

STUDY MANUAL
AUDIT AND ASSURANCE SERVICES (PEA 4)



ASSOCIATION OF NATIONAL ACCOUNTANTS OF NIGERIA (ANAN)

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MODULE 1

1.00

AUDITORS AND THE AUDIT ENVIRONMENT

1.01 Learning Outcomes

On successful completion of this module, students should be able to:

- i. Interpret and discuss the fundamental principles of auditing, the skills required of auditors and the general merits of conducting audits;
- ii. Explain the objectives, principles and nature of techniques applied in the process of financial statement audits;
- iii. Evaluate, explain and discuss issues and developments relating to corporate governance from both internal and external environmental perspectives and
- iv. Explain the concept of 'true and fair view' as applied by auditors when expressing their opinions.

1.02 Conceptual Background

An audit may be defined as an examination of the financial statements of a registered company by a person qualified to do so to check whether they have been properly kept. It can also be defined as the independent examination of, and an expression of opinion on the financial statements of an enterprise by an appointed Auditor in accordance to the terms of his engagement and in compliance with any relevant statutory obligations and professional requirements. The auditor may be engaged to perform statutory and non-statutory roles of auditing. In this regard, the professional body to which an accountant belongs sets out the fundamental principles expected to guide his conduct in rendering services to his varied clients. The guideline is contained in a set of rules for example the ANAN code of ethics issued by the Association of National Accountants of Nigeria. The Code, when taken with the ethical guideline issued by ANAN, ensures that the professional accountant maintains the highest quality of performance and public confidence in the profession.

The primary objective of an audit under Companies and Allied Matters Act (CAMA 2004) is

for an appointed auditor to express a professional opinion on the financial position of an enterprise as contained in the financial statement prepared by the management so that any person reading and using them can have faith in them. Other secondary objectives include the need to:

- i. prevent fraud and errors
- ii. detect any form of irregularity
- iii. evaluate the effectiveness or otherwise of the internal control system within the enterprise
- iv. assist the management in the establishment of an effective auditing system
- v. advise on financial matters for efficient decision making by the management
- vi. ascertain and ensure that an enterprise conform to the statutory and professional requirement

1.03 Merits and Demerits of Auditing

1.03.1 Merits of auditing

- i. Auditing serves as a deterrent to fraudulent staff within an enterprise.
- ii. Audited financial statement serve as a basis for determining the net worth of a business for the purpose of ascertaining the purchase consideration.
- iii. Audited financial statement can be used to negotiate bank loan.
- iv. A financial statement examined independently by an auditor will be readily accepted by the tax authority for the purpose of taxation.
- v. Audited financial statement serves as a basis for measuring performances by the potential investors.
- vi. Audited account is one of the requirements of the Nigeria Stock Exchange for a business that is willing to be listed in the Nigeria stock markets.

1.03.2 Demerits of auditing

- i. Auditing fee is seen as additional expenses to a business enterprise.
- ii. Audited financial statement, if qualified, could lead to liquidation of an enterprise, even when there is a solution in sight.
- iii. Auditing within the enterprise could lead to management /shareholder conflict.
- iv. Auditing could be time consuming as the time being used to attend to members of

the audit team could be effectively used on productive matters by members of the company.

1.03.3 Stakeholder Interests

All parties to corporate governance have an interest, whether direct or indirect, in the financial performance of the corporation. Directors, workers and management receive salaries, benefits and reputation, while investors expect to receive financial returns. For lenders, it is specified interest payments, while returns to equity investors arise from dividend distributions or capital gains on their stock. Customers are concerned with the certainty of the provision of goods and services of an appropriate quality; suppliers are concerned with compensation for their goods or services, and possible continued trading relationships. These parties provide value to the corporation in the form of financial, physical, human and other forms of capital. Many parties may also be concerned with corporate social performance.

A key factor in a party's decision to participate in or engage with a corporation is their confidence that the corporation will deliver the party's expected outcomes. When categories of parties (stakeholders) do not have sufficient confidence that a corporation is being controlled and directed in a manner consistent with their desired outcomes, they are less likely to engage with the corporation. When this becomes an endemic system feature, the loss of confidence and participation in markets may affect many other stakeholders, and increases the likelihood of political action. There is substantial interest in how external systems and institutions, including markets, influence corporate governance.

1.04 Qualities of an Auditor

- i. **Integrity:** An auditor must be honest and be seen to be honest in the implementation of the audit assignment.
- ii. **Independence and Objectivity:** During the course of the audit assignment, auditors must be objective and be independent as much as possible within the enterprise. He must not have financial involvement in the business (affairs) of the enterprise. He must be able to plan, execute and report his findings on the statement examined to members of the enterprise without being biased and without undue influence either from within or outside the business centre.

- iii. **Conformity with Confidentiality Principles:** An Auditor must not disclose information about his clients to third parties except where the permission to do so has been granted.
- iv. **Maintenance of Technical Competence:** An Auditor must be technically competent in the implementation of audit assignment.
- v. **Conformity with Technical Standard:** An auditor must comply with the provision of auditing standards as well as guidelines being issued from time to time by the regulatory body.

1.05 Principles of Auditing

The Auditors' Code published by Auditing Practices Board (APB), prescribes nine fundamental principles of independent auditing as follows:

- i. **Accountability:** Auditors act in the interests of primary stakeholders, whilst having regard to the wider public interest. The identity of primary stakeholders is determined by reference to the statute or agreement requiring an audit: in the case of companies, the primary stakeholders are the general body of investors.
- ii. **Integrity:** Auditors should act with integrity, discharging their responsibilities with honesty, fairness and truthfulness. Integrity helps to insulate auditors from matters of conflict of interests and elevate their objectivity. Confidential information obtained in the course of the audit is disclosed only when required in the public interest, or by operation of law.
- iii. **Objectivity and independence:** Auditors should be seen to be objective in all their dealings with their clients. They express opinions independent of the entity and its directors.
- iv. **Competence:** This is the ability to carry out professional duty with great knowledge and skills. Auditors should exhibit competence, derived from the acquired qualifications, training and practical experience. Auditing demands an understanding of financial reporting and business issues, together with expertise in accumulating and assessing the evidence necessary to form an opinion.
- v. **Rigour:** Auditors should approach their work with thoroughness and attitude of professional skepticism. This was emphasised in the famous

pronouncement of Lord Justice Lopes in the case of Kingston Cotton Mill (1896), which states that an auditor is not a bloodhound, but should approach his job with professional skepticism believing that someone, somewhere, has made a mistake and that a check needs to be carried out to ensure that no such mistake was made and this forms the whole essence of auditing. Auditors assess critically the information and explanations obtained in the course of their work and such additional evidence as they consider necessary for the purpose of their audits

- vi. **Judgement:** Auditors apply professional judgement, taking account of materiality in the context of the matters on which they are reporting
- vii. **Clear communication:** Auditors reports contain clear expressions of opinion which are set out in writing for proper understanding
- viii. **Association:** Auditors allow their reports to be included in documents containing other information only if they consider that the additional information is not in conflict with the matters covered by their reports and that they have no cause to believe it to be misleading
- ix. **Providing value:** Auditors add to the reliability and quality of financial reporting. They provide to directors and officers constructive observations arising from the audit process, thereby contributing to the effective operation of the business entity.

1.06 Objective and General Principles Governing the Audit of Financial Statements

Auditing Practices Board's Statement of Auditing Standard 100 entitled. Objective and general principles governing an audit of financial statements says that the objective of an audit of financial statements is to enable auditors to give an opinion on those financial statements taken as a whole and thereby provide reasonable assurance that the financial statements give a true and fair view (where relevant) and have been prepared in accordance with relevant accounting or other requirements. The standard states the following matters which the auditor should consider in undertaking the audit of financial statements.

- i. the auditor should carry out procedures designed to obtain sufficient and appropriate evidence in accordance with the auditing standards and determine with reasonable confidence whether the financial statements are free of material misstatements;

ii. evaluation of the overall presentation of the financial statements in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and

iii. Issuing a report, containing a clear expression of the auditor's opinion on the financial statements. In Nigeria, financial statements are prepared with the objective that they present a true and fair view of the state of affairs of the entity and of the profit or loss for that period, and comply with the Companies and Allied Matters Act, CAP C20, LFN 2004.

In the preparation of financial statements, there are inherent uncertainties and use of judgement in making accounting estimates and selecting appropriate accounting policies. Consequently, financial statements may be prepared in different ways and still present a true and fair view. The auditor's opinion adds credibility to the financial statements prepared by the directors. Users have reasonable assurance that the financial statements which carry the seal of the independent auditor, present a true and fair view of the state of affairs of the reporting entity.

According to Owoeye, (2015), the concept of True and Fair View relates to adequately ensuring that events and transactions are fairly presented in financial statements in accordance with the frameworks regulating such transactions. However, the user should not assume that the opinion of the auditor is a guarantee as to the future viability of the entity or an assurance that the efficiency or effectiveness with which management has conducted the affairs of the entity in one year will continue in future years.

1.07 Corporate Governance

Corporate governance refers to the system by which corporations are directed and controlled. The governance structure specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and specifies the rules and procedures for making decisions in corporate affairs. Governance provides the structure through which corporations set and pursue their objectives while reflecting the context of

the social, regulatory and market environment. Governance is a mechanism for monitoring the actions, policies and decisions of corporations. Governance involves the alignment of interests among the stakeholders.

Corporate governance has also been defined as "a system of law and sound approaches by which corporations are directed and controlled focusing on the internal and external corporate structures with the intention of monitoring the actions of management and directors and thereby mitigating agency risks which may stem from the misdeeds of corporate officers."

In contemporary business corporations, the main external stakeholder groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives and other employees.

Much of the contemporary interest in corporate governance is concerned with mitigation of the conflicts of interests between stakeholders. Ways of mitigating or preventing these conflicts of interests include the processes, customs, policies, laws, and institutions which have an impact on the way a company is controlled. An important theme of governance is the nature and extent of corporate accountability.

A related but separate thread of discussions focuses on the impact of a corporate governance system on economic efficiency, with a strong emphasis on shareholders' welfare. In large firms where there is a separation of ownership and management and no controlling shareholder, the principal-agent issue arises between upper-management (the "agent") which may have very different interests, and by definition considerably more information, than shareholders (the "principals"). The danger arises that rather than overseeing management on behalf of shareholders, the board of directors may become insulated from shareholders and beholden to management. This aspect is particularly present in contemporary public debates and developments in regulatory policy.

Economic analysis has resulted in a literature on the subject. One source defines corporate governance as "the set of conditions that shapes the ex-post bargaining over the quasi-rents

generated by a firm." The firm itself is modelled as a governance structure acting through the mechanisms of contract. Here corporate governance may include its relation to corporate finance.

1.08 Principles of Corporate Governance

Contemporary discussions of corporate governance tend to refer to principles raised in three documents released since 1990: The Cadbury Report (UK, 1992), the Principles of Corporate Governance (OECD, 1998 and 2004), the Sarbanes-Oxley Act of 2002 (US, 2002). The Cadbury and OECD reports present general principles around which businesses are expected to operate to assure proper governance. The Sarbanes-Oxley Act, informally referred to as Sarbox or Sox, is an attempt by the federal government in the United States to legislate several of the principles recommended in the Cadbury and OECD reports.

- i. **Rights and equitable treatment of shareholders:** Organisations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings.
- ii. **Interests of other stakeholders:** Organisations should recognise that they have legal, contractual, social, and market-driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policymakers.
- iii. **Role and responsibilities of the board:** The board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment.
- iv. **Integrity and ethical behaviour:** Integrity should be a fundamental requirement in choosing corporate officers and board members. Organisations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.
- v. **Disclosure and transparency:** Organisations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organisation should be timely and balanced to ensure that all investors have access to clear, factual information.

1.09 Parties to Corporate Governance

Key parties involved in corporate governance include stakeholders such as the board of directors, management and shareholders. External stakeholders such as creditors, auditors, customers, suppliers, government agencies, and the community at large also exert influence. The agency view of the corporation posits that the shareholder forgoes decision rights (control) and entrusts the manager to act in the shareholders' best (joint) interests. Partly as a result of this separation between the two investors and managers, corporate governance mechanisms include a system of controls intended to help align managers' incentives with those of shareholders. Agency concerns (risk) are necessarily lower for a controlling shareholder.

Responsibilities of the Board of Directors

The OECD Principles of Corporate Governance (2004) describe the responsibilities of the board; some of these are summarized below:

- i. Board members should be informed and act ethically and in good faith, with due diligence and care, in the best interest of the company and the shareholders.
- ii. Review and guide corporate strategy, objective setting, major plans of action, risk policy, capital plans, and annual budgets.
- iii. Oversee major acquisitions and divestitures.
- iv. Select, compensate, monitor and replace key executives and oversee succession planning.
- v. Align key executive and board remuneration (pay) with the longer-term interests of the company and its shareholders.
- vi. Ensure a formal and transparent board member nomination and election process.
- vii. Ensure the integrity of the corporations' accounting and financial reporting systems, including their independent audit.
- viii. Ensure appropriate systems of internal control are established.
- ix. Oversee the process of disclosure and communications.
- x. Where committees of the board are established, their mandate, composition and working procedures should be well-defined and disclosed.

Control and Ownership Structures

Control and ownership structure refers to the types and composition of shareholders in a corporation. In some countries such as most of Continental Europe, ownership is not necessarily equivalent to control due to the existence of e.g. dual-class shares, ownership pyramids, voting coalitions, proxy votes and clauses in the articles of association that confer additional voting rights to long-term shareholders. Ownership is typically defined as the ownership of cash flow rights whereas control refers to ownership of control or voting rights. Researchers often "measure" control and ownership structures by using some observable measures of control and ownership concentration or the extent of inside control and ownership. Some features or types of control and ownership structure involving corporate groups include pyramids, cross-shareholdings, rings, and webs. Corporate engagement with shareholders and other stakeholders can differ substantially across different control and ownership structures.

Family Control

Family interests dominate ownership and control structures of some corporations and it has been suggested that the oversight of family-controlled corporation is superior to that of corporations "controlled" by institutional investors (or with such diverse share ownership that they are controlled by management). A recent study by Credit Suisse found that companies in which "founding families retain a stake of more than 10% of the company's capital enjoyed a superior performance over their respective sectorial peers." Since 1996, this superior performance amounts to 8% per year. Forget the celebrity CEO. "Look beyond Six Sigma and the latest technology fad. One of the biggest strategic advantages a company can have is blood ties," according to a Business Week study.

1.10 Mechanisms and Controls

Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. There are both internal monitoring systems and external monitoring systems. Internal monitoring can be done, for example, by one (or a few) large shareholder(s) in the case of privately held companies or a firm belonging to a business group.

Furthermore, the various board mechanisms provide for internal monitoring. External monitoring of managers' behavior, occurs when an independent third party (e.g. the external auditor) attests the accuracy of information provided by management to investors. Stock analysts and debt holders may also conduct such external monitoring. An ideal monitoring and control system should regulate both motivation and ability, while providing incentive alignment toward corporate goals and objectives. Care should be taken that incentives are not so strong that some individuals are tempted to cross lines of ethical behavior, for example by manipulating revenue and profit figures to drive the share price of the company up.

1.11 Internal Corporate Governance Controls

Internal corporate governance controls monitor activities and then take corrective action to accomplish organisational goals. Examples include:

- i. **Monitoring by the board of directors:** The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes, ex ante. It could be argued, therefore, that executive directors look beyond the financial criteria.
- ii. **Internal control procedures and internal auditors:** Internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organisation who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting.
- iii. **Balance of power:** The simplest balance of power is very common; require that the President be a different person from the Treasurer. This application of separation of

power is further developed in companies where separate divisions check and balance each other's actions.

