***Authorisation***

A feasibility study should be carried out, examining the requirements, the costs and the benefits, to ensure that the expense is justified. Suppliers should be invited to tender, and responses from the suppliers should be evaluated and compared. All interested parties within the organization should be identified and involved throughout the whole procedure. If possible, other users of the system (e.g., the auditors) should be contacted and asked for their opinion.

b. ***Suitability***
There is a risk that the client will not have the expertise to evaluate the relative merits of systems. This could give rise to compatibility and/or capacity problems thereby restricting future developments, unless in the last resort, the entire system is replaced. Many first time users tend to purchase standard software packages which create an even greater risk as regards suitability, for such systems may not fit precisely the company's trading methods. Moreover, the first time user is unlikely to have the expertise required to tailor such packages.

c. ***Support Facilities***
The support facilities offered by the supplier and/or software house should be ascertained and a maintenance contract entered. The client should ensure that:
   i. In the event of machine breakdown, prompt service and, if necessary, backup facilities are available;
   ii. any bugs in the programme can be sorted out;
   iii. minor modifications to the program can be carried out;
   iv. adequate systems documentation and operator manuals have been provided, such documentation falling into three generally accepted categories:
      - program documentation: which states in detail how each program within each part of the system operates, what files are being opened and accessed, and what functions are being performed;
      - operator instructions: which are designed to be "desk-top" instructions enabling the PC user to access and use the system as required;
      - user manual: which is the "layman's guide" to the operation of the whole system and would usually include the operator instructions; and
   v. operators have received adequate instruction.

d. ***Standards***
In a formal data processing environment there will normally be standards covering controls and accounting principles to which all procedures regarding hardware and software should conform. With PCs, where the time taken from ordering, through installation to operation, may be a matter of weeks only, there is great danger that standards are not set.

Strict disciplines must be imposed to ensure that recognized systems development controls are applied and sufficient administration procedures are implemented.

10.2.2 Lack of Documentary Evidence

We have identified that many PCs operate in real time via VDUs, which allows users to have direct access to the computer thus enabling them to input data, update files and make one-off enquiries on data held on files. The necessity for edit programs and hard copy is avoided.

Control can be enhanced by ensuring that edit programs are in-built at the design stage and by incorporating into the system a user-usage file which logs details of the user's identification, the application involved, the records accessed or updated and so on. Such a file can be reviewed periodically by a responsible official and the auditor. It may be prudent to implement manual controls to ensure that transactions can only be processed when supported by an appropriate initiating document. Similarly, manual batching can be imposed.

10.2.3 Lack of Security and Confidentiality

a. ***Lack of segregation of duties***

Poor segregation of duties all too easily occurs since frequently the same person prepares the data, feeds it into the computer, supervises the processing and acts as end user. This lack of division of duties enhanced opportunities for fraud, the user having access to assets and the recording and disposal of assets. The auditors may well have to perform extensive substantive verification work to compensate for this serious lack of control.

b. ***Lack of Control Over Users***

Because PCs do not require a protected environment the terminals are readily available to any user. In order to safeguard the records, control to prevent unauthorized users from using the computer are necessary (use of locks, passwords and so on).

c. ***Lack of Control Over Alterations to Programs***

We have emphasized that a lack of expertise, particularly in the case of first time users, may lead to imprudent purchase in terms of capacity and compatibility. Conversely, there are dangers arising because of the relative ease with which expertise may be acquired once a machine is installed and it becomes operational. PCs employ high level languages and a working knowledge can be grasped within a short time. When in the wrong hands, there is a danger that programs might be altered without detection or that programs are written at the time data is being processed without adequate testing.

Stringent supervisory arrangements are required to prevent unauthorized personnel from having access to the programs together with programmed controls preventing unauthorized running. A degree of security will be guaranteed to the extent that the programs are permanently etched onto silicon chips and are hence an integral part of the hardware (ROMs) such programs can only be altered by specialist electronics engineers.

10.3 DOCUMENTATION PROCEDURES IN IT-BASED SYSTEMS

Until recently, auditing firms used computers for very basic administrative functions. From the various types of IT systems explained above, it is obvious that clients have shifted from manual to IT information systems and programs have now been developed which allow more sophisticated uses of computers in the audit.

Computerised working paper packages have been developed which can make the documenting of audit work much easier. Such programs will aid preparation of working papers, lead schedules, extended trial balance and the financial statements. These are automatically cross referenced and balanced by the computer. Whenever an adjustment is made, the computer will automatically update all the necessary schedules, including the trial balance, rather than the auditor having to do so manually.

a. **The advantages of automated working papers are:**

i. The risk of errors is reduced.
ii. The working papers will be neater and easier to review.
iii. The time saved will be substantial as adjustments can be made easily to all working papers, including working papers summarizing the key analytical information.
iv. Standard forms do not have to be carried to audit locations. Forms can be designed to be called up and completed on the computer screen.
v. Audit working papers can be transmitted for review via the internet.

A system combining office packages such as Word, Excel or Access may have special advantages as it can be designed to allow logical steps to be automated, as follows:

b. **Automated checking of electronic working papers for completeness**

(i) Is there any evidence of supervision and review on each schedule?
(ii) Is there an audit conclusion on each lead schedule?
(iii) Have all points raised by the auditors on "audit point sheets" been answered?

c. **Automated checking of electronic working papers for accuracy**

i. Are all the totals of numeric data consistent?
ii. Do numeric totals carry forward accurately to the lead schedule?

d. **Automated processing**

i. Footing and cross footing (standard word processing software, e.g., Excel, can also do this).
ii. Carry forward of numeric data to lead schedules.
iii. Highlight proposed audit recommendations for audit management review.
iv. Consolidate and reformat material contained within the audit working papers in order to prepare the draft audit report.

More generally, the audit can be assisted or facilitated by software applications dealing with graphics production, image processing, and desk-top publishing. Auditors may also benefit from on-line accessing and real-time file updating.

e. **Statistical Sampling and Analytical Procedures**

Auditors can now use software packages to perform analytical procedures. These packages are most useful when information can be imputed directly from the client's computer system. This information can be updated year after year, building up cumulative data.

Such information can also be used for statistical sampling. The package can then perform such tasks as determining sample sizes, generating random numbers from a given sequence and evaluating results from tests based on samples.

f. **Decision Support Systems**

These systems involve judgemental process which would normally only be carried out by a "human" auditor. The main developments in this area include the automation of checklists, such as those used for internal control evaluation, statutory requirements and materiality estimations. These checklists are formulated so as to follow different logic paths in response to answers given at various stages of the checklists, including omitting questions.

10.4 AUDIT APPROACH IN IT-BASED SYSTEMS

Audits are performed in a computer environment wherever computer-based accounting systems, large or small, are operated by an enterprise, or by a third party on behalf of the enterprise, for the purpose of processing information supporting the amounts included in the financial statements, and even the production of the financial statements.

The nature of computer-based accounting systems is such that the auditors are afforded opportunities to use either the entity's or the auditor's computers in the performance of their audit work. Techniques performed with computers in this way are known as Computer Assisted Audit Techniques (CAATs) of which the following are the major categories:

a. **Use of Audit Software**: computer programs used for audit purposes to examine the contents of the enterprise's computer files.

b. **Use of Test Data**: data used by the auditors for computer processing to test the operation of the enterprise's computer programs.

Audit software and test data are considered in detail in the next session.

Knowledge and Skills

When auditing in a computer environment, the auditors should obtain a basic understanding of the fundamentals of data processing and a level of technical computer knowledge and skills which, depending on the circumstances, may need to be extensive.

10.4.1 Planning, Controlling and Recording

Planning an audit in a computer environment

As part of their planning considerations, auditors should decide at an early stage what effect the system itself and the way it is operated will have on the timing of and the way they will need to perform and record their work.

The auditors should also consider the use of CAATs, as this may have a significant effect on the nature, extent, and timing of audit tests. In certain circumstances the auditors will need to use CAATs in order to obtain the evidence they require, whereas in other circumstances they may use CAATs to improve the efficiency or effectiveness of the audit.

In choosing the appropriate combination of CAATs and manual procedures, the auditors will need to take the following points into account.

(a) Computer programs often perform functions of which no visible evidence is available. In these circumstances it will frequently not be practicable for the auditors to perform tests manually.

(b) In many audit situations the auditors will have the choice of performing a test either manually or with the assistance of a CAAT. In making this choice, they will be influenced by the respective efficiency of the alternatives, taking into account:
   - the extent of tests of controls or substantive procedures achieved by both alternatives;
   - the pattern of cost associated with the CAAT;
   - the ability to incorporate within the use of the CAAT a number of different audit tests.

(c) In some cases, the auditors will need to report within a comparatively short time-scale. In such cases it may be more efficient to use CAATs because they are quicker to apply, even though manual methods are practicable and may cost less.

(d) To use a CAAT, auditors should ensure that the required computer facilities, computer files and programs are available. Furthermore, given that enterprises do not retain copies of computer files and programs for an indefinite period, the auditors should plan the use of any CAAT in good time so that these copies are retained for their use. This is to avoid the loss of audit trail.