- One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group checks that the interests of people (customers, shareholders, employees) outside the three groups are being met.
- iv. **Remuneration:** Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behavior, and can elicit myopic behavior.
- v. **Monitoring by large shareholders and/or monitoring by banks and other large creditors:** Given their large investment in the firm, these stakeholders have the incentives, combined with the right degree of control and power, to monitor the management.

1.12 External Corporate Governance Controls

External corporate governance controls encompass the controls external stakeholders exercise over the organisation. Examples include:

- i. Competition
- ii. Debt covenants
- iii. Demand for and assessment of performance information (especially financial statement)
- iv. Government regulations
- v. Managerial labour market
- vi. Media pressure
- vii. Takeovers

1.13 Review Questions

1. Discuss what you consider to be the fundamental principles of auditing (16 Marks)
2. Explain the following terminologies as used in the audit environment
 - i. auditing skills and applicable technique (5 Marks)

ii. audit independence objectivity, due care and competence

(9 Marks)

iii. True and fair view

(8 Marks)

MODULE 2

2.00 AUDITOR'S LEGAL, ETHICAL AND PROFESSIONAL RESPONSIBILITIES

2.01 Learning Outcomes

On successful completion of this module, students should be able to:

- i. Interpret and discuss the legal, regulatory and ethical framework within which the auditor operates.
- ii. Recognize ethical issues, discuss, escalate or resolve these as appropriate demonstrating objectivity, independence, integrity and professional skepticism
- iii. Identify and analyse matters relating to auditor's responsibilities arising from alleged negligence (financial statements misstated), related exposure and consequences;
- iv. Discuss pre-appointment procedures including the assessment of clients for instance terms of; Management's integrity, past audit engagements, etc.

2.02 Professional Ethical Responsibilities

In carrying out the audit of financial statements, auditors should comply with the ethical guidelines issued by their relevant professional bodies. Ethics refers to a system or code of conduct based on moral duties, values and obligations that indicates how to behave within a constituted body or society. It dictates some degree of inward values expected of such groups of individuals or bodies.

The ethical principles which govern the auditors' professional responsibilities include:

- i. Integrity
- ii. Objectivity
- iii. Independence
- iv. Professional competence and due care; professional behaviour; and
- v. Confidentiality

Auditors in Nigeria are to comply with the 'Rules of Professional Conduct for Members' issued by The Association of National Accountants of Nigeria; Institute of Chartered Accountants of Nigeria; and the Accounting Standards issued by the Nigerian Accounting Standards Board (now Financial Reporting Council of Nigeria).

The 'Professional Conduct for Members' covers the following matters:

- i. Fundamental principles
- ii. Integrity, objectivity and independence
- iii. Conflicts of interest
- iv. Confidentiality
- v. Changes in a professional appointment
- vi. Consultancy
- vii. Association with non-members
- viii. Fees
- ix. Obtaining professional work
- x. The names and letterheads of practicing firms
- xi. Second and other opinions
- xii. Members in business; and
- xiii. Enforcement of ethical standards.

2.03 Independence, Objectivity, Integrity, Confidentiality, Skills, Care and Competence Independence

IFAC Code of Ethics for Professional Accountants states that "it is in the public interest, and therefore, required by this Code of Ethics, that members of assurance firms and, when applicable, network firms be independent of assurance clients".

The Code states that "Assurance engagements are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria. The International Standards on Assurance Engagements issued by The International Auditing and Assurance Standards Board (IAASB), describes the objectives and elements of assurance engagement to provide, either a high or a moderate level of assurance.

IAASB has also issued specific standards for certain assurance engagements. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (Moderate level assurance) of financial statements".

The Code provides guidance to auditors in determining whether a particular engagement is an assurance engagement and states that, this will depend upon whether the assurance engagement exhibits all of the following elements:

- i. A three party relationship involving:
 - a. A professional accountant
 - b. A responsible party; and
 - c. An intended user
- ii. A subject matter
- iii. Suitable criteria
- iv. An engagement process; and
- v. A conclusion

There is a broad range of engagements to provide a high or moderate level of assurance. Such as engagements may include:

- i. Engagements to report on a broad range of subject matters covering financial and non-financial information;
- ii. Attest and direct reporting engagements;
- iii. Engagements to report internally and externally; and
- iv. Engagements in the private and public sectors.

The aim of an assurance engagement may take many forms, such as the following:

- i. Data (for example, historical or prospective financial information, statistical Information, performance indicators);
- ii. Systems and processes (for example, internal controls); or
- iii. Behavior (for example, corporate governance, compliance with a Regulation, human resources practices)

The Code further identifies that not all engagements performed by professional Accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include:

- i. Agreed-upon procedures;
- ii. Compilation of financial or other information;
- iii. Preparation of tax returns when no conclusion is expressed, and tax consulting;

- iv. Management consulting; and
- v. Other advisory services.

The Code also provides a conceptual approach to independence which requires the following:

i. Independence of mind

The state of mind, which permits the provision of opinion without being affected by influences that compromise professional judgement, allowing individual to act with integrity, and exercise objectivity and professional skepticism; and

ii. Independence in appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude that a firm or a member of the assurance team's integrity, objectivity or professional skepticism had been compromised.

Statutory Responsibilities and Rights

The 'Rules of Professional Conduct for Members' issued by The Association of National Accountants of Nigeria stipulate guidance on integrity, objectivity and independence. The Rules require that a member should behave with integrity in all professional, business and financial relationships. The Rules also call for a degree of objectivity and indolence to be exercised by members of the Association in respect of financial reporting and similar roles outside the audit.

Integrity and objectivity

IFAC Code of Ethics states that "integrity implies not merely honesty but fair dealing and Truthfulness. The principle of objectivity imposes the obligation on all professional accountants to be fair, intellectually honest and free of conflicts of interest".

The Code identifies that professional accountants serve in many different capacities and should demonstrate their objectivity in varying circumstances.

Professional accountants in public practice undertake assurance engagements and render tax and other management advisory services. Other professional accountants prepare financial statements as a subordinate of others, perform internal auditing services, and serve in financial management capacities in the industry, commerce, public sector and education.

They also educate and train those who aspire to be admitted into the profession. Regardless of service or capacity, professional accountants should protect the integrity of their professional service and maintain objectivity in their judgement. In ethics requirements relating to objectivity, the Code states that adequate consideration should be given to the following factors in the course of selecting the situations and practices to be dealt with:

- i. Professional accountants are exposed to situations which involve the possibility of Pressure pressures being exerted on them. These pressures may impair their objectivity;
- ii. It is impracticable to define and prescribe all such situations where these possible pressure exist. Reasonableness should prevail in establishing standards for identifying relationships that are likely to, or appear to, impair a professional accountant's objectivity;
- iii. Relationships should be avoided which allow prejudice, bias or influence of others to override objective
- iv. Professional accountants have an obligation to ensure that personnel engaged in professional service adhere to the principle of objectivity; and professional accountants should neither accept nor offer gifts or entertainment which might reasonably be believed to have a significant and improper influence on their professional judgements or those with whom they deal. What constitutes an excessive gift or offer an entertainment varies from country to country but professional accountants should avoid circumstances which would bring their professional standing into disrepute.

In addition to the above, the 'Rules of Professional Conduct for Members' issued by the Association of National Accountants of Nigeria provides a framework within which members can identify actual or potential threats to objectivity and assess the safeguards which may be available to offset such threats.

Professional Competence

The IFAC Code of Ethics for Professional Accountants states that professional accountants should not portray themselves as having expertise or experience which they do not possess.

Professional competence may be divided into two separate phases:

i. **Attainment of professional competence**

The attainment of professional competence requires initially a high standard of general education, followed by specific education, training and examination in Professionally relevant subjects, and whether prescribed or not, a period of work experience. This should be the normal pattern of development for a professional accountant.

ii. **Maintenance of professional competence**

a. The maintenance of professional competence requires a continuing awareness of developments in the accountancy profession including relevant national and international pronouncements on accounting, auditing, other relevant regulations and statutory requirements.

b. A professional accountant should adopt a program designed to ensure quality control in the performance of professional service consistent with appropriate national and international pronouncements.

The 'Rules of Professional Conduct for Members' issued by The Association of National Accountants of Nigeria provides that a member should not accept or perform work which he or she is not competent to undertake, unless he obtains such advice and assistance as will, enable him or her competently carry out the work.

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. The Code states that:

- i. Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.
- ii. Professional accountants have an obligation to ensure that staff under their control and persons from whom advice and assistance is obtained respect the principles of confidentiality
- iii. Confidentiality is not only a matter of disclosure of information. It also requires that

professional accountants acquire information in the course of performing professional services does, neither use, nor appear to use that information for personal advantage, or for the advantage of a third party.

- iv. A professional accountant has access to a lot of confidential information about a client's or employer's affairs not otherwise disclosed to the public.

Therefore, the professional accountant should be relied upon not to make unauthorised disclosures to other persons. This does not apply to disclosure of such information in order to properly discharge the professional accountant's responsibility according to the profession's standards.

- v. It is in the interest of the public and the profession that, the profession's standards relating to confidentiality be defined and guidance given on the nature and extent of the duty of confidentiality and the circumstances in which disclosure of information acquired during the course of providing professional service shall be permitted or required.

- vi. It should be recognised, however, that confidentiality of information is part of a statute or common law and therefore detailed ethical required in respect thereof, will depend on the law of the country of each member body. Matters which should be considered in determining whether confidential information may be disclosed are as follows:

- a. When disclosure is authorised - when authorisation to disclose is given by the the client or the employer, the interests of all the parties including those third parties whose interests might be affected should be considered

- b. When disclosure is required by law - examples of when a professional accountant is required by law to disclose confidential information are to produce documents or to give evidence in the course of legal proceedings and disclose to the appropriate public authority's infringements of the law which come to light.

- v. There is a professional duty or right to disclose when for instance the need arises to:
 - a. comply with technical standards and ethics requirements; such disclosure is not contrary to this section;

- b. protect the professional interests of a professional accountant in the Legal proceedings;
- c. comply with the quality (or peer) review of a member body or professional Body; and
- d. respond to an inquiry or investigation by a member body or regulatory body.

When the professional accountant has determined that confidential information can be disclosed, the following points should be considered:

- i. Whether or not all the relevant facts are known and substantiated, to the extent it is
 - a. practicable to do so; when the situation involves unsubstantiated fact or opinion, professional judgement should be used in determining the type of disclosure to be made, if any;
- ii. What type of communication is expected and the addressee; in particular, the
 - a. professional accountant should be satisfied that the parties to whom the
 - b. communication is addressed are appropriate recipients and have the responsibility to act in; and
- iii. Whether or not the professional accountant would incur any legal liability having made a communication and the consequences thereof.

In all such situations, the professional accountant should consider the need to consult legal counsel and/or the professional organisation(s) concerned.

The 'Rules of Professional Conduct for Members' issued by The Association of National Accountants of Nigeria provides, in relation to confidentiality, that;

- i. Information confidential to a client or employer acquired in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper sources, or where there is a legal right or duty to disclose.
- ii. Where a legal right or duty of disclosure does exist, the client or employer should normally be notified in advance of the disclosure being made.

Skills, Care and Diligence

The 'Rules of Professional Conduct for Members' issued by The Association of National Accountants of Nigeria provides that a member should carry out his or her professional work with due skill, care, diligence and expedition and with proper regard for technical and professional standards expected of him or her as a member. A member should conduct himself or herself with courtesy and consideration towards all with whom he comes into contact, during the course of performing his or her work. Under the section on Professional Competence and Due Care of the Fundamental principles as contained in the IFAC Code of Ethics for Professional Accountants, it is stated that "a professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques".

Publicity

The IFAC Code of Ethics for Professional Accountants provides guidance on the Public. It states that in the marketing and promotion of themselves and their work, professional accountants should not:

- i. use means which bring the profession into disrepute;
- ii. make exaggerated claims for the services they are able to offer, the qualification they possess, or experience they have gained; and
- iii. denigrate the work of other accountants.

The 'Rules of Professional Conduct for Members' issued by the Association of National Accountants of Nigeria provides as follows:

In relation to practice promotion, a member may seek publicity for his or her services, achievements and products and may advertise his or her services, achievement and products in any way consistent with the dignity of the professional in that he should not project an image inconsistent with that of a professional person bound to high ethical and technical standards. In relation to advertisement, the code states that advertisement

must comply with the law and should be legal. An advertisement should be clearly distinguishable as such.

The statutory rights and responsibilities may be discussed further, thus:

2.04 The Auditor and Companies and Allied Matters Act (CAMA) Cap C20, 2004

The Companies and Allied Matters Act, (CAMA) CAP C20, LFN 2004 is the Principal Law which sets the tone for the incorporation and conduct of business in Nigeria.

Appointment of auditors

Section 357 of the Companies and Allied Matters Act provides for the appointment of auditors. The section states as follows:

- i. Every company shall at each annual general meeting appoint an auditor or auditors to audit the financial statements of the company, and to hold office from the conclusion of that, until the conclusion of the next annual general meeting.
- ii. At any annual general meeting a retiring auditor, however appointed, shall be appointed without any resolution being passed unless:
 - a. He is not qualified for re-appointment;
A resolution has been passed at that meeting appointing some other person instead of him or providing expressly that he shall not be re-appointment;
and
 - b. He has given the company notice in writing of his unwillingness to be re-appointed.

Where notice is given of an intended resolution to appoint some other person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that other person or of all those other persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be automatically re-appointed by virtue of this sub-section. Whereat an annual general meeting, no auditors are appointed or re-appointed, the directors may appoint a person to fill the vacancy:

- i. The company shall, within one week of the power of the directors becoming exercisable, give notice of that fact to the Corporate Affairs Commission, and if a company fails to give required notice the company and every officer of the company who is in default shall be guilty of an offence and liable to fine of N 100 for every day during which the default continues;
- ii. The first auditors of a company may be appointed by the directors at any time before the company is entitled to commence business and auditors so appointed shall

hold office until the conclusion of the next annual general meeting provided that:

- a. the company may at a general meeting remove any such auditors and appoint in their place any other person who has been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than 14 days before the date of the meeting;
- b. general meeting convened for that purpose, appoint the first auditors and thereupon the said powers of the directors shall cease.
- c. The directors may fill any casual vacancy in the office of auditor but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

Qualification of Auditors

Section 358 of Companies and Allied Matters Act (CAMA) and provisions of the Association of National Accountants of Nigeria Decree, 1993 shall have effect in relation to any investigation or audit for the purpose of this Decree so however that none of the following persons shall be qualified for appointment as auditor of a company, that is –

- i. Whereat officer or servant of the company;
- ii. a person who is a partner of or in the employment of an officer or servant of the company; or
- iii. a body corporate

The disqualification shall extend and apply to persons who in respect of any period of an audit were in the employment of the company or were otherwise connected therewith in any manner. A person shall also not qualify for appointment as an auditor of a company if he is disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company. A firm is qualified for appointment as auditor of a company if, but only if, all the partners are qualified for appointment as auditors of it.

No person shall act as auditor of a company at a time when he knows that he is disqualified for appointment to that office and if an auditor of a company to his knowledge becomes so disqualified during his term of office, he shall thereupon vacate his office and give notice in writing to the company that he has vacated it by reason of that disqualification.

A person who acts as an auditor in contravention or fails without reasonable excuse to give notice of vacating his office shall be guilty of an offence and liable to a fine of ₦500 and, for continued contravention, to a daily default fine of ₦50.

Auditors' Report

Auditors of a company shall make a report to the members of the entity on the accounts examined by them, and on every balance sheet and profit and loss account, and on all group financial statements. Copies of the report are to be laid before the company in a general meeting during the auditors' tenure of office.

The auditors' report shall state the matters set out in the Sixth Schedule to the Companies and Allied Matters Act as follows:

- i. Basis of preparation of the entity's financial statements (i.e. that the financial statements have been prepared on the basis of the entity's accounting policies);
- ii. Respective responsibilities of the directors and the auditors;
- iii. Basis of the auditors' opinion;
- iv. Whether proper books of account have been kept;
- v. Compliance with the provisions of the Companies and Allied Matters Act, CAP. C20 LFN 2004; and
- vi. Compliance with the statements of accounting standards issued by the Nigerian Accounting Standards Board
- vii. Accounting Standards Board

The Companies and Allied Matters Act, CAP C20, LFN 2004 further provides that:

- a. It shall be the duty of the company's auditors, 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 received from branches not

visited by them; and

- ii. The company's balance sheet and (if not consolidated) its profit and loss account are in agreement with the accounting records and returns.
- b. If the auditors are of the opinion that proper accounting records have not been received from branches not visited by them, or if the balance sheet and (if consolidated) the profit and loss account are not in agreement with the accounting records and returns, the auditors shall state that fact in their report.
- c. Where certain requirements (i.e. Part V and VI of the Third Schedule and Parts I to III of the Fourth Schedule) of the Companies and Allied Matters Act are not complied within the accounts, it shall be the auditors' duty to include such matters in their report, so far as they are reasonably able to do so, a statement giving the required particulars.
- d. It shall be the auditors' duty to consider whether the information given in the directors' report for the year for which the accounts are prepared is consistent with those accounts; and if they are of opinion that it is not, they shall state that fact in their report, (Section 359).

Audit Committee (Section 359)

The Companies and Allied Matters Act, CAP C20, LFN 2004 Section 359 provides that:

- a. In addition to the auditor's report made to the members on the entity's financial statements, 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.
- b. The audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members) and shall examine the auditors' report and make recommendations thereon to the annual general meeting as it may think fit, provided, however, that such member of the audit committee shall not be entitled to remuneration and shall be subject to re-election annually. Section 359 (iv)
- c. Any member may nominate a shareholder as a member of the audit committee by giving notice in writing of such nomination to the secretary of the company at least 21 days before the annual general meeting.
- d. 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:

- i. ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
- ii. review the scope and planning of audit requirements;
- iii. review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- iv. keep under review the effectiveness of the company's system of accounting and internal control;
- v. make recommendations to the Board with regard to the appointment, removal and remuneration of the external auditors of the company; and
- vi. authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

Auditors' Duties and Powers (Section 360)

- a. It shall be the duty of the company's auditors, 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 received from branches not visited by them; and
 - ii. the company's balance sheet and (if not consolidated) its profit and loss account are in agreement with the accounting records and returns.
- b. Every auditor of a company shall have a right of access at all times to the company's books, accounts and vouchers, and be entitled to require from the company's office such information and explanations as he thinks necessary for the performance of the auditor's duties.
- c. It shall be the auditors' duty to consider whether the information given in the directors' report for the year for which the accounts are prepared is consistent with those accounts.

Remuneration of Auditors (Section 361)

- a. The remuneration of the auditors of a company-
 - i. in the case of an auditor appointed by the directors, may be fixed by the directors the general meeting empowers the directors to do so; or
 - ii. shall be fixed by the company in general meeting.

"Remuneration" includes sums paid by the company in respect of the auditors' expenses.

Removal of Auditors (Section 362)

- a. A company may by ordinary resolution remove an auditor before the expiration of his term of office, notwithstanding anything in any agreement between it and him. 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 Corporate Affairs Commission and if a company fails to give the required notice the company and every officer of it who is in default shall be guilty of an offence and liable to a daily default fine of N100.
- b. Nothing shall be taken as depriving the auditor removed of compensation or damages payable to him in respect of the termination of his appointment as auditor or of any appointment terminating with that as auditor.

Auditors' Right to Attend Company's Meetings (Section 363)

- a. A company's auditors shall be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which a member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditor.
- b. An auditor of a company who has been removed shall be entitled to attend:
 - i. the general meeting at which his term of office would otherwise have expired; and
 - ii. any general meeting at which it is proposed to fill the vacancy caused by his removal, and
 - iii. to receive all notices of, and other communications relating to, and such meeting which any member of the company is entitled to receive, and to be heard at any such meeting which he attends on any part of the business of the meeting which concerns him as former auditor of the company.

Supplementary Provisions Relating to Auditors (Section 364)

- a. A special notice shall be required for a resolution at a general meeting of a company:
 - i. appointing as auditor a person other than a retiring auditor;
 - ii. filling a casual vacancy in the office of auditor;
 - iii. re-appointing as auditor a retiring auditor who was appointed by the directors

- to fill a casual vacancy; and
 - iv. Removing an auditor before the expiration of his term of office.
- b. On receipt of notice of such an intended resolution the company shall forthwith send a copy of it:
 - i. to the person proposed to be appointed or removed, as the case may be;
 - ii. to the retiring auditors; and
 - iii. Where the casual vacancy was caused by the resignation of an auditor who resigned.
- c. Where notice is given of such a resolution the retiring auditor (or, as case may be, the auditor proposed to be removed) makes with respect to the intended resolution representations in writing to the company not exceeding a reasonable length, and requests their notification to members of the company, the company shall (unless the representations are received by it too late for it to do so:
 - i. in any notice of the resolution given to members of the company, state the fact of the representations having been made; and
 - ii. send a copy of the representations to every member of the company to whom notice of the meeting is or has been made;
- d. If a copy of any such representations is not sent out as required because they were received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representations shall be read out at the meeting; and
- e. Copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person claiming to be aggrieved, the court is satisfied that the rights conferred are being abused to secure needless publicity for defamatory matter; and the court may 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.

Resignation of Auditors (Section 365)

- 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 any such notice shall operate to bring his term of office to an end on the date of 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:
 - i. 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
 - ii. A statement of any such circumstances as are mentioned above.
- c. Where a notice under this section is deposited at a company's registered office, the company shall within 14 days send a copy of the notice -
 - i. To the Corporate Affairs Commission; and
 - ii. If the notice contained a statement, to every person who is entitled to be sent copies of the financial statements.
- d. The company or any person claiming to be aggrieved may, within 14 days of the receipt by the company of a notice containing a statement, apply to the court for an order.
- e. If in 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 direct 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.
- f. The company shall, within 14 days of the court's decision, send to the persons mentioned:
 - i. If the court makes an order a statement setting out the effect of the order; and
 - ii. If not, a copy of the notice containing the statement.
- g. If default is made in complying with certain provisions the company and every officer of it who is in default shall be guilty of an offence and liable to a daily default fine of N100.

Right of Resigning Auditor to Requisition for Company Meeting (Section 366)

- a. Where an auditor's notice of resignation contains a statement, there may be deposited with the notice a requisition signed by the auditor calling on the directors of the company forthwith to duly convene an extraordinary general meeting of the company for the purpose of receiving and considering such explanation of the

circumstances connected with his resignation as he may wish to place before the meeting.

- b. Where an auditor's notice of resignation contains such a statement, the auditor may request the company to circulate to its members before:
 - i. The general meeting at which his term of office would otherwise have expired; or
 - ii. Any general meeting at which it is proposed to fill the vacancy caused by his resignation or convened on his requisition, a statement in writing (not exceeding a reasonable length) of the circumstances connected with his resignation.
- c. If a resigning auditor requests the circulation of a statement the Company shall (unless the statement is received by it too late for it to comply) :
 - i. In any notice of the meeting given to members of the company, state the fact of the statement having been made; and
 - ii. Send a copy of the statement to every member of the company to whom notice of the meeting is or has been sent.
- d. If the directors do not within 21 days from the date of the deposit of requisition under this section proceed duly to convene a meeting for a day not more than 28 days after the date on which the notice convening the meeting is given, every director who fails to take all reasonable steps to ensure that a meeting is convened as mentioned above shall be guilty of an offence and liable to a fine of N500.
- e. If a copy of the statement is not sent out as required because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the statement be read out at the meeting.
- f. Copies of a statement need not be sent out and the statement need not be read out at the meeting if, on the application, either of the company or of any other person who claims to be aggrieved, the court is satisfied that the rights conferred are being abused to secure needless publicity for defamatory matter; and the court may order the company's costs on such an application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.
- g. An auditor who has resigned his office shall be entitled to attend any such meeting and to receive all notices of and other communications relating to any such meeting

which any member of the company is entitled to receive, and to be heard at any such meeting which concerns him as former auditor of the company.

Powers of Auditors in Relation to Subsidiaries (Section 367)

- a. Where a company has a subsidiary, then-
 - i. If the subsidiary is a body corporate incorporated in Nigeria, it shall be the duty of the subsidiaries and its auditors to give the auditors of the holding company such information and explanation as those auditors may reasonably require for the purposes of their duties as auditors of the holding company;
 - ii. In any other case, it shall be the duty of the holding company, if required by its auditors to do so, to take all such steps as are reasonably open to it to obtain from the subsidiary such information and explanation as are mentioned above.
- b. If a subsidiary or holding company fails to comply with the provisions, the subsidiary or holding company, and every officer of it who is in default, shall be guilty of an offence and liable to a fine; and if an auditor fails without reasonable excuse to comply he shall be guilty of an offence and so liable.

Liability of Auditors for Negligence (Section 368)

- a. 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. Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him 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, any member may do so after the expiration of 30 days' notice to the company, of his intention to institute such action.

False Statements to Auditors (Section 369)

- a. An officer of a company commits an offence if he knowingly or recklessly makes to a company's auditors a statement (whether written or oral) which:
 - i. conveys or purports to convey to the auditors any such information or explanation which the auditors require, or are entitled to require, as auditors

- of the company; and
 - ii. is misleading, false or deceptive in a material particular.
- b. A person guilty of an offence shall be liable to imprisonment for one year or to a fine of N500 or both.

2.05 The Auditor and Banks and Other Financial Institutions Act 25 Of 1991

The Banks and Other Financial Institutions Act 1991 (BOFIA) regulates the operations of banks and other financial institutions 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
- b. Forward to the Central Bank, copies of the bank's balance sheet and profit and loss account duly signed and containing the full and correct names of the directors of the bank.
- c. Every published account of a bank shall disclose, in detail, penalties paid as a result of contravention of the provisions of this Act and provisions of any policy guidelines in force during the financial year in question and the auditor's report shall reflect such contravention;
- d. The balance sheet and profit and loss account of a bank shall bear on their face the report of an approved auditor and shall contain statements on such matters as may be specified by the Bank, from time to time;
- e. For the purpose of subsection (3) of this section, an "approved auditor" shall be an auditor approved for the purpose of section 29 of this Act; and
- f. 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 on conviction to a fine of N10,000 each day during which the offence continues. (Section 27).

Contents and form of accounts

- a. Every balance sheet and every profit and loss account 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 balance sheet and every profit and loss account of a bank forwarded to the Bank shall comply with the requirements of any circular which has been issued by the Central Bank thereon; and
 - 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 an offence and liable to pay to the Bank a fine of N1,000 or to imprisonment for five years or to both such fine and imprisonment. (Section 28).

Appointment, power and report of an 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 balance sheet and profit and loss account 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 than 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; and
 - v. A person appointed as such auditor who subsequently: acquires such interest; or becomes a director, officer or agent of the bank; or becomes indebted to a partner in a firm 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 N200,000 and not exceeding N500,000.
- 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 auditor's 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 contravention of this Act, or that an offence under any other law has 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 jeopardies the interest of depositors or creditors of the bank, or any other irregularity has occurred; or
 - iv. He is unable to confirm that the claims of depositors or creditors are covered by the assets of the bank, and he shall immediately report the matter to the Central Bank.
- h. 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.
- i. 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 not exceeding N500,000; and where the approved auditor is a firm, the individual partner or partners shall in addition be liable on conviction to imprisonment for a term not exceeding five years and to the fine required to be paid by the firm.

- j. The appointment of an approved auditor shall not be determined without prior approval of the Central Bank. (Section 29).

2.06 The Auditor and Insurance Act 2007

Classification of Insurance Business

- a. The Act provides for two main classes of insurance as follows:
 - i. Life insurance business; and
 - ii. General insurance business.
- b. In the case of life insurance, there shall be three categories:
 - i. individual life insurance business;
 - ii. group life insurance and pension business; and
 - iii. Health insurance business.
- c. In the case of general insurance, there shall be eight categories:
 - I. Fire insurance business;
 - II. General accident insurance business;
 - III. Motor vehicle insurance business
 - IV. Marine and aviation insurance business;
 - V. Oil and gas insurance business;
 - VI. Engineering insurance business;
 - VII. Bonds credit guarantee and suretyship insurance business; and
 - VIII. Miscellaneous insurance business. (Section 2).

Minimum Paid-up Share Capital

No insurer shall carry on insurance in Nigeria unless the insurer has and maintained, while carrying on that business, a paid-up share capital of the following amounts as the case may require, in the case of:

- a. Life insurance business, not less than N150,000,000;
- b. General insurance, not less than N200,000,000;
- c. Composite insurance business, not less than N350,000,000; or
- d. Reinsurance business, not less than N350,000,000 (Section 9).

Records to be Kept by Insurer

- a. An insurer shall keep and maintain at its principal office the following-
 - i. The Memorandum and Articles of Association or other evidence of the constitution of the insurer;
 - ii. A record containing the names and addresses of the owners of the insurance business whether known as or called shareholders 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 of 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, that is -
 - 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 (Section 17).

Records to be Kept by Re-insurer

- a. A re-insurer shall keep and maintain at its principal office the following:
 - i. The Memorandum and Articles of Association or other evidence of the constitution of the reinsure;
 - ii. Records containing the names and address of the owners of the re-insurer (whether known as or called shareholders or otherwise);
 - iii. Minutes of any meeting of the owners and of the policy-making executive (whether known as the Board of Directors or otherwise);
 - iv. A register of all treaties, in which shall be entered in respect of every treaty issued, the name of the cedant, and the date when the treaty was effected;
 - v. A register of all claims, in which shall be entered every claim made together with the date of claim, the name of the cedant or insured, their proportionate share and the date the claim is settled;
 - vi. A register of events showing those which are attributable to the insurance funds and those which are not also any alteration in value from time to time;
 - vii. A register of assets;
 - viii. A register of business or retrocession, showing separately those ceded within and outside Nigeria;
 - xi. A register of new and existing clients;
 - x. A cashbook; and
 - xi Domestic or management report prepared by external auditors.
- b. A life re-insurer shall keep the following additional records:
 - i. a register of assured under group policies;
 - ii. a register of cancelled, lapsed and expired policies; and
- c. A register of claims showing the name of the cedant and when the claim is settled. (Section 18).

Separation of Accounts and Reserve Funds

- a. Where an insurer carries on the two classes of insurance business, all the receipts of each of those classes of insurance business shall be entered in a separate and distinct account and shall be carried to and from a separate insurance fund with the appropriate name so that in case of life insurance there shall be:
 - i. the individual life insurance business fund;

- ii. the group life insurance business and pension fund; and
 - iii. health insurance business.
- b. Each insurance fund shall represent the liabilities in respect of all contracts of insurance of that particular class and shall consist:
 - i. In the case of life insurance business, the life business funds shall be a sum not less than the mathematical reserve; and
 - iii. In the case of general insurance business of the provisions for unexpired risk and provisions estimated to provide for the expenses of adjustment or settlement of such claims.
- c. The insurance fund of each particular class shall:
 - i. be absolutely the security of the policyholders of that class as though it belonged to an insurer carrying on other business than insurance business of that class;
 - ii. not be liable for any contract of the insurer for which it would not have been liable had the business of the insurer been only that of particular insurance class; and
 - iii. not be applied, directly or indirectly, for any purposes other than those of the class of business to which the fund is applicable. (Section 19).