(e) The operation of some CAATs requires frequent attendance or access by the auditors. The auditors may be able to reduce the level of their tests by taking account of CAATs performed by the internal auditors, but the extent to which they can do this in any given situation will depend, amongst other things, on their assessment of the effectiveness and relevance of the internal audit function.

(f) Where the enterprise's accounting records include computer data, the auditors will need to have access to that data. Further, where the auditors wish to perform a CAAT, it is often necessary for the enterprise to make computer facilities available to the auditors to enable them discharge their responsibilities. The current practice is that auditors go w their laptops, which allow them to test client's data even without entering the client's system but with data collected from the client's system.

Controlling of CAATs

Where CAATs are used, however, particular attention should be paid to:

i. the need to co-ordinate the work of staff with specialist computer skills with the work of others engaged on the audit;

ii. the approval and review of the technical work by someone with the necessary computer expertise.

Auditors may use a CAAT on copies of computer records or programs, provided they have taken steps to gain reasonable assurance that the copies are identical to the originals.

10.4.2 Internal Control Evaluation

The principles relating to internal controls are the same in a computer environment as in any other environment, but there are additional considerations.

Internal controls over computer-based accounting systems may be considered under the following two main headings:

- application controls (relating to specific controls over the transaction and standing data); and
- general controls (which relate to the whole environment in which computerized operations take place).

Application controls relate to the transactions and standing data pertaining to each computer-based accounting system and are therefore specific to each such application.

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 in these records resulting from both manual and programmed processing.

General controls are controls, other than application controls, which relate to the environment within which computer based accounting systems are developed, maintained and operated, and which are therefore applicable to all the applications. The objectives of general controls are to ensure the proper development and implementation of applications and the integrity of program and data files and of computer operations. Like application controls, general controls may be either manual or programmed.

Where preliminary evaluation of the application controls and general controls discloses the absence of, or uncompensated weaknesses in, controls, and therefore the auditors cannot rely on the controls, they should move directly to substantive procedures which may be assisted by the use of CAATs.

However, where preliminary evaluation reveals application controls or general controls which may meet the auditors' objectives, they carry out tests of controls if they wish to rely on those controls. In determining whether they wish to place reliance on application controls or general controls, the auditors will be influenced by the cost effectiveness and ease of testing and by matters affecting the reliability of general and application controls.

Tests of Controls

Procedures the auditors may consider include:

(a) observing the control in operation;
(b) examining documentary evidence of its operation;
(c) performing it again (repeat performance);
(d) testing specific parts of the programs, or re-performing them, by taking advantage of CAATs, in the case of programmed application controls.

10.4.3 Review of Financial Statements

CAATs (particularly audit software) may be of assistance to auditors in carrying out certain aspects of their work (for example analytical review).

Working Papers

Where a CAAT is used, the working papers should indicate the work performed by the CAAT, the results of the CAAT, the auditors' conclusions, the manner in which any technical problems were resolved and may include any recommendations about the modification of the CAAT for future audits.

Audit Trails

The original purpose of an audit trail was to preserve details of all stages of processing on *paper*. This meant that transactions could be followed stage-by-stage through a system to ensure that they had been processed correctly: thus, a sales system transaction record could be traced right through the system because the audit trail would show a reference to the customer order, delivery note, invoice, and cheque/cash receipt.

10.4.4 The Audit Approach

a. ***Around the computer***

Traditionally, therefore, it was widely considered that auditors could fulfil their function without having any detailed knowledge of what was going on inside the computer.

The auditors would commonly audit "**round the computer"**, ignoring the procedures which take place within the computer programs and concentrating solely on the inputs and the corresponding outputs. Audit procedures would include checking authorization, coding and control totals of inputs and checking the outputs with source documents and clerical control totals.

However, besides consuming vast amounts of paper and computer and printer time, the traditional approach does not reflect the modern reality of computerized accounting, where computers are used to manipulate and interpret data to assist in the management of the business, as much as to satisfy the record-keeping and reporting requirements. As the complexity of computer systems has increased there has been a corresponding loss of audit trail.

b. ***Through the computer***

The "round the computer approach" is now frowned upon. Typical audit problems that arise as audit trails move further away from the hard copy trail include:

(a) testing computer generated totals when no detailed analysis is available;

(b) testing the completeness of output in the absence of control totals.

It is recognized that one of the principal problems facing the auditors is that of acquiring an understanding of the workings of electronic data processing and of the computer itself.

Auditors now customarily audit "through the computer". This involves an examination of the detailed processing routines of the computer to determine whether the controls in the system are adequate to ensure complete and correct processing of all data. In these situations it will often be necessary to employ computer assisted audit techniques (CAATs).

10.5 COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)

There is no mystique using a computer to help with auditing. You probably use common computer assisted audit techniques all the time in your daily work without realizing it. Some examples are:

(a) Most modern accounting systems allow data to be manipulated in various ways and extracted into an ad-hoc report. Even the popular accounting software allows its database to be quizzed in quite sophisticated ways.

(b) Even if reporting capabilities are limited, the data can often be exported directly into a spreadsheet package and then analysed, say, by sorting in order of highest balances, or recalculating totals using the SUM function.

(c) Most systems have searching facilities that are much quicker to use than searching through print-outs by hand. This offsets the so-called "loss of audit trail" to a significant extent. The trail is still there, even though it may have to be followed through in electronic form.

There are a variety of packages specially designed either to ease the auditing task itself, or to carry out audit interrogations of computerized data automatically. There are also a variety of ways of testing the processing that is carried out.

Much of this work can now be done using PCs such as laptops that are independent of the client organisation's systems. (In the past this has been problematic because the storage capacity and speed of PCs rendered them unable to cope with large volumes of data, but with advances in PC technology this is not much of a problem today).

Using the Right Files

Before any audit software is run, the auditors should check the identity and version of the data files and programs used, whether they are taken from the company's records and systems or supplied by themselves. This will normally involve checking with external evidence, such as control totals, and looking at file lengths, dates, times or other file properties.

10.5.1 Audit Interrogation Software

Interrogation software performs the sort of checks on data that auditors might otherwise have to perform by hand.

Although audit interrogation software may be used during many tests of controls and substantive procedures, its use is particularly appropriate during substantive testing of transactions and especially balances. By using audit software, the auditors may scrutinize large volumes of data and concentrate skilled manual resources on the investigation of results, rather than on the extraction of information.

Major consideration when deciding whether to use file interrogation software are as follows:

(a) As a minimum, auditors will require a basic understanding of data processing and the enterprise's computer application, together with a detailed knowledge of the audit software and the computer files to be used.
(b) Depending on the complexity of the application, the auditors may need to have a sound appreciation of systems analysis, operating systems and, where program code is used, experience of the programming language to be utilized.
(c) Auditors will need to consider how easy it is to transfer the client's data onto the auditors' PC.
(d) The client may lack full knowledge of the computer system, and hence may not be to explain fully all the information it produces.

10.5.2 Test Data

An obvious way of seeing whether a system is processing data in the way that it should be is to input some test data and see what happens. The expected results can be calculated in advance and then compared with the results that actually arise.

The problem with test data is that any resulting corruption of the data files has to be corrected. This is difficult with modern real-time systems, which often have built in (and highly desirable) controls to ensure that data entered cannot easily be removed without leaving a mark. Consequently test data is being disused as a CAAT.

10.5.3 Embedded Audit Facilities

The results of using test data would, in any case, be completely distorted if the programs used to process it were not the ones normally used for processing. For example a fraudulent member of the IT department might substitute a version of the program that gave the correct results, purely for the duration of the test, and then replace it with a version that siphoned off the company's funds into his own bank account.

To allow a continuous review of the data recorded and the manner in which it is treated by the system, it may be possible to use CAATs referred to as "embedded audit facilities".

An embedded audit facility consists of audit modules that are incorporated into the computer element of the enterprise's accounting system. Two frequently encountered examples are Integrated Test Facility (ITF) and System Control and Review File (SCARF).

a. ***Integrated test facility***

Integrated Test Facility involves the creation of a fictitious entity (for example a department or a customer) within the framework of the regular application. Transactions are then posted to the fictitious entity along with the regular transactions. The results produced by the normal processing cycle are compared with what should have been produced, which is predetermined by other means.

It is important to ensure that the fictitious entities do not become part of the financial reporting of the organization. Several methods can be adopted to prevent this. The simplest and most secure method is to make reversing journal entries at appropriate cut-off dates. ITF enables management and auditors to keep a constant check on the internal processing functions applied to all types of valid and invalid transactions.

b. ***Systems Control and Review File (SCARF)***

SCARF is a relatively simple technique to build into an application. It is best described by illustrating an example, in this case, a general (nominal) ledger application.

Each general account would have two "auditors" fields: a Yes/No field indicating whether or not SCARF applies to this account; and a monetary value which is a threshold amount set by the auditors. The system would be set up so that only the auditors could specify whether an account was a SCARF account or not and what the monetary value would be.

Subsequently all transactions posted to a SCARF account which has a value in excess of the threshold amount would also be written to a separate SCARF file. This technique thus enables the auditors to monitor material transactions or sensitive accounts with ease and provides an assurance that all such transactions are under scrutiny.