Provisions for Unexpired Risks and Claims

- a. An insurer shall in respect of its general business, establish and maintain the following provisions applicable in respect of each class of insurance business:
 - i. Provisions for unexpired risks which shall be calculated on a time apportionment basis of the risks accepted in the year;
 - ii. Provision for outstanding claims which shall be credited with an amount equal to the total estimated amount of all outstanding claims with a further amount representing 10 per centum of the estimated figure for outstanding claims in respect of claims incurred but not reported at the end of the year under review; and
 - iii. Provision for outstanding claims (Section 20).

Contingency Reserves

- a. An insurer shall establish and maintain contingency reserves to cover fluctuations in securities and variation in statistical estimates.
- b. The contingency reserves shall be credited with an amount not less than 3 per centum of the total premium or 20 per centum of the net profits (whichever is greater) and the amount shall accumulate until it reaches the amount of the minimum paid-up capital or 50 per centum of the net premiums (whichever is greater). (Section 21).

Reserve for Life Insurance Business

An insurer shall, in respect of its life insurance business maintain the following reserve:

- a. A general reserve fund which shall be credited with an amount equal to the net liabilities on policies in force at the time of the actuarial valuation and an additional 25% of net premium for every year between valuation date; and
- b. A contingency reserve fund which shall be credited with an amount equal to 1 percent of the gross premiums or 10 percent of the profits (whichever is greater) and accumulated until it reached the amount of the minimum paid-up capital. (Section 22).

Reserve of Re-insurers

A re-insurer shall establish a general reserve fund which shall be credited with an amount:

- (a) Not less than 50 per centum of his insurer's gross profit for the year where the fund is less than the authorised capital of the insurer; and
- (b) Not less than 25 per centum of the re-insurer gross profit for the year where the fund is equal to or exceed the authorised capital of the reinsurer. (Section 23).

Solvency Margin

- a. An insurer shall in respect of its business other than its life insurance business, maintain at all times a margin of solvency being the excess of the value of its admissible assets in Nigeria over its liabilities in Nigeria consisting of:
 - i. Provisions for unexpired risks;

- ii. Provision for outstanding claims;
 - iii. Provisions for claims incurred but not yet reported; and
 - iv. Funds to meet other liabilities.
- b. The solvency margin referred to in subsection (1) of this section shall not be less than 15 per centum of the gross premium income less reinsurance premium paid out during the year review or the minimum paid-up capital whichever is greater;
- c. For the purpose of calculating the solvency margin, all monies owned by policyholders, brokers or agents by way of premiums due to but not received by the insurer as at the end of the relevant year shall not count as admissible assets or be included in determining qualifying liabilities;
- d. Any amount due as liability to re-insurers which are attributable to outstanding premium in respect of the current year excluded under the above shall be excluded from liabilities;
- e. An auditor who audits a balance sheet profit and loss and revenue account of an insurer under section 28 of this Act shall insure a certification stating the extent to which the insurer has satisfied the margin of solvency required under this section;
- f. If the Commission is not satisfied with a certification issued under this section, it may conduct an independent investigation on the matter with a view to determining what action to take against the insurer or the auditor;
- g. Where an investigation conducted discloses a false certification by an auditor, the Commission may make a report on the auditor to the appropriate professional body for necessary disciplinary action;
- h. Where an insurer or reinsurance company fails to account of its being insolvent, any auditor or official of the Commission who in the 3 previous years certifies the said company as being solvent shall be held liable;
- i. In this section - "admissible assets" means assets designated as admissible assets consisting of the following:
 - i. Cash and bank balance;
 - ii. Quoted investment at market value;
 - iii. Unquoted stock at cost;
 - iv. Land and building;
 - v. Furniture and fittings;

- vi. Office equipment;
- vii. Motor vehicles;
- viii. Prepaid expenses made to member of staff;
- ix. Amount due from retrocession;
- x. Staff loans and advance; and
- xi. Claims receivable. (Section 23).

Investment

- a. An insurer shall at all times in respect of the insurance transacted by it in Nigeria, invest and hold invested in Nigeria assets equivalent to not less than the amount of policy holder's funds in such accounts of the insurer;
- b. The policyholder's funds shall not be invested in property and securities expect:
 - i. Shares of limited liability companies;
 - ii. Shares in other securities of a co-operative society registered under a law relating to co-operative societies;
 - iii. Loans to building societies approved by the Commission;
 - iv. Loans on real property, machinery and plant in Nigeria;
 - v. Loans on life policies within their surrender values;
 - vi. Cash deposit in or bills of exchange accepted by licensed banks; and
 - vii. Such investments as may be prescribed by the Commission.
- c. No insurer shall:
 - i. In respect of its general insurance business, invest more than 35 per centum of its assets as defined in subsection (1) of this section in real property; or
 - ii. In contract of its life insurance business, invest more than 35 per centum of its assets as defined in subsection (1) of this section in real property.
 - iii. An insurer which contravenes the provisions of this section commits an offence and is liable on conviction to a fine of N50, 000. (Section25).

Statements of Accounts, etc.

- a. An insurer shall not later than 30 June of each year submit in writing to the Commission the following:
 - i. A balance sheet duly audited showing the financial position of the insurance business of the insurer and its subsidiaries at the close of that year together

- with a copy of the relevant profit and loss account which the insurer is to present to its shareholders at its annual general meeting;
- ii. A revenue account applicable to each class of insurance business for which the insurer is required to keep a separate account of receipts and payment; and
 - iii. A statement of investments representing the insurance funds.
- b. The returns and accounts required to be submitted under subsection (1) and (b) of this section shall be in such form as may be approved by the Commission;
 - c. An insurer which fails, neglects or refuses to file the returns and accounts under this section commits an offence and is liable on conviction to a fine of N5,000 per day for each day of default.
 - d. An insurer shall in each year after receipt of the approval of the Commission, publish its general annual balance sheet together with its profit and loss accounts in at least one newspaper having wide circulation in Nigeria.
 - e. No insurer shall distribute any dividends until the Commission has approved the annual returns of the insurer within 30 days of its submission to the Commission. (Section 26).

Life Insurance Accounts

- a. An insurer transacting life insurance business shall submit to the Commission every three years in the prescribed form, the following:
 - i. An abstract of the report if an actuary and valuation report of the life insurance business;
 - ii. A summary and valuation of the life policies;
 - iii. A table showing premium, policy reserve values and guaranteed surrender values together with the relationship between premium paid and such guaranteed surrender values; and
 - iv. A certificate of solvency signed by an actuary stating that the value of the assets representing the funds maintained by the insurer in respect of the life insurance business exceeds the value of the liabilities.

- b. The commission may require an insurer transacting business to:
- i. cause the person who is for the time being the actuary of the insurer to make an investigation into its financial condition (including evaluation of its liabilities) in respect of that business as at a specified date;
 - ii. cause an abstract of that person's report of the investigation to be made and submitted to it;
 - iii. prepare and submit to it a statement of its life insurance business or part thereof as at the date of the request; and
 - iv. show sufficient evidence that not more than 40 per centum of the actuarial surplus declared is appropriated for shareholders.
- (c) An insurer transacting life insurance shall at the expiration of each year:
- i. Prepare with reference to that year in the prescribed form a statement and exhibit of the life policies; and
 - ii. Submit the statement and exhibit together with such other documents and information relating to the relevant accounts and balance sheet (including copies of reports on the affairs of the insurer for the year as submitted to the policy-holders of the insurer as the Commission may from time to time require.
- (d) On receipt of the documents mentioned in subsections (2) and (3) of this section, the Commission shall, if it appears to it that the statement furnished by an insurer under any of those subsections is inaccurate or is prepared in the prescribed form, or is defective in any material particular:
- i. Require from the insurer such further information as it may consider necessary;
 - ii. Call on the insurer to submit for its examination any book of account, register or any other document;
 - iii. Require the insurer to confirm on oath or by or a sworn declaration the authenticity of any statement submitted by the insurer;
 - iv. Refuse to approve the insurer's annual statement unless or until the inaccuracies have been supplied.
- f. An insurer who fails, neglects or refuses to file the required returns or accounts under this section is guilty of an offence and liable on conviction to a fine of N5,000

per day for every day of default.

- g. An insurer shall in each year after receipt of the approval of the Commission publish its general annual balance sheet together with its profit and loss account in at least one newspaper having wide circulation in Nigeria. (Section 27)

It is necessary for an auditor to ensure compliance with accounting and auditing standards in the discharge of his professional duties. He must be conversant also, with the provisions of the Company and Allied Matters Act CAP C20 LFN 2004 and that of other regulatory bodies in Nigeria as the understanding of the laws and formulations will enable the auditor to test compliance or otherwise on the part of the client.

More so, the auditor needs to understand or be familiar with and have a good knowledge of the instruments establishing various organisations and the requirements of regulatory agency of such entity as this might affect or determine the scope and terms of engagement of the auditor as provided in the laws.

There is need for him to adhere to ethical rules and guidance on independence, objectivity, integrity, skill, care, confidentiality and competence that will enable him/her to act in a professional manner which will afford him the opportunity of being able to moderate his conduct on regular basis and to avoid professional sanctions.

Auditor's Interest

The balance sheet profit and loss account and revenue account of an insurer in respect of the insurance business transacted by the insurer, shall be audited annually by an external auditor.

If those policies do not resolve the ethical conflict, the following should be considered:

- a. Review the conflict problem with the immediate superior. If the problem is not resolved with the immediate superior and the professional accountant determines to go to the next managerial level, the immediate superior should be notified of the decision. If it appears that the superior is involved in the conflict problem, the professional accountant should raise the issue with the next higher level of management. When the immediate is the Chief Executive Officer (or equivalent) the next higher reviewing level may be the Executive Committee, Board of Directors,

Non-Executive Directors, Trustee, Partners' Management Committee or Shareholders;

- b. Seek counselling and advice on a confidential basis with an independent advisor or the applicable professional accountancy body to obtain an understanding of possible courses of action; and
- c. If the ethical conflict still exists fully exhausting all levels of internal review, the professional accountant as a last resort may have no other recourse on significant matters (e.g. fraud) resign and submit an information memorandum to an appropriate representative of that organisation.

In Nigeria, the banking laws and regulations require cases of fraud to be reported to the regulatory authorities. Any professional accountant in a senior position should endeavor to ensure that policies are established within his or her employing organisation to seek resolution of conflicts.

The professional bodies should provide confidential counselling and advice to members who experience ethical conflicts. The Institute of Chartered Accountants of Nigeria requires a member who is in doubt as to his or her ethical position in any matter to seek advice of the Institute through the Registrar/Chief Executive.

Knowledge of the Client's Business (KOB)

Auditing Practices Board (APB) statement of Auditing Standard 210 provides for the knowledge of the business by the auditor.

Obtaining Knowledge before and after acceptance of an Engagement

Before the acceptance of an engagement, auditors should obtain a preliminary knowledge of the industry and of the ownership, directors, management and operations of the entity to be audited, sufficient to enable them to consider their ability to undertake the audit.

Knowledge obtained before the acceptance of an engagement generally includes:

- a. Knowledge from previous relevant experience;
- b. Knowledge from enquiries of predecessor auditors;
- c. Specific rules or regulations pertaining to the industry;

- d. Accounting standards applicable to the industry;
- e. An initial perception of the viability of the business; and
- f. The perceived integrity of the directors and management.

Auditors also require sufficient knowledge to enable them assess whether there is a requirement for staff with specialist audit expertise (for example computer audit specialists) or other experts. After the acceptance of an engagement, the auditor should:

- (a) Obtain further and more detailed knowledge and information sufficient to enable them to plan the audit and develop an effective audit approach;
- (b) Obtain the required knowledge at the start of the engagement.
Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit; and
- (c) Information obtained as the audit progresses enable auditors to update and augment that knowledge, and may require them to reassess it.

Auditors should observe the following in order to achieve success in subsequent years -

- a. Consider the information gathered previously; and
- b. Perform procedures designed to identify significant changes that have taken place since the last audit.

Sources of Knowledge

The under-listed are some of the sources through which an Auditor can obtain knowledge of the industry and the entity -

- a. Previous experience with the entity and its industry;
- b. Visits to the entity's premises and plant facilities;
- c. Discussion with people within the entity (for example directors, internal auditors, computer personnel and senior operating personnel);
- d. Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry;
- e. Discussion with knowledgeable people outside the entity (for example economists, industry regulators);
- f. Publications related to the industry (for example government statistics, surveys,

- texts, trade journals, reports prepared by banks and securities dealers, financial newspapers);
- g. Legislation and regulations that significantly affect the entity;
 - h. Documents produced by the entity (for example minutes of meetings, material sent to shareholders or filed with regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manuals, manuals of accounting and internal control systems, charts of accounts, job descriptions, marketing and sales plans); and
 - i. Professional literature giving industry-specific guidance.

Uses of Knowledge

Understanding the business and using this information appropriately assists auditors in:

- i. Evaluating audit evidence.
- ii. Assessing risks and identifying problems.
- iii. Planning and performing the audit effectively and efficiently.

Where knowledge of the business is important, Auditors make judgements about many matters throughout the course of the audit, for example:

- a. Considering risks pertaining to the entity's business activities and the directors' response thereto;
- b. Identifying areas where special audit considerations and skills may be necessary;
- c. Developing the overall audit plan and the audit programme;
- d. Considering the complexity of the entity's information systems and any effect on the audit approach;
- e. Determining a materiality level and assessing whether the materiality level chosen remains appropriate;
- f. Assessing inherent risk and control risk;
- g. Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions;
- h. Evaluating accounting estimates and representations by the directors or management;

- i. Recognising conflicting information (for example contradictory representations);
- j. Recognising unusual circumstances (for example undisclosed related party transactions, possible fraud or non-compliance with law or regulations, or unexpected relationships of statistical operating data with reported financial results);
- k. Making informed enquiries and assessing the reasonableness of answers; and
- l. Considering the appropriateness of accounting policies and financial statement disclosures.

It is expected of the audit engagement partner to 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 knowledge may be transmitted initially by:

- a. Means of the overall audit plan;
- b. An audit briefing meeting; and
- c. Subsequently during the course of the audit.

The audit engagement partner also ensures that the audit team:

- a. Understands the need to be alert; and
- b. Shares additional information.

2.07 Obtaining Knowledge of the Client's Operational Background in Respect of its Financial, Legal and Personnel Situations and the Operating Environment

Auditors should have or obtain knowledge of the business of the entity to be audited which is sufficient to enable them to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or the audit thereof.

Knowledge of the business is used by auditors in:

- i. Assessing risks of error;
- ii. Determining the nature, timing and extent of audit procedures; and
- iii. Considering the consistency and reliability of the financial statements as a whole when completing the audit.

The auditors' level of knowledge for an engagement normally includes:

- i. General knowledge of the economy and the industry within which an entity operates;
- ii. A more particular knowledge of how the entity operates. The level of knowledge required by auditors is less than that possessed by the directors.

The extent to which auditors need to formally document their knowledge of the business depends:

- i. Upon its complexity and the number of persons who will be engaged on the audit;
- ii. The need to cover possible departure, illness or incapacity of key members of the
 - a. audit team.
- iii. Auditors prepare such documentation to a level sufficient to facilitate proper
 - a. planning of the audit.

Matters to Consider in Relation to Knowledge of the Business

The auditor should consider the following matters in relation to knowledge of the business:

General Economic Factors

- i. General level of economic activity (for example recession, growth);
- ii. Interest rates and availability of financing;
- iii. Inflation;
- iv. Government policies -
 - a. Monetary policies,
 - b. Fiscal policy,
 - c. Taxation - corporate and others,
 - d. Financial incentives (for example government aid programmes),
 - e. tariffs, trade restrictions; and
 - f. Foreign currency rates and controls.

The Operating-Environment Conditions Affecting the Client's Business

- i. The market and competition;
- ii. Cyclical or seasonal activity;
- iii. Changes in product technology;

- iv. Business risk (for example high technology, high fashion, ease of entry for competition);
- v. Declining or expanding operations;
- vi. Adverse conditions (for example declining demand, excess capacity, and serious price competition);
- vii. Key ratios and operating statistics;
- viii. Specific accounting practices and problems;
- ix. Environmental requirements and problems;
- x. (j) Regulatory framework; and
- xi. (k) Specific or unique practices (for example relating to labour contracts, financing methods, accounting methods).

The Entity

Directors, management and ownership

- i. Corporate structure - private, public, government (including any recent or planned changes); Beneficial owners, important stakeholders and related parties, local, foreign, business reputation and experience) and any impact on the entity's transactions;
- ii. The relationships between owners, directors and management;
- iii. Attitudes and policies of owners;
- iv. Capital structure (including any recent or planned changes); and
- v. Organisational structure.

Group Structure

- i. Subsidiaries' audit arrangements;
- ii. Directors' objectives, philosophy, strategic plans;
- iii. Acquisitions, mergers or disposals of business activities (planned or recently executed);
- iv. Sources and methods of financing (current, historical);
- v. Board of directors;
- vii. Composition of the board;
- viii. Business reputation and experience of individual independence from and control

- over operating management;
- ix. Frequency of meetings;
- x. Existence and membership of the audit committee and scope of its activities;
- xi. Existence of policy on corporate conduct; and
- xii. Changes in professional advisors (for example lawyers).

Operating Management

- i. Experience and reputation;
- ii. Turnover;
- iii. Key financial personnel and their status in the organisation;
- iv. Staffing of accounting department;
- v. Incentive or bonus plans as part of remuneration (for example based on profit);
- vi. Use of forecasts and budgets;
- vii. Pressures on management (for example over-extended dominance by one individual, support for share price, unreasonable deadlines for announcing results);
- viii. Management information systems;
- ix. Internal audit function (existence, quality); and
- x. Attitude to internal control environment.

The entity's business - products, markets, suppliers, expenses, operations

- i. Nature of business (for example, manufacturer, wholesaler, financial services, import/ export);
- ii. Location of production facilities, warehouses, offices;
- iii. Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation);
- iv. Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, export, pricing policies, reputation of products, warranties, order books, trends, marketing strategy and objectives manufacturing processes);
- v. Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery);
- vi. stocks (for example, locations, quantities);
- vii. Franchise, licences, patents;

- viii. Important expense categories;
- ix. Research and development;
- x. Foreign current assets, liabilities and transactions by currency, hedging;
- xi. Legislation and regulations that significantly affect the entity;
- xii. Information systems - current, plan to change; and
- xiii. Debt structure, including covenants and restrictions.

2.08 Review Questions

1. 'Professional competence is a must for an Auditor.' Expand this line of thinking
(15 Marks)
2. Enumerate and explain the provisions of CAMA 1990 in respect of auditor's engagement (20 Marks)
3. (a) What is Knowledge of the business from the perspective of auditors? (10 Marks)
(b) Of what importance is it? (5 Marks)

MODULE 3

3.00 AUDIT PLANNING AND SUPERVISION

3.01 Learning Outcomes

On successful completion of this module, students should be able to:

- i. Design, plan and apply audit testing techniques and procedures in the practical application of international standards on auditing (ISAs) and other technical pronouncements relating to audits;
- ii. Evaluate and describe the nature (quantitative and qualitative) of materiality as it applies to audits;
- iii. Identify audit risks, and describe the procedures undertaken at the planning stage to meet the objectives of the audit;
- iv. Describe the nature, extent and timing of audit procedures;
- v. Design and apply the appropriate audit tests and reviews to include in audit programmes and
- vi. Evaluate, explain and discuss issues and developments relating to auditing including audit expectations and developments in the regulation of audits.

3.02 Audit Planning

International Standard on Auditing (ISA) 300: Planning an Audit of Financial Statement, deals with the responsibility of an Auditor to plan an audit of financial statement. Audit planning involves developing an overall audit strategy for the expected conduct, organisation, and staffing of an audit engagement. The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control. Partner and other key members of the engagement team should be involved in planning the audit.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning and performing an audit in accordance with generally accepted auditing standards.

- i. The auditor must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion. As a result of anyone planned audit procedures.
- ii. The auditor may obtain disconfirming evidence that might cause the auditor to revise the overall audit strategy.

3.2.1 Importance of Audit Planning

Audit planning is important as it assist the audit to:

- i. Devote appropriate attention to important areas of the audit.
- ii. Identify and resolve potential problems on a timely basis.
- iii. Properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- iv. Select engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- v. Facilitating the direction and supervision of engagement team members and the review of their work.
- vi. Assist in coordination of work done by auditors of components and experts.

3.2.2 Audit Plan Activities

- i. Identify the characteristics of the engagement that define its scope;
- ii. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- iii. Consider the factors that, in the auditor's professional judgement, are significant in directing the engagement team's efforts;
- iv. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- v. Ascertain the nature, timing and extent of resources necessary to perform the

engagement.

3.03 Materiality

The Auditing Practices Board (APB) Statement of Auditing Standard 220 covers materiality. The International Auditing and Assurance Standards Board of IFAC issued International Statement on Auditing 320 on Audit Materiality. The International Statement on Auditing on Audit Materiality states that information is considered to be material to the financial statements if the misstatement or omission of such information may reasonably be expected to influence the economic decisions of users of those financial statements, including their assessments of management stewardship.

Auditors must consider the effect of possible misstatement of relatively small amounts in that a relatively small error in a month end procedure may be an indication of possible material misstatement when the cumulative effect on the financial statements is considered at the end of the financial period. A misstatement or the aggregate of all misstatements in financial statements is material if, considering the surrounding circumstances:

- i. It is probable that, the decision of a person who is relying on the financial statements; and
- ii. Who has a reasonable knowledge of business and economic activities (the user), would be changed or influenced by such misstatement or the aggregate of all misstatements.

3.3.1 Steps in Establishing Materiality

The steps to be followed in establishing materiality of an audit item are:

- i. Set a threshold at the planning stage about materiality;
- ii. Record misstatements identified in the course of the audit; and
- iii. Document the likely misstatements and compare with materiality.

When immaterial information is given in the financial statements, the result may distort the explicitness of the other information provided. In such circumstances, the auditors need to consider the exclusion of such immaterial information. However, the requirements of legislation, accounting standards and auditing standards must be considered in determining

the nature of information to be given in the financial statements.

3.3.2 Principal Factors Affecting Materiality

The auditor must exercise judgement in determining whether the information is material. An item may be material considering its size and nature. The principal factors which may affect materiality are as follows:

- i. The size of the item when taken in the context of the financial statements as a whole and of the other information readily available in the market place to investors and users that would affect their evaluation of the financial statements;
- ii. Consideration may be given to the nature of the item in relation to:
 - a. The basis of transaction or other event giving rise to it;
 - b. The significance of the event or transaction;
 - c. The legality, sensitivity, normality and potential consequences of the item;
 - d. The disclosure requirement of such item.

The auditor should determine materiality by a combination of these factors, rather than anyone in particular. When there are two or more similar items, the auditor should consider the aggregate.

3.3.3 Consideration of Materiality

In planning the conduct of an audit, auditors seek to provide reasonable assurance that the financial statements are free of material misstatement and give a true and fair view. Auditors exercise professional judgement in determining what material is. Both the amount (quantity) and nature (quality) of misstatements are considered in determining materiality. There exists a difficulty in ascribing general mathematical definition to materiality in that it has both qualitative and quantitative aspects. Auditors must consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, a relatively small error in a month-end procedure could be an indication of a potential material misstatement, if that error is repeated each month during the financial year that is being audited. Auditors should also pay attention to the nature of misstatements relating to qualitative aspects of a matter. Examples of qualitative misstatements would be the inadequate or inaccurate description of an accounting policy when it is likely that a user of the financial statements could be misled by

the description.

3.4.4 Materiality and audit work

In planning and conduct of an audit, auditors must consider:

- i. Materiality and its relationship with audit risk; and
- ii. Materiality when determining the nature, timing and extent of audit procedures.

At the planning stage, the assessment of materiality based on the latest available reliable financial information assists in the determination of an efficient and effective audit approach. The preliminary materiality assessment helps auditors decide such questions as what items to examine, and whether to use sampling techniques. This enables auditors to select audit procedures that, in combination, reduce audit risk to an acceptably low level.

In practice, the assessment of materiality at the audit planning stage may differ from that at the time of evaluating the results of audit procedures. This may be caused by a change in circumstances, or a change necessitated by the outcome of the audit. For example, if the actual results of operations and financial position are different from those they expected when the audit was planned.

Auditors must consider the implications of factors which result in the revision of their preliminary materiality assessment on their audit approach. In this circumstance, auditors may modify the nature, timing and extent of planned audit procedures. For example, if, after planning for specific audit procedures, auditors determine that the acceptable materiality level falls short of the initial materiality level, the risk of failing to detect a material misstatement necessarily increases. The risk may be compensated for by the auditors by carrying out more audit work.

There are no standardized methods of qualitatively computing materiality in auditing. However, during an audit there may be some qualitative methods that the auditor may adopt to determine materiality. According to McKee and Eilifsen (2000) quantitative approaches by auditors for making the preliminary materiality judgement typically can be classified into one of the following four categories:

- i. Single Rules
- ii. Variable or Size Rules
- iii. Blend or Averaging Methods

iv. Formula Methods

Single rules are "rules of thumb" that use a single financial variable for computing materiality. Typically, as a matter of policy, an audit firm would provide three or four such rules and allow the auditor in an individual audit to choose the most appropriate rule. Depending on his/her assessment of qualitative factors, an auditor would select the single rule that was judged to be the most appropriate way to compute materiality for a specific client. Examples of possible common single rules are:

5% of pre-tax income

1/2% of total assets

1% of equity

1/2% of total revenues

Variable or size rules are similar to single rules but they differ in that they provide a range of possible different materiality levels for companies of different sizes. As with a single rule, an auditor would use an assessment of qualitative factors to help decide what materiality level to select within the appropriate range. An example of a possible variable rule is:

2 to 5% of Gross Profit if it is less than N20,000

1 to 2% of Gross Profit if it is between N20,000 - N1,000,000

1/2 to 1% of Gross Profit if it is between N1,000,000 - N100,000,000

1/2% of Gross Profit if it is over N100,000,000

Blend or average methods typically take four or five individual rules of thumb and then either weight each rule according to some proportion or average them (an equal weighting). Presumably, the blending or averaging process provides an indirect way of considering qualitative factors. An example of the averaging method would be to take the previously listed four single rules and average them (give each of them a 25% weight).

Formula methods use a mathematical formula that has been determined from a statistical analysis of the materiality levels for a large sample of companies. Since the individual materiality levels in this sample are typically determined via single rules of thumb, the formula methods are merely another form of the blend or average method. The most widely known formula is one used by KPMG although there are many others in the audit literature. The 1998 version of the KPMG formula is:

$$\text{Materiality} = 1.84 \text{ times (Greater of Assets or Revenues)}^{2/3}$$

Illustration

The following summary financial statements are for Mama Company plc.

Balance Sheet		Income Statement	
	₦		₦
Assets	<u>3,000,000</u>	Total Revenues	9,000,000
		Cost of Merchandise	<u>5,000,000</u>
		Gross Profit	4,000,000
		Selling & Other Expenses	<u>3,200,000</u>
Liabilities	2,000,000	Net Income before Tax	800,000
Owners' Equity	<u>1,000,000</u>	Income Tax	<u>300,000</u>
	<u>3,000,000</u>	Net Income after Tax	<u>500,000</u>

Single Rule Method

The single rule method would involve the auditor selecting one of the four following materiality amounts:

Single Rule	Computation	Materiality Amount
5% of pre-tax income	5% x ₦800,000	₦40,000
1/2% of total assets	1/2% x ₦3,000,000	₦15,000
1% of equity	1% x ₦1,000,000	₦10,000
1/2% of total revenues	1/2% x ₦9,000,000	₦45,000

Variable or Size Rule Method

The variable or size rule method would involve the following computations with the auditor judgementally selecting a materiality amount somewhere in the computed materiality range:

Variable or Size Rule	Computation	Materiality Range
1/2% to	1/2% x ₦4,000,000	₦20,000
1% of Gross Profit	1% x ₦4,000,000	₦40,000

The Average or Blending Method

The average or blending method using the single rules previously given would involve the following computation:

Average Method

(5% of pre-tax income+ 1/2% of total assets + 1% of equity + 1/2% of total revenues)/4

$$= (40,000 + 15,000 + 10,000 + 45,000)/4 = 110,000/ 4 = \text{₱}27,500$$

Materiality Amount = ~~₱~~27,500

3.04 Audit Working Papers

It is the duty of the auditor to document matters which are important in providing evidence to support the audit opinion and evidence that the audit was carried out in accordance with auditing standards, accounting standards and relevant regulations.

The International Federation of Accountants (IFAC) published the International Standard on Auditing. The document establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

The Auditing Practices Board (APB) Statement of Auditing Standard 230 on working papers provides guidance on working papers.

The Auditor's Operational Standard (AOS) states that the auditor should record his work. The main objective of the auditor's working paper is to show details of the work done to enable him form professional opinion on the account, which he is required to report on.

Working papers are sometimes classified into the following: -

- i. Permanent Working Papers
- ii. Current Working Papers.

A permanent audit working paper provides information which is of continuing relevance to the audit while current working paper contains only current information about the audit and it is otherwise known as annual file.

3.4.1 Reasons for Audit Working Papers

- i. Provide evidence of work done;

- ii. They support the audit opinion;
- iii. They assist in audit planning;
- iv. They provide a basis for control of work done through independent review.
- v. Serve as a record of problem encountered during the audit, the information and explanation obtained and the conclusion drawn for further reference.
- vi. They encourage the auditors to adopt a methodical approach in the conduct of an audit
- vii. Allow continuity of audit
- viii. Facilitate review by partners and managers alike
- ix. They provide evidence of work done in case of litigation

3.4.2 Contents of Working Papers

Generally, the audit working paper will consist of the following: -

- i. Information and documents, which are of continuing importance to each annual audit;
- ii. Information relating to the audit planning and control;
- iii. Details of the client's system and record;
- iv. Analysis in support of the account or summary of the details in the client's book;
- v. Detailed evidence of the work carried out e.g. Note to queries raised and actions taken and conclusion thereon;
- vi. Evidence of proper review of work done;
- vii. A summary of significant points affecting the financial statement and audit report and how they were resolved.

3.4.3 Factors Affecting Form and Content of Working Papers

The following matters may affect the form and content of working papers:

- i. Nature of the engagement;
- ii. Form of the auditor's report;
- iii. Nature and complexity of the business;
- iv. Nature and condition of the entity's accounting and internal control systems;
- v. Needs in the particular circumstances for direction, supervision and review of work performed by assistants;

- vi. Specific audit methodology and technology used in the course of the audit;
- vii. Use of standardised working papers, for example, checklists, specimen letters, standard organisation of working papers;
- viii. Need to facilitate the delegation of work while providing a means to control its quality; and
- ix. Schedules, analyses and other documentation prepared by the entity and the need to be satisfied that those materials have been properly prepared.