10.3.4 Simulation

Simulation (or "parallel simulation") entails the preparation of a separate program that simulates the processing of the organisation's real system. Real data can then be passed not only through the system proper but also through the simulated program. For example the simulation program may be used to re-perform controls such as those used to identify any missing items from a sequence.

10.5.5 Program Logic and Coding

Two further types of CAATs worth mentioning are:

a) **Logical path analysis** which will draw flowcharts of the program logic; and
b) **Code comparison programs** which compare the original specified program to the current program to detect unauthorized amendments.

10.5.6 Knowledge-Based Systems

"Decision support systems" and "expert systems" can be used to assist with the auditors' own judgement and decisions. This is likely to save time and money as such methods increase the efficiency of the audit procedures used, and the maintenance of audit records. Other cost savings include the reduction in the number of staff required, and the fact that routine tasks can be assigned to technicians who are helped by the expert system.

10.6 CONTROLS IN A COMPUTER ENVIRONMENT

The expansion in the use of computers for accounting purposes will certainly continue. Auditors must therefore be able to cope with the special problems that arise when auditing in a computer environment and keep abreast of technical innovation.

Auditors are concerned with application controls and general controls. These are inter-related. Strong general controls contribute to the assurance which may be obtained by an auditor in relation to application controls. On the other hand, unsatisfactory general controls may undermine strong application controls or exacerbate unsatisfactory application controls.

The following points will particularly influence the auditors' approach.

(a) Before auditors place reliance on application controls which involve computer programs, they need to obtain reasonable assurance that the programs have operated properly, by evaluating and testing the effect of relevant general controls or by other tests on specific parts of the programs.

(b) Sometimes a programmed accounting procedure may not be subject to effective application controls. In such circumstances, in order to put themselves in a position to limit the extent of substantive procedures, the auditors may choose to perform tests of controls by testing the relevant general controls either manually or by using CAATs, to gain assurance of the continued and proper operation of the programmed accounting procedure.

(c) In a computer environment there is the possibility of systematic errors. This may take place because of program faults or hardware malfunction in computer operations. However, many such potential recurrent errors should be prevented or detected by general controls over the development and implementation of applications, the integrity of the program and data files, and of computer operations.

(d) The extent to which the auditors can rely on general controls may be limited because many of these controls might not be evidenced, or because they could have been performed inconsistently. In such circumstances, which are particularly common where small computers are involved, the auditors may obtain assurance from tests on manual application controls or by tests on specific parts of the programs.

10.6.1 Examples of Application Controls

To achieve the overall objectives of application controls, the specific requirements are controls over:

a. Completeness, accuracy and authorization of input;
b. Compliance with authorisation procedures
c. Completeness and accuracy of processing;
d. Maintenance of master files and the standing data files contained therein.

(The Master file contain permanent information while the standing data file contains current information, for example staff grades and wage rates, which will be used over and over again when carrying out processing.)

a. Controls over Input

Control techniques for ensuring the completeness of input in a timely fashion include:

a. manual or programmed agreement of control totals;
b. one for one checking of processed output to source documents;
c. manual or programmed sequence checking;
d. programmed matching of input to a control file, containing details of expected input;
e. procedures over resubmission of rejected inputs.

Controls over the accuracy of input are concerned with the data fields on input transactions. Control should be exercised not only over value fields, such as invoice amounts, but also important reference fields, such as account number or date of payment.

Some of the completeness control techniques, such as a batch total, will also control accuracy but others, such as sequence checks, will not. Additional techniques to ensure accuracy include:

a. programmed check digit verification (a check digit included in a reference number is arithmetically checked to ensure that it bears the required relationship to the rest of the number);
b. programmed reasonableness checks, including checking the logical relationship between two or more files;
c. programmed existence checks against valid codes;
d. manual scrutiny of output.

b. **Controls over Authorization**

Controls are required to ensure that:

i. all transactions are authorized; and

the individual who authorized each transaction was empowered to do so.

This will generally involve a clerical review of input transactions, although a programmed check to detect transactions that exceed authorization limits may be possible. The clerical review should be done either after a control total has been established or after processing, to ensure that unauthorized transactions cannot be introduced after the review.

c. ***Controls over Processing***

Controls are required to ensure that:

i. all input data is processed;
ii. the correct master files and standing data files are used;
iii. the processing of each transaction is accurate;
iv. the updating of data, and any new data generated during processing, is accurate and authorized;
v. output reports are complete and accurate.

The control techniques used to ensure the completeness and accuracy of input may also be used to ensure the completeness and accuracy of processing. The techniques must be applied to the results of processing, such as a batch reconciliation produced after the update and not the one produced after the initial editing or review.

d. ***Controls over Master Files and Standing Data Files***

Techniques for ensuring the completeness, accuracy and authorization of amendments to master files and standing data files and for ensuring the completeness and accuracy of the processing of these amendments are similar to the techniques for transaction input.

The following controls may be particularly important:

a. More costly techniques such as one to one checking may be used because of the importance of master files and standing data files.
b. All master files and standing data files may be reviewed cyclically

c. Record counts and hash totals may be used every time master files are used. (Read are counts of the total number of documents processed. Hash totals are the totals of for example the payroll numbers of all staff members on a payroll. That total can be used as a check that all records have been processed, but is otherwise of no significance).
d. Controls may be exercised over the deletion of accounts which contain a current balance.

10.6.2 Example of General Controls

To achieve the overall objectives of general controls above, controls are required to:

a. ensure proper development of computer applications;
b. prevent or detect unauthorized changes to programmes;
c. ensure that all program changes are adequately tested and documented;
d. prevent or detect errors during use of programs;
e. prevent unauthorized amendments to data files;
f ensure that software which controls operations of the computer systems is properly installed and maintained;
g. ensure that proper documentation is kept; and
h. ensure continuity of operations.

a. ***Control over Development of Computer Application***

The auditors might consider:

i. system design standards;
ii. programming standards;
iii. documents controls and standards;
iv. testing procedures;
v. approval of development stages by users and computer management;
vi. internal audit involvement;
vii. segregation of duties for system design;
viii. programming and operations; and
ix. training and supervision.

b. ***Controls to Prevent or Detect Unauthorized Changes to Programs***

This covers both accidental and fraudulent corruption of program logic during program maintenance or program execution.

For programme maintenance, auditors would consider:

i. segregation of duties and the training and supervision of staff;
ii. authorization of jobs prior to processing;
iii. record of program changes and its review to detect unauthorized changes;
iv. password protection of programs;
v. virus checks on software;
vi. emergency modification procedures;
vii. integrity of backup copies of programs;
viii. physical protection of production programs;
ix. programs stored in other locations as an extra copy; and

x. comparison of production programs to controlled copies.

For program execution, auditors would consider:

- procedures to prevent access to programs while they are being run;
- controls over use of utility programs;
- restricted access to the computer and remote terminals;
- review of job accounting reports and investigation of unusual delays; and
- rotation of duties.

c. ***Controls to Ensure that all Program Changes are Adequately Tested and Documented***

As program changes may range from a small alteration of an output report to a major redesign, most installations will have more than one set of standards for testing and documenting changes. The auditors would consider the adequacy of such matters as:

i. testing procedures;
ii. documentation controls and standards;
iii. approval of changes by users and computer management;
iv. internal audit involvement, and segregation of duties;
v. training and supervision of the staff involved.

d. ***Controls to Prevent or Detect Errors during Program Execution***

The auditors might consider:

- adequacy of operations controls included in the systems software;
- use of job control procedure libraries;
- set up and execution procedures;
- job scheduling, emergency backup procedures;
- Training and supervision.

These procedures should provide protection against errors such as:

i. incorrect data files being used;
ii. wrong versions of production programs being used;
iii. running programs in the wrong sequence, incorrect response to a programme request;
iv. job control errors.

e. ***Controls to Prevent Unauthorized Amendment to Data Files***

Controls to prevent unauthorized amendments to data files are dependent upon;

- application controls over the files;
- manner in which the file is maintained;
- file management software used.

The auditors might consider the adequacy of general control procedures such as:

i. authorization of jobs prior to processing;
ii. procedures to detect unauthorized amendments;
iii. password protection and procedures for recording and investigating unauthorized access attempts;
iv. emergency modification procedures;
v. integrity of back up files;
vi. physical protection of data files;

vii. restricted use of utility programs;
viii. segregation of duties.

f. ***Controls to Ensure That Systems Software is Properly Installed and Maintained***

Systems software includes the operating system, teleprocessing monitors, data base management systems and other software used to increase the efficiency of processing and to control processing. The auditors should consider not only the controls exercised by the software but also the controls over the software, such as:

- frequency of amendments;
- amendment procedures;
- access controls;
- Segregation of duties.

g. ***Controls to Ensure That Proper Documentation is Kept***

Proper documentation aids efficient and accurate operations by users and computer personnel, setting up and amendments to applications, and recovery from disaster. The auditors would consider such matters as:

i. quality of documentation;
ii. quality of standards used;
iii. enforcement of standards, internal audit involvement;
iv. updating procedures.

h. ***Controls to Ensure Continuity of Operation***

As part of their overall assessment of the enterprise the auditors might consider:

i. back up procedures such as storing extra copies of programs off-site;
ii. testing of back up facilities and procedures;
iii. protection of equipment against fire and other hazards;
iv. separate power sources;
v. emergency and disaster recovery procedures;
vi. maintenance agreements and insurance.