3.4.4 Contents of Current Audit File

- i. A copy of management account being audited;
- ii. Schedule of major items in the account;
- iii. Management letter for the accounting year;
- iv. Audit programme;
- v. Extract of board's minute of meeting held during the year;
- vi. Audit planning memorandum for the accounting year;
- vii. Letter of representation;
- viii. Replies to all circularization letter;
- ix. List of queries and their disposition;
- x. Published financial statement (current),

3.4.5 Contents of Permanent Audit File

- i. Copy of certificate of incorporation;
- ii. Articles and Memorandum of Association;
- iii. Copies of the important agreement entered into by the organisation;
- iv. Organisational Structure;
- v. Major accounting policy;
- vi. Audited account of the company for the year to date.
- vii. Specimen original copy of transaction document e.g. journal voucher,
- viii. payment voucher, credit notes, goods received notes, etc;
- ix. List of directors and their interest in the business, which includes service contract if
- x. any;
- xi. List of major shareholders and their stake in the company;
- xii. A description of accounting and internal control system;

- xiii. List of professional advisers and their addresses;
- xiv. List of branches and the addresses of the branches of the company;
- xv. The first audit planning memorandum written for the company;
- xvi. Auditors' appointment and their engagement letters thereon.

3.4.6 Qualities of a Good Working Paper

- i. It should be clear;
- ii. The information in the working paper should be complete;
- iii. Working paper should be logical;
- iv. Working paper should be detailed enough to contain all aspects of the audit;
- v. It should be neat and tidy;
- vi. It should contain details of all problems encountered so as to enable an independent reviewer to deduce the reasonableness of the auditor's conclusion in view of the problem encountered during the audit assignment.
- vii. It should be well structured i.e. referenced and cross-referenced.
- viii. It should contain the following details: -
 - a. Schedule of reference
 - b. Subject
 - c. Name of the company being audited
 - d. Name of the firm
 - e. Date prepared
 - f. Initials of the preparer
 - g. Date reviewed
 - h. Initials of the reviewer
 - i. Year-end of the enterprise etc.

3.4.7 Uses Audit Working Papers

- i. Assist in the planning and performance of the audit;
- ii. Assist in the supervision and review of the audit work; and
- iii. Record the audit evidence resulting from the audit work performed to support the auditor's opinion.

3.4.8 Duties of Auditors on Working Papers

It is the duty of the Auditor to:

- i. Prepare working papers which are sufficiently complete and detailed to provide an overall understanding of the audit;
- ii. Record in the working papers information on planning the audit work, the nature, timing and extent of the audit procedures performed, the results thereof, and the conclusions drawn from the audit evidence obtained;
- iii. Record auditor's reasoning on all significant matters which require the exercise of judgement, together with the auditor's conclusion thereon;
- iv. Document areas involving difficult questions of principle or judgement; and
- v. Record the relevant facts known to the auditor at the time the conclusions were reached on matters of judgement or principles.

The extent of working papers to be prepared and retained is a matter of professional judgement. In determining the extent of working papers to be prepared and retained the auditor should consider:

- i. The legal and professional requirements; and
- ii. What would be necessary to provide another auditor who has no previous experience with the audit with an understanding of the work performed?

3.4.9 Confidentiality, Safe Custody, Retention and Ownership of Working Papers

Working papers are the property of the auditors. Although portions of or extracts from the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity's accounting records.

The auditor should therefore adopt appropriate procedures:

- i. For maintaining the confidentiality and safe custody of the working papers; and
- ii. For retaining the working papers for a period sufficient to meet the needs of the practice and in accordance with legal and professional requirements of record retention.

3.05 True and Fair View, Materiality and Judgement True and Fair View

The concept of true and fair view occupies a central place in financial reporting. The concept which has been debated over time has a powerful, direct effect on accounting practice and it is the ultimate test for financial statements. The Companies and Allied Matters Act requires the auditors to include in their report whether the financial statements show a true and fair view of the affairs of the entity at a balance sheet date. The auditing standards also put the concept of true and fair view in perspective.

The true and fair view is a dynamic concept in that, over time, the concept has always moved in sympathy with changes in accounting and business practice. The more the laws change and the more accounting and auditing standards change, the more the requirements which the auditor must meet to ensure the financial statements upon which he or she is reporting, meet the concept of true and fair view. The concept affects the interpretation of the components of financial reporting and comes to play in setting procedures for the conduct of audit in an accounting practice.

It is important to note that financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. The concept of true and fair view influences accounting standards and other authoritative pronouncements.

3.06 Audit Supervision

In the conduct of an audit, it is important the process and staff involved be supervised. This will not ensure that the evidence gathered are complete, accurate and relevant to the achievement of the audit objective. Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Supervision elements includes instructing assistants, keeping informed of significant issues encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel.

The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client's business and industry.

3.6.1 Extent and Nature of Supervision

Extent and nature of supervision is determined by certain factors, which border on familiarity, competence and skills of the auditor and the audit team. This means the less the factors the more the supervision and the more of the factors the less the supervision.

The extent of supervision appropriate in a given instance depends on factors such as:

- i. the complexity of the subject matter
- ii. the qualifications of persons performing the work,
- iii. the knowledge of the client's business and industry.
- iv. Need for additional procedure
- v. the involvement of an expert

3.07 Review Questions

1. Explain the concept 'Materiality' as it applies to auditing (10 Marks)
2. From the auditing view point, when does an item become material? (8 Marks)
3. Indicate whether an auditor should audit immaterial items? (6 Marks)
4. Consider whether errors are or are not material in relation to verification of annual accounts. (10 Marks)
5. Design and analyse audit working papers paying particular attention to their relationship with audit evidence (18 Marks)
6. Write short explanatory notes on the following;
 - a. Permanent Audit file (6 Marks)
 - b. Current Audit File (6 Marks)
 - c. Audit Planning (6 Marks)
 - d. Audit Supervision (6 Marks)

MODULE 4

4.00 AUDIT EXECUTION: INTERNAL CONTROL, ASSESSING CONTROL RISK AND TEST OF CONTROLS

4.01 Learning Outcomes

On successful of this module, students should be able to:

- i. Outline the nature of internal controls and the procedures required to evaluate control risks relating to specific accounting systems so as to identify internal control weaknesses within the system's components of internal control systems and discuss their relevance and application in auditing;
- ii. Describe and differentiate the various forms of audit risks and indicate the way and manner they are assessed for audit purposes
- iii. Discuss the factors that determine audit risk levels
- iv. Design and apply appropriate audit programmes for risk assessment
- v. Recognize what constitutes risks of material misstatement in audits and specify remedial measures to be taken

4.02 Internal Control System

The Auditing Practices Committee defines internal control system in their Guideline as: 'the whole system of control, financial or 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's policies, safeguard the asset and secure as far as possible the completeness and accuracy of the records. Internal control is the process, that encompasses a set of rules, policies, and procedures set by an entity's Board of Trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- i. Reliability of financial reporting,
- ii. Effectiveness and efficiency of operations, and
- iii. Compliance with applicable laws and regulations.

The individual components of an internal control system are known as 'controls' or 'internal controls'.

It is for management to determine the extent to which internal controls are to be applied within the organisation. There are numerous factors to be considered e.g.

- i. The nature, size and volume of transactions;
- ii. The geographical distribution of the enterprise;
- iii. The controls exercised personally by individual members of management; and
- iv. The cost of setting up controls and the benefits obtained thereby.
- v. Managements' attitude to controls.

Types of Internal Controls:

- i. **Detective:** Designed to detect errors or irregularities that may have occurred.
- ii. **Corrective:** Designed to correct errors or irregularities that have been detected.
- iii. **Preventive:** Designed to keep errors or irregularities from occurring in the first place.

Limitations of Internal Controls:

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:

- i. **Judgement:** The effectiveness of controls will be limited by decisions made with human judgement under pressure to conduct business based on the information at hand.
- ii. **Breakdowns:** Even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.
- iii. **Management override:** High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.
- iv. **Collusion:** Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

Internal Control Objectives

Internal Control objectives are desired goals or conditions for a specific event cycle which, if achieved, minimize the potential that waste, loss, unauthorised use or misappropriation will occur. They are conditions that we want the system of internal control to satisfy. For a control objective to be effective, compliance with it must be measurable and observable.

Internal Audit evaluates the system of internal control by accessing the ability of individual process controls to achieve seven pre-defined control objectives. The control objectives include authorization, completeness, accuracy, validity, physical safeguards and security, error handling and segregation of duties.

- i. **Authorization** - The objective is to ensure that all transactions are approved by responsible personnel in accordance with specific or general authority before the transaction is recorded.
- ii. **Completeness** - The objective is to ensure that no valid transactions have been omitted from the accounting records.
- iii. **Accuracy** - The objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data and information is recorded in a timely manner.
- iv. **Validity** - The objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.
- v. **Physical Safeguards & Security** - The objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorised personnel.
- vi. **Error handling** - The objective is to ensure that errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.
- vii. **Segregation of duties** - The objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing the transaction.

A well designed process with appropriate internal controls should meet most, if not all of

these control objectives.

Effects of Weak or Non-existent Internal Control System

Where recommendations for improving controls within a department or organisation, three basic arguments for not implementing recommendations are always raised:

- i. There is not enough staff to have adequate segregation of duties.
- ii. It is too expensive.
- iii. The employees are trusted and controls are not necessary.

These arguments represent pitfalls to unsuspecting management. Each argument is in itself a problem that needs to be resolved.

- i. The problem of not having enough staff or other resources should be discussed with your supervisor. In most cases, compensating controls can be implemented in situations where one person has to do all of the business-related transactions for a department.
- ii. If implementing a recommended control seems too expensive, be sure to consider the full cost of a fraud that could occur because of the missing control. In addition to any funds that may be lost, consider the cost of time that would have been spent by the department during the time of an investigation of the matter, and the cost of hiring a new employee. Fraud is always expensive and the prevention of fraud is worth the cost.
- iii. Finally, consider the issue of trust. Most employees are trustworthy and responsible, which is an important factor in employee relations and departmental operations. However, it is also the responsibility of administrators to remain objective. Experience shows that it is often the most trusted employees who are involved in committing frauds.

Types of Computer Control

As part of the risk assessment process, the auditor should obtain an understanding of how the entity has responded to the risks arising from IT. The controls which the auditor would expect to find can be considered in two categories:

- i. **General IT-controls:** policies and procedures that relate to many applications and

support the effective functioning of application controls by helping to ensure the continued proper operation of information systems.

ii. **Application controls:** manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Application controls and general controls are inter-related. Strong general controls contribute to the assurance which may be obtained by an auditor in relation to application controls. Unsatisfactory general controls may undermine strong application controls.

Application Controls: Controls over Input

i. **Batch controls** where data entered onto the system is first subject to manual processes to pre-determine the results and the input data will only be accepted by the system when it meets the pre-determined totals. Typically, the information checked is:

- a. Number of documents
- b. Net amount
- c. Gross amount
- d. Hash totals for due dates and codes

ii. **Range/Limit checks** which specify maximum and minimum expected values (in a wages system an exception report may be produced for employees receiving net pay of more than N3,000 per month to allow management to follow up and investigate before payment is made).

iii. **Existence checks** that will only allow data to be input for valid account codes. This is useful in a sales or purchase system.

iv. **Check digits** that give codes a mathematical pattern and data will not be accepted for codes that do not match this pattern. These are used to prevent transposition errors.

v. **Sequence checks** which will highlight gaps in data both within and between batches.

Controls over Processing and Computer Data Files

The control techniques used over input may also be used to ensure the completeness and accuracy of processing provided they are applied to the results of processing e.g. a batch reconciliation produced after processing.

Controls over Output

These are designed to provide reasonable assurance that processing is accurate, the output is restricted to authorised personnel and provided on a timely basis. Examples include:

- i. Test checks on outputs
- ii. Approval of computer-generated payments
- iii. Reconciliation of report totals to general ledger accounts
- iv. Use of programmed control procedures.

Controls over Standing Data (Master Files)

- i. Amendments to standing data should only be made by authorised persons.
- ii. This can be achieved either through passwords or pre-numbered forms.
- iii. Regular printouts of data should be obtained and reviewed by someone in authority.
- iv. The computer could be programmed to provide a list of all amendments, additions and deletions on a daily or weekly basis. These could then be reviewed to ensure that all changes have been properly authorised.

Communication on Internal Control

The auditor has no duty to report any weaknesses in control systems to the shareholders but Communications of audit matters with those charged with governance requires the external auditor to communicate 'audit matters of governance interest' to those charged with governance of the entity.

The matters to be communicated include:

- i. Approach and scope of audit
- ii. Selection of, or changes in, accounting policies
- iii. Audit adjustments that could have a material effect on the entity's financial statements
- iv. Material uncertainties that may cast doubt on the entity's ability to continue as a going concern
- v. Material weakness in internal control

Procedures

- i. Such communications should be on a sufficiently prompt basis to enable those charged with governance to take appropriate action. All communications will be before the financial statements are finalised.
- ii. The form of communications and the addressee of communications should be established at an early stage in the audit process (i.e. planning).
- iii. Before reporting issues to the board, auditors should first discuss those matters with management. This gives management an opportunity to provide further information or explanations.
- iv. If possible, matters should be addressed to the audit committee or to the board if there is no audit committee.

4.03 Risk Assessment

Risk assessment includes both an assessment of:

- i. **Business risk** resulting from the entity's objectives and strategies that may result in material misstatement of the financial statements
- ii. **Audit risk** and its component parts.

4.3.1 Business Risk

Business risks result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. It is usually split into financial risk, operational risk and compliance risk. The auditor should obtain an understanding of the entity's process for identifying business risks relating to financial reporting objectives and deciding about actions to address those

4.2.2 The Implications of Business Risk for the Audit

The study of business risk is a good way of understanding the business. The effects of planning may include:

- i. Is there a risk of litigation against the company?
- ii. Is there any risk of withdrawal of support by loan or trade creditors?

- iii. Is the business under threat of being taken over with the risk of management misstating financial statements?
- iv. Are there related parties with different agendas?
- v. Is there a high risk of fraud - e.g. poor controls, management override, egotistical ambition and arrogance in the chief executive?
- vi. Does any of the risk have implications for cash flow?
- vii. Does any risk threaten the going concern status of the company?
- viii. Is the accounting system adequate both in Companies Act terms and also considering the complexities of modern business?

4.3.3 Audit Risk

This is the 'risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated'. Audit risk is the risk that auditors may give an inappropriate opinion on the financial statement. It is the probability that the auditor would draw invalid audit conclusions and therefore express invalid audit opinion. Audit risk is the risk that the auditors give an unqualified opinion on the accounts when they should have given a qualified opinion, or they give an opinion qualified for a particular reason where that reason was not justified. Audit risk can never be completely eliminated. This means that external auditors will always be exposed to the damaging consequences of negligent action, including costs of legal action and through adverse publicity. The auditors are called upon to make subjective judgement in the course of forming an opinion and so fraud or error may possibly go undetected.

4.04 Factors that Determine the Level of Audit Risk

The entity's management

Factors constituting the management attribute are;

- i. The integrity of the entity's management,
- ii. The competence of the entity's management,
- iii. The existence of any unusual pressures that might predispose management to misstate financial information.

Nature of the Business:

The nature of the entity's business and the inherent propensity for misstatement indicate

the level of risk to expect. For example, where there is a high potential for technological obsolescence of the entity's products and services, where there is significant related parties' involvement and where there is a high number of locations or a wide geographical spread of the entity's production facilities.

Nature of the items in the financial statements:

- i. Prior period's experience regarding the vulnerability of a class of transaction or an account balance to misstatement. For example, accounts, which required adjustment in the previous period or which involve a high degree of estimation.
- ii. The complexity of a class transaction or account balance. For example, those that might require expert involvement in their determination,
- iii. The degree of judgement involved in determining account balance.
- iv. Susceptibility of assets to loss or misappropriation. For example, assets that are highly desirable and movable such as cash.
- v. Whether the items or transactions are unusual in nature. For example, related party transactions or significant transactions occurring at or near the year-end.

The Entity's Accounting and Internal Control System:

- i. The design of the entity's accounting and internal control systems.
- ii. The extent of compliance with existing controls.

The Auditor's Substantive Procedures:

- i. The representativeness of the audit sample.
- ii. The appropriateness of the audit tests applied by the auditor in view of the audit objective.
- iii. The correctness of the interpretation of the audit evidence obtained and the appropriateness of conclusions derived.
- iv. The credibility of the audit evidence obtained. This can hardly be guaranteed as audit evidence is merely persuasive and not conclusive.

4.05 Components of Audit Risk

Audit Risks is made up of 3 component parts,

- i. **Inherent risk,**

ii. **Control risk and**

iii. **Detection risk:**

The Audit Risk Model

$$AR = IR \times CR \times DR$$

Where:

AR = Audit Risk

CR = Control Risk

IR = Inherent Risk

DR = Detection Risk

Inherent Risk

This is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there were no related internal controls. The risk of such the is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example,

- i. Complex calculations are more likely to be misstated than simple calculations
- ii. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than accounts consisting of relatively routine, factual data.

External circumstances giving rise to business risks may also influence inherent risk.

Control Risk

This is the risk that a misstatement could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to the preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

Note that both inherent risk and control risk together form the 'risk of material

misstatement'.

Detection Risk

This is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection Risks can be divided into Sampling Risk and Non-Sampling Risk.

It is primarily the consequence of the fact that the auditor does not, and cannot, examine all available evidence (sampling risk).

Factors affecting non-sampling risk are

- i. Auditor's experience
- ii. Time pressure
- iii. Financial constraints
- iv. Poor planning
- v. New client
- vi. Industry knowledge

4.06 Assessing the Risks of Material Misstatement

- i. Perform audit procedures to understand the entity and its environment
- ii. Assess the risk of material misstatement at the financial statement and assertion level

Some of the matters to be considered when obtaining an understanding of the entity include among others;

- i. Industry, regulatory and other external factors, including the applicable financial reporting framework
- ii. Market and competition
- iii. Product technology
- iv. Accounting principles
- v. Tax
- vi. Legislation: Nature of the entity

- vii. Revenue sources
- viii. Products or services
- ix. Locations
- x. Key customers/suppliers
- xi. Financing
- xii. E-commerce: Objectives and strategies and related business risks:
- xiii. New products/services
- xiv. Expansion
- xv. Use of IT: Measurement and review of the entity's financial performance:
- xvi. Trends
- xvii. Ratios, KPIs
- xviii. Budgets and forecasts

Risk Assessment Matters

The major approaches to the assessment of an entity's level of risk include;

- i. Identifying risks by considering the entity and its environment, including its internal control
- ii. Relating the identified risks to what can go wrong at the assertion level
- iii. Considering the significance and likelihood of the risks
- iv. Establishing materiality and evaluating whether the original level set remains appropriate as the audit progresses
- v. Developing expectations for use when performing analytical procedure
- vi. Designing and performing further audit procedures to reduce audit risk to an acceptably low level
- vii. Evaluating the sufficiency and appropriateness of audit evidence

Risk assessment procedures

Auditors are required to perform the following procedures to obtain an understanding of the entity and its environment, including its internal control:

- i. Enquiries of management and others within the entity
- ii. Analytical procedures
- iii. Observation and inspection.

The members of the audit team should also discuss the susceptibility of the entity's financial statements to material misstatements.

Analytical procedures

Analytical procedures mean the analysis of relationships to identify inconsistencies and unexpected relationships. The auditor should apply analytical procedures as risk assessment procedures and in the overall review at the end of the audit. They can also be used as a source of substantive audit evidence when their use is more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions. Analytical procedures include the following type of comparisons:

- i. Prior periods
- ii. Budgets and forecasts
- iii. Industry information
- iv. Predictive estimates
- v. Relationships between elements of financial information, i.e. ratio analysis
- vi. Relationships between financial and non-financial information, e.g. payroll costs to the number of employees.

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 risks determine the nature, timing and extent of further audit procedures. It is however, worthy to mention that risks faced by businesses can be classified into external and internal risks.

External Risks

Risks arising from outside the company may include the following:

- i. Changing legislation
- ii. Changing interest rates
- iii. Changing exchange rates
- iv. Public opinion, attitudes, fashions

- v. Price wars initiated by competitors
- vi. Import competition

Internal Risks

Risks arising within the company include:

- i. Failure to modernize products, processes, labour relations, marketing Employees Board members
- ii. Failure to modernize e.g. failure to achieve standard organisation requirement
- iii. The process of dealing with suppliers or customers
- iv. Excessive reliance on a dominant chief executive
- v. Cash flow problems including over trading
- vi. Gearing
- vii. Related parties
- viii. Inappropriate acquisitions
- ix. Excessive reliance on one of a few products, customers' suppliers
- x. Internal controls
- xi. Lack of research and development
- xii. Computer systems failures
- xiii. Fraud

4.07 Review Questions

1. In relation to audit risks, **write** short notes on the following;
 - i. Inherent risk (5 Marks)
 - ii. Control risk (5 Marks)
 - iii. Detection risk (5 Marks)
2. Describe the relationship between inherent risk, control risk and detection risk (15 Marks)
3. Describe any five control measures that should be put in place for purposes of verifying each of the following;
 - i. Cash sales and its proceeds (5 Marks)
 - ii. Bank balances (5 Marks)
 - iii. Salaries and wages (5 Marks)
4. Classify the major control areas associated with the purchasing system

MODULE 5

5.00 AUDIT EXECUTION: FINANCIAL STATEMENT ITEMS SUBSTANTIVE PROCEDURES

5.01 Learning Outcomes

On successful completion of this module, students should be able to:

- i. Distinguish between tests of control and substantive procedures in the context of an audit;
- ii. Outline the key aspects to be confirmed with regards to each item of asset, liability, income expenses, etc;
- iii. Describe the audit vouching steps required to confirm key aspects of substantive procedures including; ownership, existence, valuation, and authorization with regards to all items under audit and
- iv. Design and apply an effective substantive audit programme to verify assets, liabilities, income and expenses

5.02 Verification Principles

Business entities keep records of their business activities on a daily basis. The business of the clients may arise from buying, producing, and selling goods, services, and paying and collecting cash in connection with those activities. Recording of the transactions in the books of the clients are reflected in the revenue, expenses, assets and liability accounts.

In the course of preparation of financial statements, the directors make certain financial statements assertions. The assertion constitutes representations of the directors that are included in the financial statements. The directors, by approving the financial statements confirm the representations made by them.

The following matters constitute representations or assertions usually made by the Directors in approving financial statements:

- i. **Existence:** an asset or a liability exists at a given date
- ii. **Rights and obligations:** an asset or a liability pertains to the entity

at a given date

- iii. **Occurrence:** a transaction or event took place which pertains to the entity during the relevant period
- iv. **Completeness:** there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
- v. **Valuation:** an asset or liability is recorded at an appropriate carrying value;
- vi. **Measurement:** a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
- vii. **Presentation and disclosure:** an item is disclosed, classified and described in accordance with the applicable reporting framework (for example relevant legislation and applicable accounting standards).

The above therefore are the fundamentals of all verification exercises.

The auditor must obtain audit evidence to support each financial statement assertion.

The audit evidence presented in support of one assertion (for example, the existence of stock) does not compensate for failure to obtain audit evidence regarding another (for example, its valuation). Tests may, however, provide audit evidence about more than one assertion (for example, testing subsequent receipts from debtors may provide some audit evidence regarding both their existence and valuation). In conducting substantive tests, the auditor must consider the nature, timing and extent of substantive procedures. These may depend, amongst other factors, on the following matters:

- i. The auditors' assessments of the control environment and accounting systems generally;
- ii. The inherent and control risks relating to each assertion;
- iii. Evidence obtained from audit work performed during the preparation of the financial statements; and
- iv. Where tests of control provide satisfactory evidence as to the effectiveness of accounting and internal control systems, the extent of relevant substantive procedures may be reduced, but not entirely eliminated.

Auditors Normally Obtain Audit Evidence by:

- i. Inspection

- ii. Observation
- iii. Enquiry and confirmation
- iv. Computation; and
- v. Analytical procedures

The choice of one or a combination of the procedures which the auditors may adopt is dependent, in part, on the type of audit, the time the audit is conducted and the form in which the accounting records are maintained.

Inspection

Inspection provides reliable audit evidence about the existence of the tangible assets inspected but not necessarily as to the ownership or value of such assets. It involves examining records, documents or tangible assets and provides audit evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing. Inspection also provides three major categories of documentary audit evidence, listed in ascending degree of reliability, viz:

- (a) Evidence created and held by the entity;
- (b) Evidence created by third parties and held by the entity; and
- (c) Evidence created and provided to auditors by third parties.

Observation

The auditor, by the, looks at a procedure being performed by others, for example, the auditors observe the counting of stock by the entity's staff or the performance of internal control procedures as part of the conduct of an audit.

Enquiry and confirmation

Enquiry involves seeking information within and outside the entity. Enquiry may be formal or informal. Responses to enquiries obtained from third parties may confirm or disprove information previously made available to the auditors. Confirmation involves obtaining response to an enquiry to corroborate information previously made available to the auditors in the course of the audit.

Examples of direct confirmation are as follows:

- (a) Confirmation of debts by communication with debtors;
- (b) Confirmation of legal cases by communication with the entity's solicitors; and
- (c) Confirmation of bank balances by communication with the entity's bankers.

Computation

The auditor uses computation to check the arithmetical accuracy of source documents and accounting records. Computation also involves re-performing independent calculations.

Analytical Procedures

Analytical procedures consist of the analysis of relationships between:

- (a) Items of financial data;
- (b) Items of financial and non-financial data, deriving from the same period;
- (c) Comparable financial information deriving from different periods or differed entities.

Analytical procedures are used in identifying consistencies and predicted patterns or significant fluctuations and unexpected relationships, and the results of investigations thereof. Verification of assets is essential in auditing. Verification is a form of substantive test. The auditor has a duty to verify the assets and liabilities which appear on the balance sheet. The auditor also has a duty to verify that no other assets and liabilities which ought to appear on the balance sheet have been omitted from the financial statements.

At this juncture, it is important to know that an auditor must have a good understanding of his or her client's business. He should document the client's business and conduct tests of control and substantives tests on class of transactions and balances usually generated by the entity. All items considered to be material must be covered in the substantive tests. Auditors are not necessarily suggesting that the risk of material misstatement is particularly at the maximum, in the financial statements presented for audit.

Before performing substantive tests on each asset, the auditor would have gathered sufficient information or updated the information previously at his disposal about the client to make preliminary materiality judgement and to

assess inherent and control risk.

- i. Verifications of the following accounts are considered below as part of substantive tests in the course of an audit:
- ii. Current assets
- iii. Fixed assets
- iv. Liabilities
- v. Goodwill, patents, trademarks, copyright and franchise accounts
- vi. Reserve and equity
- vii. Income and expenditure
- viii. Revenue and expenses
- ix. Sales and Purchases
- x. Wages and Salaries; and
- xi. Other income and expenditure account items.

Verification may be in the form of:

- i. Confirmation of authorisation
- ii. Checking existence
- iii. Confirmation of costs or value;
- iv. Confirmation of title;
- v. Physical inspection;
- vi. Ensuring completeness; and
- vii. Presentation and disclosure.

5.03 Verification Of Current Assets And Liabilities

Verification of Current Assets Inventory

Audit objectives

The audit objectives applicable to inventories are:

I Completeness

This is to ensure that:

- a. Inventories represent all raw materials, work-in-progress, and finished goods that the entity owns, including those on hand, in

transit or on the premises of others.

b. All shipments of goods during the period covered by the financial statements.

ii **Accuracy**

This is to ensure that:

- a. The detailed perpetual inventory records are correct and agree with the general ledger inventory control account.
- b. Costs associated with inventories have been properly classified and accumulated.
- c. Cost of sales is based on correct costs and quantities, is properly summarised and posted to the costs of sales and inventory control accounts, and, where appropriate, is credited in the perpetual inventory records.

iii. **Existence/Occurrence**

This is to ensure that:

- a. Recorded inventories physically exist in saleable condition and represent property held for sale in the ordinary course of business.
- b. Recorded cost of sales relate specifically to goods actually shipped during the period covered by the financial statements.

Xv **Cut- off**

This is a procedure to ensure that production costs incurred are charged to work-in-progress and on completion are transferred to finished goods such that cost of goods sold are recorded in the period when the sales are made.

v. **Valuation**

This is to ensure that:

- a. Costs associated with inventories and costs of sales are determined and accumulated using generally accepted accounting principles consistently applied.
- b. Inventories are stated at cost or net realizable value, whichever is lower.

vi. **Rights and obligation**

This is to confirm that:

The entity has legal title or ownership rights to the inventory; inventory excludes goods that are the property of others or have been billed to customers.

vii. **Presentation and Disclosure**

This is to ensure that:

- a. Inventories and cost of sales are properly described and classified in the financial statements
 - b. All encumbrances against inventory are adequately disclosed.
- The auditor achieves these objectives by performing substantive tests or a combination of substantive tests and tests of control, structure, policies and procedures.

Planning the Inventory Observation

The client has the primary responsibility for planning and taking the physical inventory. The auditor should observe stocktaking and should include observation of stock taking in his planning of the audit. The client and auditor should agree on the timing of the inventory after considering the following factors:

- i. The inventory should be counted at year-end if it is subject to significant volatility of movement or quantities, or if the control procedures for accounting for movement are ineffective
- ii. If those procedures are effective, the count can be taken before year-end or, if the client used cycle counts, on a staggered basis throughout the year and
- iii. If the inventory is taken at once, both client and auditor usually prefer a month in the last quarter of the fiscal year.

Unless the client has effective control procedures that address proper cut-off, the auditor should discourage the client from taking inventories of different departments over a period of several days; this could result in double-counting of inventory. The auditor should review and comment on the written instructions of inventory plans.

Often the client personnel responsible for the inventory hold one or more instructional meetings with those who are to supervise the stock-taking. The auditor's presence at the meetings usually facilitates the plans for observing the inventory. There may be need for large number of audit staff to be present when a complete physical inventory is taken at a time than if cycle counts or staggered inventories are taken.

Audit staffing requirements must be determined based on the following variables:

- i. Timing of inventories at various locations;

- ii. Difficulty of observing them; and
- iii. Number of counting teams the client provides

Observing the Physical Inventory

The auditor must keep in mind the objectives of observing a physical inventory, namely to:

- i. ascertain that the inventory exists;
- ii. observe that the count is accurate;
- iii. ensure the description of the inventory is accurate; and
- iv. ensure that its condition is properly recorded.

An auditor is neither a taker nor an expert appraiser of inventory quality, quantities, or condition; nonetheless, an auditor should intelligently apply common sense. Well-arranged inventory is more likely to be accurately counted than poorly arranged inventory. Signs of age and neglect are often obvious, for example, dust on cartons or rust and corrosion of containers, and they naturally raise questions about the inventory's usefulness. The condition of the inventory is particularly important if the product must meet technical health specifications.

Before observing the inventory auditor should know enough about the client's business to be able to recognize, at least in broad terms:

The product under observation and the measures appropriate to determining its quality and condition.

Thus, an auditor should spend some time examining the inventory being counted. However, the client, and everyone else concerned, should recognize that the auditor is not acting as an expert appraiser.

The auditor should spend most of the time observing the client's procedures in operation. The diligence of the counting teams should be noted as to:

- i. How carefully they count, weigh, and measure;
- ii. How well they identify and describe the inventory; and
- iii. What methods they use to make sure no items are omitted or duplicated.