10.7 CONTROLS IN ON-LINE AND REAL-TIME SYSTEMS

Whilst traditional batch processing is still a common method of using a computer to process accounting data there is a rapid increase in the use of an on-line system, including those in real-time.

a. **On-line** systems provide the facilities for data to be passed to and from the central computer via remote terminals.
b. **Real-time** systems are a further development of on-line systems and permit immediate updating of computer held files. The data input and file update phases are therefore merged and the system accepts individual transactions rather than batches of data.

Real-time systems, which are often referred to as one-write systems, are the computerized equivalent of bookkeeping systems. In those systems, several accounting records are prepared simultaneously by the use of carbon paper between specially aligned sheets of paper, the bottom sheet being, say, a sales day book, followed by the customer's account, then the customer's statement.

10.6.1 Controls in Real-time Systems

There are certain control problems associated with most real-time systems. The main points to remember are as treated below. Take note that we are concerned primarily with larger, multi-user systems. By reference to terminals, we mean either dumb terminals or networked PCs.

a. ***Segregation of Duties***

The same person is often responsible for producing and processing the same information. To compensate for the reduction in internal check, supervisory controls should be strengthened.

b. ***Data File Security***

The ability of a person using a remote terminal to gain access to databases at will results in the need for special controls to ensure that files are neither read nor written to (nor destroyed), either accidentally or deliberately, without proper authority.

(i) The controls may be partly physical. For example:

- access to terminals is restricted to authorized personnel;
- the terminals and the rooms in which they are kept are locked when not in use.

(ii) They may be partly controlled by the operating system by:

- The use of password (or lockwords), or special badges or keys, sometimes linked to a user's personal identification code which must be used before the terminal operator can gain access to the computer or particular files. In some systems one password or other identification is required before it is possible to read a file, a second before it is possible to write new data and yet a third if both operations are permitted. Obviously, the code given to a particular individual will depend on his job function and status within the organization.
- Restriction by the operating system of certain users to certain files. For example, the PC in the Wages Department may only be given access to the wages' files.
- Logging of all attempted violations of the above controls possibly accompanied by the automatic shutdown of the PC or terminal used. Obviously, all violations should be investigated speedily and thoroughly.

(iii) Application controls may include validity checks on inputs and reporting of unusual transactions.

d. ***Program Security***

The points discussed above apply equally to the use of programs.

e. ***Back-ups***

Back-up copies of data must be taken at least daily, and separately on a weekly basis. In a real time system it may be necessary to have a cut off time after which no further transactions are ever posted. Attempts to open a file when a back-up is in progress can sometimes corrupt the process. Stray transactions posted after the back-up has been done could be lost if there is some sort of accident and the back-up data has to be restored in full the next day.

On the other hand, immediate access to files allows more sophisticated checks to be performed. For example it allows more extensive use of computer matching, where the information input may be checked for accuracy against that held on file.

Moreover, in spite of the potential for abuse, there is a distinct advantage to enable users to correct certain types of error immediately.

10.6.2 Database Management Systems (DBMS)

DBMS are normally designed for use in real-time environments. They enable elements of data to be accessed by different programs. This avoids the duplication of data which inevitably occurs in a traditional system.

As data is normally only stored once, and may be accessible to all users that require it, the principal control problems raised concern the authorization of data amendments and restriction of access to data. Any data amendments must take into account the requirements of all the users. And **administration function** should be set up to run and control the day to day operation of the database, thereby enhancing segregation of duties (this function will be independent of the systems development personnel and programmers and the data processing manager).

The following controls, some of which are common to all real-time systems, might be incorporated into DBMS.

a. ***Controls to Prevent Unauthorised Changes to Programs***

These include:

i. no access to live program files by any personnel except for the operations personnel at the central computer;
ii. password protection of programs;
iii. restricted access to the central computer and terminal;
iv. maintenance of a console log and scrutiny by the data processing manager and by an independent party such as the internal auditors;
v. periodic comparison of live production programs to control copies and supporting documentation.

b. ***Controls to Prevent or Detect Errors during Operation***

These include:

i. restriction of access to terminals by use of password and restrictions of programs themselves to certain fields;

ii. satisfactory application controls over input, processing and master files and their contents;
iii. use of operations manuals and training of all users;
iv. maintenance of logs showing unauthorised attempts to access and regular scrutiny by the data processing manager and internal auditors;
v. physical protection of data files;
vi. training on emergency procedures.

c. ***Controls to Ensure Integrity of the Database System*** These include:

a. restriction of access to the data dictionary (this contains standard descriptions, including definitions, characteristics, and inter-relationship of data;
b. segregation of duties between the data processing manager, the database administration function and systems development personnel;
c. liaison between the database administration function and systems development personnel to ensure integrity of systems specifications;
d. preparation and update (as necessary) of user manuals in conjunction with the data dictionary.

The audit of DBMS creates particular problems as the two principal CAATs (test data and audit software) tend to work unsatisfactorily on the programs and files contained within such systems. The auditors may, however, be able to use embedded audit facilities. Close liaison with the internal auditors may also provide audit comfort. The auditors should if possible be involved at the evaluation, design, and development stages so that they are able to determine their audit requirements and identify control problems before implementation.

10.7 BUSINESS SYSTEMS AND ASSOCIATED IT RISKS

Clients that rely on IT systems such as computers and networks for key business activities face a range of related risks. Three main risks stand out: natural disaster, general IT risks, and criminal IT risks.

Natural disasters such as floods, earthquake, and fire, are a set of risks to IT systems. Damage to buildings and computer hardware can result in loss or corruption of business data records.

General threats to IT systems and data include:

- viruses – a program that can copy itself and spread from one computer to another, often disrupting computer operations
- spam, scams and phishing – unsolicited email that seeks to fool people into revealing personal details or buying fraudulent goods
- malware – malicious program designed to disrupt computer operations
- human error – incorrect data processing, careless data disposal, or accidental opening of infected email attachments.
- hardware and software failure – due to power outage or data corruption

Criminal threats to IT systems and data include:

- denial-of-service – online attacks that prevent website access for authorised users
- fraud – altering data for illegal benefit
- hackers – people who illegally break into computer systems
- passwords theft – often a tool for malicious hackers
- security breaches – e.g., online intrusion, physical break-ins
- staff dishonesty – theft of sensitive information e.g., customer details.

Main effects of IT Risks

IT systems' risks have the following negative effects on businesses:

- loss of confidential and sensitive data
- loss of business continuity
- brand and reputational damage
- fines by regulatory agencies if client is found negligent.

Preventive Measures

A preventive measure should focus on how the business of the entity will continue without interruptions. In relation to IT risks, this entails:

- Identifying, preventing and reducing risks
- Buying an insurance cover for the risks that cannot be controlled
- Quick response and recovery when and if a risk occurs.

Thus, for each of the following risks, there are deterrents the client can put in place to safeguard its business systems:

Risk	**Inhibition**
Trojans: Disguised as harmless software to attack computers	Install anti-virus software
Malware: Software designed to damage a computer system	Install anti-virus software
	Use strong passwords
	Change passwords regularly
Spam: Unsolicited emails sent out in bulk	Use junk email filters in inbox
Cookies: Software that tracks your movements online and reports back to originating website	Clear cookies from web browser settings regularly
Identity Theft: Using client information to commit fraud	Store identity information securely and do not give it out to untrusted sources
Phishing: Fake emails designed to capture your sensitive data and information	Do not open or click any links in unsolicited emails
Hackers: People who are trying to gain unauthorised access to your computer or systems	Keep software up to date

	Use a firewall
Theft of IP Address: Stealing and profiting from client data	Create non-disclosure agreements with employees
	Complete security training with personnel
	Create security policies and procedures
	Identify and secure valuable data

10.8 CURRENT TRENDS IN INFORMATION TECHNOLOGY

10.8.1 Big Data Analytics

Big data is a mixture of structured, semi-structured, and unstructured data collected by organizations. Big data can be mined for information and used in advanced analytics applications e.g., predictive modelling and machine learning projects. Big data comes in greater variety, arrives in increasing volumes and are captured with more velocity. This gives rise to the three Vs of Big Data:

- the data comes from many environments in large ***volume***;
- the data comes in frequently in wide ***variety***; and
- the data is generated, collected and processed at higher ***velocity***.

The data sets are so voluminous that traditional data processing software would not manage them. Yet, the data volumes are valuable because they are used to solve business problems. For example, they help to:

i. improve operational efficiencies
ii. optimize product development
iii. drive new revenue and growth opportunities
iv. streamline resource management
v. enable smart decision making.

When high-performance analytics is applied to big data the following business-related tasks are accomplished:

- the root causes of failures, issues and defects are determined.
- anomalies are spotted faster and more accurately.
- data outcomes are swiftly converted into insights.
- entire risk portfolios and scenarios are recalculated speedily.
- The ability of deep learning models is sharpened to accurately classify and react to changing variables.
- fraudulent behaviour is detected before it affects the organization.

10.8.2 Audit of Electronic Transactions

Electronic commerce has penetrated every facet of human endeavor. Cashless transactions use digital platforms to consummate transactions between buyers and sellers. In such circumstance, the auditor must observe the following procedures:

i. Identify accepted payment methods;
ii. Evaluate roles and responsibilities;
iii. Test the reconciliation process; and
iv. Analyse trends

1. **Identifying accepted payment methods**

The auditors will observe the following procedures to identify the accepted payment methods:

a. Obtain a list of the types of payments the client accepts and the process maps for each payment channel. Examples of cashless payment methods include:
   - Credit and debit cards,
   - Mobile wallets,
   - Digital currencies (such as Bitcoin),
   - Automated Clearing House payments,
   - Wire transfers, and
   - Payments via intermediaries (such as Interswitch, PayPal).

b. reviews documents detailing how the receipt of cashless payments works and how the funds end up in the company's bank account.

c. amend the audit programme to review them in detail, depending on the number of cashless methods.

2. **Evaluating roles and responsibilities**

The auditors will observe the following procedures in evaluating roles and responsibilities:

a. obtain a list of employees involved in the receipt, recording, analysis, and reporting of cashless transactions;

b. review how the company manages and monitors employee access to every technology platform connected to cashless payments;

c. evaluate who handles each aspect of the cashless payment cycle to ascertain whether the appropriate level of security and segregation of duties are observed to prevent fraud and misstatement.

3. **Testing the reconciliation process**

Auditors will observe the following procedures to test the reconciliation process:

a. review prior sales reconciliations to test their accuracy and ensure appropriate recognition of revenue. This may be especially challenging as companies implement the new accounting rules on revenue recognition for long-term contracts.

b. test the accounting entries related to such accounts as inventory, deferred revenue and accounts receivable.

4. **Analysing trends**

Cashless transactions create an electronic audit trail that gives the auditors opportunity to analyse trends. To uncover anomalies, auditors:

a. analyse sales by payment channel, over different weeks (or months) and according to each employee's (or unit's) sales activity and compare results with prior years.
b. collect information about past experience with payment problems and the remedial actions taken to recover losses.

10.8.3 Artificial Intelligence

Artificial intelligence (AI) is the ability of a computer or a robot controlled by a computer to do tasks that are usually done by humans because they require human intelligence and discernment. Thus, *AI* is the simulation of human intelligence in machines that are programmed to think like humans and mimic their actions; and a robot is an intelligent entity created by humans, capable of performing tasks intelligently without being explicitly instructed and capable of thinking and acting rationally and humanely. Examples of AI are:

- Conversational bots (or robots)
- Email spam filters
- Netflix's recommendations
- Robo-advisors
- Self-driving (or autonomous) cars
- Smart assistants e.g., Siri, Alexa.

Types of AI

AI is divided into two broad categories, namely Strong and Weak AI. This categorization helps to differentiate the performance levels in different kinds of AI machines. Some of the core differences are:

	Weak AI	**Strong AI**
Application	narrow	wide
Scope	limited	vast
Good at	specific tasks.	human-level intelligence.
Process	uses supervised and unsupervised learning to process data.	uses clustering and association to process data.

Siri and Alexa are examples of weak AI while advanced robotics are strong AI.

AI aids human capabilities and help us make advanced decisions with far-reaching consequences. AI is shared by all the different tools and techniques to simplify human effort, and to help in making better decisions. It is used by companies to improve their process efficiencies, automate resource-heavy tasks, and to make business predictions based on data.

The Uses of AI

AI is used in the following data processing category:

a. Searching within data, and optimising the search to give the most relevant results
b. Logic-chains for if-then reasoning, that can be applied to execute a string of commands based on parameters
c. Pattern-detection to identify significant patterns in large data set for unique insights
d. Applied probabilistic models for predicting future outcomes

The main objective is to make things simpler and easier for the end-users. Examples are:

- Google's predictive search algorithm used past user data to predict what a user would type next in the search bar.
- Netflix uses past user data to recommend what movie a user might want to see next, making the user hooked onto the platform and increase watch time.
- Facebook uses past data of the users to automatically give suggestions to tag your friends, based on their facial features in their images.

Advantages of Artificial Intelligence (AI)

a. Constant availability (twenty-four hour each day)
b. Digital assistance
c. Efficient Communication
d. Faster decisions
e. Helps in repetitive work (does not experience fatigue)
f. Improves Security (digital surveillances)
g. Medical applications (in diagnosis, drugs dispensary, medical advisory, etc.)
h. Rational decision making (based on data)
i. Reduction in human error

10.8.4 Machine Learning

Machine learning (ML) is a form of AI that uses data to teach machines how to make inferences and decisions from past experiences, rather than through explicit programming. ML recognizes patterns and categorizes past data to infer the meaning of current data to reach a possible conclusion without human assistance. This helps businesses to make better decisions, handle more volumes, and save man hours.

ML is an art and a science. The art of ML aims at reducing disparate problems to a set of suitably acceptable prototypes. The science of ML solves those problems and offer guarantees for the recommended solutions.

Areas of business application includes:

a. Search engines ranking of webpage results when a query is imputed
b. Amazon (internet bookstore) attracting users to purchase more books

c. Netflix (video rental sites) inviting users to rent additional videos.
d. Multilingual entities like the United Nations doing automatic language translation during proceedings.
e. Using speech recognition to give verbal approvals.
f. Using face recognition to allow personnel to gain access to some restricted premises, rooms or consoles.

Types of ML

Machine Learning evolved through the following stages:

- Supervised Learning - This is the case where humans feed the machine with data.
- Unsupervised learning – In this case, the machine is made to learn on its own without any human assistance.
- Reinforcement Learning – The machine is rewarded when it does the job the expected way.
- Deep Learning: This is where the human brain is simulated in the machine so that it learns on its own.
- Deep Reinforcement Learning – This gives incentives to a Deep Learning network as awards when it does the job as expected.

10.9 CHAPTER SUMMARY

a. Computers have several uses in audit administration and management including linked (cross-referenced) computerized working papers, statistical sampling, and analytical procedures.
b. Auditors may use a number of computer assisted audit techniques (CAATs) including audit interrogation software, test data, embedded audit facilities, simulation, logical path analysis, and code comparison programs.
c. Application controls should ensure the completeness, accuracy, and authorization of input; the completeness and accuracy of processing; and proper maintenance of master files and standing data.
d. General controls are required to ensure proper application development; prevent or detect unauthorized changes to programs; ensure that all program changes are adequately tested and documented; prevent or detect errors during the use of programs; prevent unauthorized amendments to data files; ensure that systems software is properly installed and maintained; ensure that proper documentation is kept; and ensure continuity of operations.
e. The majority of modern systems are real-time systems, where users have instant and direct access to data. Important real time controls are segregation of duties, data file security, program security, and back-ups.
f. Many small computer systems use personal computers (PCs). The major problems with use of PCs are lack of planning over acquisition and use; lack of documentary evidence; and lack of security and confidentiality.
g. Big data analytics, audit of electronic transactions, artificial intelligence and machine learning are current trends in information technology that impact the way audit is conducted.

MULTIPLE-CHOICE QUESTIONS

1. The possibility of earning a large amount of information stored on a magnetic tape would most likely be reduced using
   A. File protection rings
   B. Check digits
   C. Completeness check
   D. Conversion verification
   E. Parity check

2. Which of the following is not an example of CAATs?
   A. System control and review file
   B. Integrated test facilities
   C. Read Only Memory
   D. Snapshot
   E. Mapping

3. Computers are useful in audit administration to do the following **EXCEPT**
   A. Footing and cross footing
   B. Carry forward of numerical data to lead schedules
   C. Highlight proposed audit recommendations for audit management review
   D. Consolidate materials in audit working papers in order to prepare the audit report
   E. None of the above

4. Which of the following computer documentations can assist to obtain an understanding of the internal control system?
   A Audit trail
   B Computer log
   C Record layout
   D System flow chart
   E Programme Code Analysis

5. The loss of audit trail can be overcome through the following techniques **EXCEPT**
   A Special print out
   B Computer programme
   C Alteration Test
   D Use of Test Pack
   E By not keeping logs

SHORT-ANSWER QUESTIONS

6. Controls over transactions and standing data appertaining to each computer-based accounting system and therefore specific to each such application is known as........................
7. When transactions could be followed stage-by-stage through a system to ensure that they had been processed correctly then, there is audit...................................
8. The audit approach which ignores the procedures which take place within the computer programs and concentrating solely on the input and corresponding output is called......................................

9. Controls which relate to the environment within which computer based accounting systems are developed, maintained and operated, and which are therefore applicable to all the applications are known as…………….
10. Which of the data processing functions should usually be set up to run and control the day-to-day operations of the data base?

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. A
2. C
3. E
4. D
5. E

SOLUTIONS TO SHORT ANSWER QUESTIONS

6. Application controls
7. Trail
8. Audit round the computer
9. General controls
10. Administration function

CHAPTER ELEVEN

REPORTS ON FINANCIAL STATEMENTS

CHAPTER CONTENTS

a. Basic elements of the Auditor's report
b. Clean Audit
c. Modified Audit

OBJECTIVES

On completion of this chapter, the reader should be able to:

a. describe the purpose, significance and content of the audit report

b. choose which type of audit report is appropriate to specific situations

11.1 BASIC ELEMENTS OF THE AUDITOR'S REPORT

The purpose of this section is to provide guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. Much of the guidance provided can be adapted to auditor's reports on financial information other than financial statements.

The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework being International Financial Reporting Standards (IFRS) or relevant national standards or practices. It may also be necessary to consider whether the financial statements comply with necessary statutory requirements.

The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

The auditor's report includes the following basic elements in the following layout:

a) Title;
b) Addressee;

c) Opening or introductory paragraph

   i. Identification of the financial statements audited;

   ii. A statement of the responsibility of the entity's management and the responsibility of the auditor;

d) Scope paragraph (describing the nature of an audit)

   i. A reference to the International Standards of Auditing (ISAs) or relevant national standards or practices;
   ii. A description of the work the auditor performed

e) Opinion paragraph containing

   i. A reference to the financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards); and
   ii. An expression of opinion on the financial statements.

f) Auditor's signature.

g) Auditor's address; and

h) Date of the report;

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding and to identify unusual circumstances when they occur.

a. **Title**

The auditor's report should have an appropriate title. It may be appropriate to use the term "Independent Auditor" in the title to distinguish the auditor's report from reports that might be issued by others, such as officers of the entity, the board of directors, or from the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor.

b. **Addressee**

The auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations. The report is ordinarily addressed to the shareholders of the entity whose financial statements are being audited.

c. **Opening or Introductory Paragraph**

The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.

The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. This determination will be made in the context of the financial reporting framework that management chooses, or is required, to use. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

An illustration of these matters in an opening (introductory) paragraph is:

"We have audited the accompanied statement of financial position of the ABC Company as of 31 December 2021, and the related statements of comprehensive income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit".

d. **Scope Paragraph**

The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with *International Standards on Auditing* or in accordance with relevant national standards or practices as appropriate. "Scope" refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. The reader needs this as an assurance that the audit has been carried out in accordance with established standards or practices. Unless otherwise stated, the auditing standards or practices followed are presumed to be those of the country indicated by the auditor's address.
The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The auditor's report should describe the audit as including:

a) Examining, on a test basis, evidence to support the financial statement amounts and disclosures;
b) Assessing the accounting principles used in the preparation of the financial statement;
c) Assessing the significant estimates made by management in the preparation of the financial statements; and
d) Evaluating the overall financial statement presentation.

The report should include a statement by the auditor that the audit provides a reasonable basis for the opinion.

As an illustration, matters in in a scope paragraph may be like the following:

"We conducted ~~out~~ our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amount and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

e. **Opinion Paragraph**

The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Financial Reporting Standards) and state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.

The terms used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects" and they are equivalent. Both terms indicate, amongst other things, that the auditor considers only those matters that are material to the financial statements.

The financial reporting framework is determined by IFRS and rules issued by recognized standard setting bodies (e.g. Financial Reporting Council of Nigeria), and the development of general practice within a country, with an appropriate consideration of fairness and with due regard to local legislation. To advise the reader of the context in which the auditor's opinion is expressed, the auditor's opinion indicates the framework upon which the financial statements are based. The auditor refers to the financial reporting framework in such terms as:

" …. In accordance with International Financial Reporting Standards (or title of financial reporting framework with reference to the country of origin) ……"

This designation will help the user to understand the financial reporting framework used in preparing the financial statements. When reporting on financial statements that are prepared specifically for use in another country, the auditor considers whether appropriate disclosure has been made in the financial statements about the financial reporting framework that has been used.

In addition to an opinion on the true and fair view (or fair presentation, in all material respects), the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law.

An illustration of these matters in an opinion paragraph is:

"In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31

December 2021, and of the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards (or [title of financial reporting framework with reference to the country of origin]) (and comply with ……).”

f. **Auditor’s Signature**

The report should be signed in the personal name of the engagement partner. The auditor then affixes the Institute’s stamp and seals the report. The auditor signing must state his/her FRC (Financial Reporting Council) number after his her name. The auditor’s report is ordinarily in the name of the firm because the audit firm assumes responsibility for the audit and the firm’s letterhead is used.
The auditor follows the following procedure in signing the audit report:

- i The engagement auditor signs
- ii Writes his full name
- iii Includes his FRC number
- iv States the name and city of the firm
- v Affixes the Institute’s stamp; and
- vi Affixes his seal

g. **Auditor’s Address**

The report should name a specific location, which is ordinarily the city where the auditor maintains the office that has responsibility for the audit.

h. **Date of Report**

The auditor should date the report as of the completion date of the audit. This informs the reader that the auditor has considered the effect on the financial statements and on the report of events and transactions of which the auditor became aware and that occurred up to that date.

Since the auditor’s responsibility is to report on the financial statements as prepared and represented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

11.2 CLEAN AUDIT REPORT

A clean or unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the identified financial reporting framework. An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

The following is an illustration of an unqualified auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

AUDITOR'S REPORT

Audit Report to the Members of ABC Plc)

We have audited the accompanied statement of financial position of ABC Company as of 31 December 2021, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31 December 2021, and of the results of its operations and its cash flows for the year then ended in accordance with the International Financial Reporting Standards.

Signature

PPP Chartered Accountants

Victory Island

Banjul

Date: 1 October 2021

11.3 MODIFIED AUDIT REPORT

An auditor's report is considered to be modified in the following situations:

a. *Matters that Do Not Affect the Auditor's Opinion – An Emphasis of matter*

b. *Matters that Do Affect the Auditor's Opinion* i)
Qualified opinion,
ii) Disclaimer of opinion, or iii)
Adverse opinion
Uniformity in the form and content of each type of modified report will further the user's understanding of such reports. Accordingly, ISA 705 – Modification to

the Opinion in the Independent Auditor includes suggested wording to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

11.3.1 Matters That Do Not Affect the Auditor's Opinion – Emphasis of Matter

In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included after the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem.

The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainly (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report:

"In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31 December 2021, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards/ International Financial Reporting Standards.

Without qualifying our opinion, we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a countersuit, and preliminary hearing and discovery proceedings on both actions are in progress.

The ultimate outcome of the matter cannot presently be determined, and a provision for any liability that may result has been made in the financial statements."

The addition of a paragraph emphasizing a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor's report by using an emphasis of matter paragraph, preferably after the opinion paragraph, to report on matters other than those affecting the financial statements. For example, if an amendment to other information in a document containing audited financial statements is necessary and the entity refuses to make the amendment, the auditor would consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency. An emphasis of matter paragraph may also be used when there are additional statutory reporting responsibilities.

11.3.2 Matters That Affect the Auditor's Opinion

An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

a There is a limitation on the scope of the auditor's work; or

b There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion and disclaimer of opinion.

The circumstances described in (b) could lead to a qualified opinion or an adverse opinion.

a. **A qualified opinion**

A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being "except for" the effects of the matter to which the qualification relates.

b. **A disclaimer of opinion**

A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

c. **An adverse opinion**

An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

11.3.3 Disclosures in a Modified Opinion

Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

11.4 CIRCUMSTANCES THAT MAY RESULT IN MODIFIED OPINION

11.4.1 Limitation of Scope

A limitation on the scope of the auditor's work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary). However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would ordinarily not accept such a limited engagement as an audit engagement unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

A scope limitation may be imposed by circumstances (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

Illustrations of Qualified Opinions Relating to Limitation of Scope a**.**
Limitation of Scope - Qualified Opinion

We have audited the accompanied statement of financial position of ABC Company as of 31 December 2021, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with International Standards on Auditing (or refer to relevant national or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not observe the counting of the physical inventories as of 31 December, 2021 *since that date was prior to the time we were initially engaged as auditors of the company. Owing to the nature of the company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.*

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary, had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31 December 2021, and of the results of its operations and its cash flows for the year then ended in accordance with the International Financial Reporting Standards.

b **Limitation of Scope - Disclaimer of Opinion**

We were engaged to audit the accompanied statement of financial position of ABC Companies as of 31December 2021, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the company's management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to circumstances)

(Add a paragraph discussing the scope limitation as follows)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the company because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.

11.4.2 Disagreement with Management

The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

Illustrations of qualified opinions relating to disagreement with management

(a) Disagreement on Accounting Policies – Inappropriate Accounting method – Qualified Opinion

"*We have audited the accompanied statement of financial position of ABC Company as of 31 December 2021, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

We conducted our audit in accordance with International Standards on Auditing). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards. The provision for the year ended 31 December, 2021 should be Nxzz based on the straight-line method of depreciation using annual rates of 5percent for the building and 20percent for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of Nxxx and the loss for the year and accumulated deficit should be increased by Nyxy respectively.

In the opinion, except for the effect on the financial statement of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31 December 2021, and of the results of its operations and it cash flows for the year then ended in accordance with International Accounting Standards/ International Financial Reporting Standards.

Signature

PPP Chartered Accountants

Victoria Island

Lagos

Date: 11 February, 2022

b. Disagreement on Accounting Policies – Inadequate Disclosure – Qualified Opinion

"We have audited the accompanied Statement of Financial Position of ABC Company as of 31 December 2021, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

*On 15 January 2022, the Company issued debentures in the amount of **N**xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after 31 December 2021. In our opinion, disclosure of this information is required by (refer to relevant law or legislation)*

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of 31 December 2021, and of the results of its operations and it cash flows *for the year then ended in accordance with the International Financial Reporting Standards.*

Signature

PPP Chartered Accountants

Victoria Island

Lagos

Date: 16 February, 2022

c. Disagreement on Accounting Policies – Inadequate Disclosure – Adverse Opinion

"We have audited the accompanied statement of financial position of ABC Company as of 31 December 2021, and the related statements of income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

(Paragraph(s) discussing the disagreement).

In our opinion, because of the effects of the matters discussed in the preceding paragraph (s), the financial statements do not give a true and fair view of (or do not present fairly) the financial position of the Company as of 31 December 2021, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (and do not comply with…)

Signature

PPP Chartered Accountants

Victoria Island

Lagos

Date: 12 February, 2022

11.5 CHAPTER SUMMARY

i. Auditors' are required to make specific reference in the audit report as to the truth and fairness of the state of the company's affairs at the period end; the truth and fairness of the Statement of Profit or Loss and Other Comprehensive Income; and whether the accounts have been properly prepared in accordance with the Companies Act and Allied Matters Act as amended (CAMA).

ii. CAMA requires certain matters to be specifically reported on by exception:
- Proper accounting records kept
- Accounts in agreement with accounting records and returns
- All information and explanations received
- Details of directors emoluments correctly disclosed
- Details of loans and other transactions in favour of directors and related parties correctly disclosed
- Information given in the directors' report consistent with the accounts.

iii. The main elements of an unqualified audit report are
- A Title identifying the addressee
- An introductory paragraph identifying the financial statements audited
- Sections dealing with responsibilities of directors and auditors; basis of the auditors' opinion; and a clear statement of opinion

iv. Auditors may qualify their audit opinion on the grounds of limitation of scope or disagreement with management, which may be material or fundamental.

v. Auditors are principally concerned with the correct treatment and disclosure of inherent and fundamental uncertainties, which relate to uncertain future events.

vi. Auditors should include an explanatory paragraph in their audit report if fundamental uncertainties exist.

MULTIPLE-CHOICE QUESTIONS

1. When there is disagreement that is material but not fundamental to a financial statement, the auditor will issue a/an
   A. Disclaimer opinion
   B. Adverse opinion
   C. Subject to opinion
   D. Except for
   E. Qualified

2. Which of the following is the term used in describing a statement where the auditor draws the attention of users of financial statement to a particular issue without the intention of qualification?

A. Unqualified report
B. Audit opinion
C. Exception
Report D. Qualified
opinion
E. Emphasis of the report

3. An auditor concludes that a client`s illegal act, which has a material effect on the financial statements, has not been properly accounted for or disclosed. Depending on the materiality of the effect on the financial statements, the auditor should express either

A. An adverse opinion or a disclaimer of opinion
B. A qualified opinion or an adverse opinion
C. A disclaimer of opinion or an unqualified opinion
D. An unqualified opinion with a separate explanatory paragraph or a qualified opinion.
E. None of the above circumstances

4. For which of the following events would an auditor issue a report that does not make any reference to consistency?

A. A change in the method of accounting for inventories
B. A change from an accounting principle that is not generally accepted to one that is generally accepted.
C A change in the life span used to calculate the provision for depreciation expense.
D Management’s lack of reasonable justification for a change in accounting principle
E A change in the assets revaluation policy

5. Which of the following statements is a basic element of the auditor`s standard report?

A The disclosure provides reasonable assurance that the financial statements are free of material misstatement
B The auditor evaluates the overall internal control
C An auditor includes assessing significant estimates made by management
D The financial statements are consistent with that of the prior period
E The audit is conducted in accordance with international statements on auditing

SHORT-ANSWER QUESTIONS

6. When the auditor concludes that the financial statements give a true and fair view, then he will express.......................opinion.
7. Under what situations will an auditor's reports be considered to be modified?
8. That paragraph stating the factual statement of what the auditor did in the audit is called....................paragraph.
9. The part of the auditor's report which clearly indicates the financial reporting framework used to prepare the financial statements is called.................paragraph.
10. Mention **TWO** circumstances that will make an auditor to issue a qualified audit report.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. C
2. E
3. B
4. C
5. C

SOLUTIONS TO SHORT ANSWER QUESTIONS

6. An unqualified
7. a. Matters that do not affect the Auditors opinion
   b. Matters that do affect the Auditors' opinion
8. Scope
9. Opinion
10. a. Uncertainty
    b. Disagreement.

CHAPTER TWELVE

AUDIT COMPLETION

CHAPTER CONTENTS

a. Audit Completion Procedures
b. Final Review of Financial Statements
c. Completion of Field Work
d. Finalisation of the audit engagement
e. Reporting to Engagement Partner, Audit Committee, Board and Management
f. Assessment of truth and fairness
g. Other assurance engagements

OBJECTIVES

After studying this chapter, readers should be able to:

a. Understand the procedures involved in disengaging from the audit.
b. Understand the stages of the audit completion process.
c. Understand when a true and fair view may or may not be given.
d. Have a basic understanding of other assurance engagements

12.1 AUDIT COMPLETION PROCEDURES

The procedures the auditor is expected to carry out to complete the audit in an orderly and proper manner are under the following headings:

a. Final review of draft financial statements
b. Completion of field work
c. Drafting the audit report
d. Issues documentation
e. Audit completion checklist
f. The engagement partner sign-off
g. Debriefing
h. Reporting to the board and to management
i. Consideration of desirability of reappointment

12.2 FINAL REVIEW OF DRAFT FINANCIAL STATEMENTS

The auditor should carry out a final review of the draft financial statements in conjunction with the conclusion drawn from other evidence obtained to provide a reasonable basis for the audit opinion. It is his duty to review all matters relating to the period to ascertain that they have all been properly presented and disclosed in the financial statements. The final review should cover the following matters:

i. That all audit programmes were followed through in each transaction cycle during the audit;
ii. That audit working papers were complete with covering memos and properly referenced and cross referenced;
iii. That all audit queries raised were attended to;
iv. That exceptional ratios arising from analytical review of the financial statements were investigated;

v. That the management letter contains all observations and issues not satisfactorily cleared;
vi. That matters carried forward from the prior year have been reviewed and treated;
vii. That comparative figures agree to prior year financial statements;
viii. That contents of letter of representation were properly appraised and referenced;
ix. That the entity's existence as a going concern is assessed; and
x. That all subsequent events are reviewed.

12.3 COMPLETION OF FIELD WORK

The engagement manager should ensure that all field work have been completed and reviewed, except as indicated in Issues Documentation, before the files are presented for final review by the engagement partner. The engagement manager should be satisfied that:

a. adequate working paper review is evidenced in the file
b. all review notes have been satisfactorily cleared and have been removed from the files. Any documents relating to matters of substance affecting the opinion must be transferred to the Issues Documentation.

12.4 DRAFTING THE AUDIT REPORTS

The draft financial statements presented to the engagement partner for review should include the draft audit report. The audit report should use the standard wording for an unqualified opinion and should ensure that all relevant circumstances have been taken into consideration.

12.5 ISSUES DOCUMENTATION

To assist the partner in the efficient review of the financial statements and clearance of the audit, it is helpful for the audit team to prepare Issues Documentation. All unresolved matters are brought together from the various sections and presented in this document to aid the partner's decisions on the final wording of the opinion. The engagement partner may evidence clearance of the opinion on the financial statements by signing off the issues documentation.

12.6 AUDIT COMPLETION CHECKLIST

To help ensure that all relevant matters are attended to before the audit report is signed, it is often useful to provide an "Audit completion checklist". This could be a manual or electronic record. When final Issues Documentation is first presented to the engagement partner for initial clearance; and it is likely that some of the matters e.g., subsequent events review would not have been completed, The audit manager should go through the checklist and ensure that various aspects of the work have been completed before presenting the Issues Documentation (with the checklist) for final clearance.

12.7 THE ENGAGEMENT PARTNER'S SIGN-OFF

It may be useful to record information relating to the signing of the master copy of the financial statements. The audit file could also contain a record of the location and movement of draft and signed copies, the number required for printing and the persons to whom copies should be sent. The partner's sign off will authorise the acceptance for issuance of the reports.

12.8 DEBRIEFING

This is a meeting held in the auditor's office, among the audit team, to share and discuss information on the success or failure of the audit just completed

The objectives of debriefing at the end of the audit are:

a. To ensure that all matters that may be used in the report to the board and to management are identified and included
b. To assist in the assignment, training and development of the audit team
c. To improve the efficiency and effectiveness of future audits
d. To allow key players to obtain important information that will lead to improvement in future performance.

12.9 REPORTING TO THE BOARD AND MANAGEMENT

In addition to considering the audit report on the financial statements, the auditor should draw together conclusions and other matters appropriate for inclusion in the report to the board and in other reports to management. The auditor's report on public limited companies goes through the Audit Committee which stands between the auditors and the Board of Directors.

12.10 CONSIDERATION OF DESIRABILITY OF REAPPOINTMENT

The auditor should consider whether the circumstances of the client have changed in such a way as to make it undesirable to continue as the client`s auditor. A decision is needed before the auditor signifies willingness to be reappointed at the company`s annual general meeting. It is necessary to be alert for conditions that might have caused a rejection of the client had they existed when the appointment was initially accepted. In case of doubt, the engagement partner should consult other partners.

The auditor should obtain assurance that the subsequent events which were necessary to give a true and fair view have been appropriately dealt with in the financial statements. Subsequent events assessment provide guidance on the auditor`s responsibilities regarding events occurring:

a. between the period end and the date of the auditor`s report
b. between the date of the auditor's report and the issue of the financial statements
c. after the financial statements have been issued, but before they are laid before the members in the annual general meeting.

12.11 TRUTH AND FAIRNESS ASSESSMENT OF FINANCIAL STATEMENTS

The expression "true and fair view" is central to auditing and without it the audit opinion would be devoid of a universal meaning. The financial statement is true when it contains no falsehoods, i.e., when it is free from material misstatements, meaning that the transactions were correctly transferred to the financial statement. In the same vein, the financial statement is fair when it presents accurately and faithfully the situation and the financial performance of the entity, i.e., it is impartial, unbiased and represents the commercial substance of the transactions of the entity. To have a true and fair view therefore means that the financial statements are truly prepared and fairly presented in accordance with the prescribed accounting standards. The auditor is reporting on the bookkeeping, application of principles and policies, and the evaluation of the decisions of the management which in total affect the financial statements.

The presentation of a true and fair view in the financial statements requires that those statements comply with:

a) generally accepted accounting practices as prescribed by the International Financial Reporting Standards (IFRS) that are applied consistently from year to year; and
b) all relevant legislations

12.11.1 Where a True and Fair View may not be given

A true and fair view may not be given, for example, where:

i) the figures given in the financial statement does not fully and properly disclose their substance or is misleading or ambiguous;
ii) the financial statements are prepared on a basis that is not consistent with previous periods unless there is adequate disclosure;
iii) the financial statements do not conform with accounting policies required by CAMA 2020, relevant accounting standards (e.g., IFRS) or those acceptable to the auditor; and
iv) the presentation of the figures in the financial statements is so complicated that they are difficult to interpret or understand.

12.11.2 True and Fair presentation of the Financial Statements as a whole

For the purpose of reaching an opinion as to whether the financial statements give a true and fair view, the auditor should be satisfied that:

a. all information materially affecting the view given by the financial statements are properly disclosed;
b. proper balance is achieved between completeness of disclosure and the degree of summarization that is necessary if the financial statements are to be clear and readily understandable;
c. the information in the financial statements ensures that the conclusions which a reader might draw from it would be justified and consistent with the circumstances of the entity's business;
d. the financial statements fairly reflect the commercial effect of the underlying transactions and balances and not merely their legal form; and
e. the presentation adopted in the financial statements has not been unduly influenced by management's desire to present facts in an unreasonably favourable or unfavourable light.

12.11.3 True and Fair Presentation of the Assets

The auditor must satisfy himself that the assets:

a. exist and they are the property of the entity
b. have not been charged or pledged, and if so, the position is properly disclosed in the financial statements.
c. are stated at amounts which are in accordance with accounting policies which are required by Companies and Allied Matters Act, 2020 (or other relevant legislation and by relevant Accounting Standards e.g. IFRS), or are otherwise acceptable to the auditor, and which have been consistently applied.

12.11.4 True and Fair Presentation of Liabilities

The auditor must ascertain that:

a. all material liabilities of the company at the date of the Statement of Financial Position have been included in the financial statements;
b. all material contingent liabilities have been referred to in the notes to the financial statements unless either the possibility of losses is remote or adequate provision has been made where losses are considered to be probable;
c. adequate provision for known or expected losses have been made; and
d. they are stated at amount which are in accordance with accounting policies which are required by Companies and Allied Matters Act, 2020 (or other relevant legislation) and by relevant Accounting Standards or are otherwise acceptable to the auditor and which have been consistently applied.

12.11.5 Results Shown by the Statement of Profit or Loss and Other Comprehensive Income

The auditor should ensure that the results:

a. represent profit or loss properly attributable to the period.
b. are stated at amounts which are in accordance with accounting policies which are required by CAMA (or other relevant legislation) and by relevant Accounting Standards or are otherwise acceptable to the auditor, and have been consistently applied.

12.12 OTHER ASSURANCE ENGAGEMENTS

a) **Forensic Audit**

Current practices and the increasing number of court cases involving professional accountants have necessitated that those accountants who carry out audit engagement will have to give evidence in the court of law. This has led to accountants learning how to review and investigate matters and give evidence in the court. Presentation of financial information to substantiate the position in the court becomes necessary.

Forensic audit is therefore the process of auditing and presenting reports in a manner that is admissible for evidence in the court of law. It often requires investigative skill and appropriate grounding in the law and presentation of evidence in the court.

b. **Due Diligence**

Investors acquire and dispose of their investments from time to time. This is often done by the assessment of recent and up-to-date information on the state of affairs of the target entity. This is done by assigning responsibility to other auditors to carry out a review of the accounting and management structure of the target entity. This review and evaluation of the entity called due diligence will therefore enable the investor to make decision on the proposed investment.

Objectives of Due Diligence

The objectives of carrying out due diligence are:

i. to determine the strengths and weaknesses of the entity
ii. to ascertain the economic worth of the entity
iii. to evaluate the needed financial injection that will be necessary to achieve the objective of the planned investment
iv. to ascertain the worthwhileness of the investment

Procedure for Due Diligence

The due diligence procedure carried out by the auditor entails the following:

- Review the financial statement of the enterprise;
- Prepare and compare the enterprise's ratios with industry and other standards;
- Make adjustments to the financial statements;
- Review management projections and expectations;
- Make cash flow projections;
- Project the business over a period; and
- Advise on the viability of the investment.

12.13 CHAPTER SUMMARY

i) The Chapter discussed the procedures involved in the completion of assurance engagements.
ii) The scope of work involves the final review of financial statements including the drafting of reports, debriefing, reappointment and the assessment of the truth and fairness of the financial statements.
iii) The other assurance engagements include forensic audit and due diligence.

MULTIPLE-CHOICE QUESTIONS

1. Which of the following procedures would be least effective in the audit of contingent liabilities?
   A. Examining invoices for professional services
   B. Reviewing Assets verification procedures
   C. Reviewing a bank confirmation letter
   D. Reviewing customer confirmation
   E. Reading the minutes of the board of directors

2. Which of the following best defines "subsequent event" for reporting purposes? Event that occurs subsequent to the
   A. Date of the auditor's report
   B. Statement of financial position date but prior to the date of the directors' report
   C. Statement of financial position date

D. Date of the auditor's report and concern contingencies that are not reflected in the financial statements.
E. Statement of financial position date but prior to the date of the auditor's report

3. For which of the following will the auditor not accept responsibility in expressing opinion on the financial statements?
A. Compliance with legal requirements
B. The preparation of financial statement
C. The appropriateness of the comparative figures included in the account
D. The reliability of the opening balances
E. The consistency of the application of accounting policies

4. Which of the following is **NOT** a basic element of audit report?
A. Director's signature
B. Title
C. Date of the report
D. Auditor's signature
E. Address

5. Which of the following statements is **NOT** part of the financial statement?
A. The chairman's statement
B. Statement of Cash-flow
C. Statement of Value Added
D. Statement of Accounting Policies
E. Statement of Financial Position

SHORT-ANSWER QUESTIONS

6. To assist the engagement partner in the review of the financial statements and clearance of the audit, the audit team have to prepare.. Documentation.
7. That procedure used in ensuring that all relevant matters are attended to before the audit report is signed is called...
8. The meeting held in the auditor's office with the engagement team at the conclusion of the field work is called..................................
9. In the course of his audit engagement, the professional accountant may be required to present evidence in the court. What skills are required for this?
10. Mention any **TWO** of the circumstances addressed in the concept of "true and fair view" used in audit reporting.

SOLUTIONS TO MULTIPLE-CHOICE QUESTION

1. D
2. E
3. B
4. A
5. A

SOLUTIONS TO SHORT-ANSWER QUESTIONS

6. Issues
7. Audit completion check list
8. Debriefing
9. Investigative skill and Evidence presentation
10.
    i. Proper disclosure in the financial statements
    ii. Compliance with relevant legislations
    iii. Adherence to standards (e.g., IFRS)
    iv. Judgements and decisions are appropriate
    v. Proper books of accounts have been kept.

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