Other Observations

The auditor should also observe:

- i. Whether supervisory personnel are present;

- ii. How planned recounting procedures are executed;
- iii. Whether cut-off procedures are performed;
- iv. How inventory count documents are controlled;
- v. How individual areas or departments are controlled and “cleared”; and
- vi. Whether instructions are followed.

The auditor should do some test counts in order to:

- i. Confirm the accuracy of the client’s counting;
- ii. Record evidence to corroborate the existence of the inventory for later tracing to the inventory summary sheet; and
- iii. Perform random selection, independent counting and comparison with quantities recorded by the clients, provide evidence that all items on hand are accurately included in the client’s recorded counts.
- iv. The auditor should use judgement in determining how many test counts to perform. In the absence of specific reasons to do otherwise:
- v. The auditor usually performs a small number of test counts in relation to the total number of items in the inventory;
- vi. Where there are an unacceptable number of errors in a particular location, the client would ordinarily recount the inventory; and
- vii. The auditor should record the test counts for subsequent tracing to the inventory summarisation.

Client’s inventory counts are commonly recorded at least in duplicate, with one copy retained at the scene of the count and another collected for summarisation.

The client normally controls the summarisation process, and the auditor makes notations of tag or count sheet numbers or other control data on a test basis for later tracing to the summarized records to provide corroborative evidence that the process was adequately controlled.

As part of the review of plans and observation of the physical inventory procedures, the auditor should note and evaluate the procedures followed in separately identifying and counting items moved from one place to another (such as from department to department) and goods on hand belonging to others, such as consignments, bailment, goods on approval, and property of customers

returned for repair or held awaiting delivery instructions. All items belonging to others should be counted and recorded separately, both because they should be subject to control and to preclude their mistaken or purposeful substitution for the client's inventory.

In order to adequately identify work-in-progress, especially its stage of completion, auditors should:

- i. Check the bill of materials or similar document; and
- ii. Identify items in process and their condition or stage of completion.

Perpetual Inventories (Cycle Counts)

All procedures applicable to wall-to-wall physical inventory observation can be readily adapted to cycle count observation. The auditor can:

- i. Review the cycle counting schedules, plans, and instructions; and
- ii. Observe the physical arrangement and condition of the inventory.

The diligence and proficiency of the inventory count teams in counting, identifying inventory, and controlling records of test counts, would prevent omissions or duplications, and help in identifying and segregating slow-moving, obsolete, or damaged goods.

In a situation where the entire inventory is not being counted at the same time, the auditor must take steps to ensure that the items counted are properly identified.

The auditor can make a few test counts either independently or with the count teams and can observe and, if desired, participate in reconciling the counts to perpetual records and investigating differences. Effective cycle counting depends on:

- i. Effective control procedures for inventory quantities; and
- ii. Timely recording throughout the production process.

Once the client's procedures for controlling inventory quantities and related cycle counting are found to be effective, the auditor can choose to observe and test physical inventory procedures at any other time.

The auditor also needs evidence that the perpetual inventories procedures observed:

- i. Were functioning before;
- ii. Can be expected to function after they were observed; and
- iii. That they are applied to substantially all inventory items.

A formal schedule of counts and specific assignments (covering both personnel to perform the counts and supervisory responsibility) is preferable. Many companies, however, operate under a loose policy of counting all items at least once a year and assign the counting to the stock keepers to do as time allows.

In those instances, the auditor can review worksheets, entries in the perpetual inventory records and other evidence of the regularity of test counting, and can evaluate the results. Evidence of proper count procedures include:

- i. Frequent counting; Absence of substantial differences between counts and records over a period of time;
- ii. Quality of investigation of differences that occur and those investigating differences;
- iii. And the quality of storeroom, housekeeping and inventory identification.

Difficult Inventories

Certain types of materials - for example, logs in a river, piles of coal and scrap metal, chemicals - by their nature may be difficult to count, and an auditor may have to use ingenuity to substantiate quantities on hand. Measurement of a pile of metals, for example, may be difficult for a number of reasons:

- i. The pile may have sunk into the ground to an unknown depth;
- ii. The metals may be of varying weights, precluding the use of an average and
- iii. The pile may be of uneven density.

The quality of chemicals and similar materials may be impossible to determine without specialized knowledge and the auditor may find it necessary to draw samples from various levels of holding tanks and send them for independent analysis. Irregularities have been perpetrated by substituting water for materials stored in tanks.

The auditor should not readily take observation of inventories as impracticable or impossible.

In a situation where the client does not or cannot take a physical inventory, or if the auditor cannot be present at the stocks taking, the auditor may be able to form

an opinion regarding the reasonableness of inventory quantities by applying any of the following alternative procedures:

If the auditor is engaged after the physical inventory has been taken, subsequent physical tests may be a satisfactory substitute for observing the inventory-taking.

The auditor may also examine written instructions for the inventory-taking, review the original tags or sheets, and make other suitable tests. In any event, the auditor must:

- i. Examine or observe some physical evidence of the existence of the inventory;
- ii. Make appropriate tests of intervening transactions or control procedures applied to them.

If the auditor is satisfied that inventories are fairly stated; he or she is in a position to express an unqualified opinion. Otherwise, there may be no practicable substitute for observation of inventory taking, and an auditor may have to express a qualified opinion or disclaimer, depending on the materiality of the inventories and on whether failure to observe was unavoidable or resulted from management's decision to limit the scope of the audit.

Sometimes procedures for substantiating inventories must be based on examining other accounting documents and records. For example, in an initial audit, the auditor generally would not have observed the physical inventory at the previous year-end, which is a principal factor in determining cost of sales for the current year. If reputable independent accountants expressed an unqualified opinion on the prior-year statements, a successor auditor may accept that opinion and perhaps merely review the predecessor auditor's working papers supporting the prior-year balances. If no audit was made for the preceding year, the auditor may have no alternative but to substantially expand the tests of accounting records to attempt to obtain reasonable assurance about the beginning inventories in order to be able to express an opinion on the current year's results of operations.

Those expanded tests may include a detailed examination of physical inventory sheets and summaries, including review and testing of cut-off data, examination of perpetual inventory records and production records, and review of individual

product and overall gross profit percentages. In connection with the latter procedures, cost accumulations for selected inventory items should be tested and significant changes in unit costs directly traced to factors such as technological changes, mass buying economies and changes in freight rates, changes in labor costs, and changes in overhead rates.

Changes in gross profit percentages should be further related to changes in unit sales prices and changes in the profitability of the sales mix, if applicable. An auditor who is unable to form an opinion on the opening inventory may decide to qualify the audit opinion or disclaim an opinion with respect to results of operations for the year under audit.

Examination of Ownership and Cut-off

The auditor must determine that the client holds the title to the inventories. Where materials are imported by the entity, the shipping documents determine the ownership of the consignment. The evidence of ownership for such materials includes:

- i. Shipping documents showing consignee, Free on Board (FOB) terms and bill of lading; and
- ii. Actual receipts of the materials into the client's warehouse.
- iii. In the case of the cut-off test, the auditor needs to ensure:
- iv. The completeness of primary documents such as purchase and sales invoices;
- v. The invoices so issued followed pre-numbered serials;
- vi. Purchases are generally recorded when received; and
- vii. Sales are made when the transactions took place.

Determination of ownership would depend on proper control of receiving and shipping activities and cut-offs at year-end and, if different, at the physical inventory date.

At the time of the inventory observation, the auditor should:

- i. Visit the receiving and shipping departments;
- ii. Record the last receiving and shipping document numbers; and
- iii. Ascertain that each department has been informed that no receipts after
- iv. or shipments before the cut-off date should be included in the inventory.

After the inventory, the auditor should:

- i. Review the records of those departments; and
- ii. Compare the last receiving and shipping numbers with accounting department records to ensure that a proper cut-off was achieved.

Special care should be taken to control the movement of inventory when manufacturing operations are not suspended during the physical inventory. If there are consignment inventories, inventories in public warehouses, or customer inventories, those procedures must be expanded. Inventory held by others should be substantiated by direct confirmation in writing with the custodians.

If such inventory is material, the auditor should apply one or more of the following procedures to obtain reasonable assurance with respect to the existence of the inventory:

- i. Test the owner's procedures for investigating the stock-keeper and evaluating the store keeper's performance;
- ii. Obtain an independent accountant's report on the store-keeper's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable;
- iii. Observe physical counts of the goods, if practicable and reasonable; and
- iv. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts.

If goods are billed to customers and held for them, care must be exercised to exclude the goods from inventory and to determine that the customers have authorized billing before delivery. Goods belonging to customers or others should be counted and, if significant in amount, should be confirmed with their owners. The auditor should be alert to the possibility of such goods and should ensure that the client properly segregates and identifies them. The auditor should also be alert for liens and encumbrances against the inventories. These are normally evident from reading minutes and agreements, or as a result of confirmations with lenders relating to loans or loan agreements. It may be necessary to investigate whether additional liens and encumbrances have been filed with relevant authorities.

Assessment of Inventory

Generally accepted accounting principles require that inventories be reported at the lower of historical cost or market (current replacement cost), provided that the carrying value should not exceed net realizable value (estimated selling price minus costs of completion and disposal) or be lower than net realizable value reduced by the normal profit margin. To achieve the valuation objective for inventories, the auditor should test the inventory costing. In addition, he should:

- i. Review and test procedures for identifying obsolete or slow-moving items;
- ii. Review the costing of damaged or obsolete items to determine that the assigned value does not exceed net realizable value; and
- iii. Review and test the determination of market prices to determine whether the market value is lower than the cost.

The auditor should:

- i. Consider not only finished goods but also work in process and raw materials that will eventually become finished goods in the review for obsolete items;
- ii. Compare quantities with those in previous inventories on test basis to identify slow-moving items or abnormally large or small balances; and
- iii. Reviews of usage records can provide further indications of slow-moving items.

If the client does not maintain perpetual records, the auditor may examine purchase orders or production orders to determine how recently certain items of inventory were acquired. Many companies have formulae or rules of thumb that translate overall judgements on obsolete stocks into practical detailed applications, for example:

- i. All items over a year's supply;
- ii. All items that have not moved within six months; and
- iii. All items bearing certain identifying numbers with regard to date or class of product.

The auditor should review whether the rules are realistic and comprehensive

enough as well as whether they are fully and accurately applied. In addition to reviewing and testing the client's rules, the auditor must evaluate, based on an understanding of the client's business climate, whether the inventory can be realized in the normal course of operations. Past experience can be a good guide to the net realisable value of items that must be disposed of at salvage prices. Then certain finished goods are declared obsolete or severe markdowns are required, consideration should be given to related raw materials and work-in-process inventories write down.

5.04 Verification of Cash Sales

Cash sales are included under this topic because of the level of cash transactions in the Nigerian economy. In the supermarkets, restaurants, filling stations, etc, transactions are made predominantly by cash. Physical and accounting controls on Cash pose problems. Segregation of duties between access to merchandise and access to cash receipts is difficult, hence control procedures are put in place to improve accountability. For effective control, customers are encouraged to demand for receipts to cover cash payments.

Steps in the verification of cash sales are:

- i. Obtain records of the entity's daily cash sales;
- ii. Check the records of cash receipts with the totals of the cash register;
- iii. Investigate and obtain necessary explanations for any discrepancy;
- iv. Check the procedures for cash transactions; and
- v. Conduct cash count.

Cash Balances

It is assumed that the auditor, using appropriate combination of risk assessment activities and substantive tests, would have reduced audit risk to an appropriately low level with regard to cash receipts from customers, cash disbursements to vendors, and other cash transactions.

Because cash is so liquid and transferable, the risk of theft is greater than that of any other asset.

Accordingly, the auditor focuses on how responsive the client's control structure policies and procedures are to the inherent characteristic risk.

Failure to detect cash defalcations is frequently a source of embarrassment to the auditor. It may be the basis for litigation; particularly if it involves material fraud that a client contends should have been detected by an auditor following a testing plan that gave appropriate consideration to the inherent risk associated with cash and the client's response to that risk. Cash defalcations are concealed by unauthorised charges to income statement accounts, resulting in income statement containing misclassified or fictitious expenses.

The nature, timing and extent of substantive tests of cash are strongly influenced by the auditor's assessment of inherent and control risk. The effectiveness of control procedures also affects the timing of substantive tests.

Audit Objectives

The objectives of auditing cash are to obtain reasonable assurance that:

- i. Recorded cash on hand and in financial institutions, exists and is accurate and complete, and the client has legal title to it at the balance sheet date;
- ii. All items properly included as part of cash are realisable in the amounts stated; for example, foreign currency on hand or on deposit in foreign countries is properly valued;
- iii. Cash restricted as to availability or use is properly identified and disclosed; and
- iv. Cash receipts, disbursements, and transfers between bank accounts are recorded in the proper period.

Cut-off objective with respect to cash receipts from customers and disbursements to vendors should be met to prevent end-of-period "window dressing" of working capital accounts. Recording bank transfers in the wrong period could be a tell-tale of a defalcation.

Substantive Tests of Cash Balances

Substantive tests are as follows:

- i. Testing completeness, accuracy, and existence of year-end balances so as to:
 - a. Confirm balances and other information with banks and other financial institutions;
 - b. Prepare, review bank reconciliations; and
 - c. Cash count.
- ii. Testing bank transfer cut-off.
- iii. Review restrictions on cash balances and related disclosures.

Confirmation of Bank Balances

The auditor should ordinarily confirm balances at year-end by direct correspondence with all the banks _____ the client has conducted business with during the year, regardless of whether all year-end reconciliations are reviewed or _____ tested. The usual practice is to confirm all bank accounts open at any time during the year under audit. The auditor should ask the client to request _____ the financial institution to communicate directly with the auditor.

Indebtedness and Other Arrangements

A bank may have arrangements with or provide services to the client other than maintaining deposits or granting loans.

The auditor should confirm:

- i. Amount(s) on deposit kept as a condition for a loan;
- ii. Items held as agent or trustee, securities or other items in safekeeping or for collection for the account of the client; and
- iii. Other arrangements - such as oral and written guarantees, commitments to buy foreign _____ currencies, repurchase or reverse repurchased agreements, and letters of credit and lines of credit.

5.05 Bank Reconciliation Procedures

Periodic reconciliation of cash receipts and disbursements to the amounts shown on bank statement is key control procedure to meet the asset protection objective for cash.

The reconciliation procedure will be more effective if in addition to reconciling the balances, the detailed items listed on the bank statements are reconciled to the detailed items recorded in the accounts during the period covered by the bank statement. Reconciling detailed items listed on the bank statements ensures that all items recorded in the accounts, including offsetting items within receipts or disbursements, are also recorded on the bank statement and vice versa.

Effective segregation of duties requires that the person reconciling bank balance to account balances does not have functions relating to:

- i. Cash receipts;
- ii. Cash disbursements; and
- iii. Preparing or approving vouchers for payment.

It also requires that the person performing the reconciliation obtains the bank statements directly from the bank and makes specific comparisons, like comparing paid cheques and other debits and credits listed on the bank statement with entries in the accounts, examining cheques for signatures and endorsements, and reconciling bank transfers.

The client's reconciliation of bank accounts and the appropriate division of duties with respect to cash balances and transactions are important to control procedures.

The auditor's assessment of how effective the client's reconciliations are determined by the nature, timing, and extent of many of the substantive tests of cash. Other factors are:

- i. Adequacy of the accounting system;
- ii. Competence of employees doing the reconciliations; and
- iii. Segregation of duties.

The more effective the auditor finds the client's reconciliations to be, that is, the lower the assessed level of control risk, the less detailed the auditor's reconciliation procedures have to be.

Those procedures may range from simply reviewing the client's reconciliations at year-end, if control risk has been assessed as low, to performing independent reconciliations covering the entire year using the proof of cash form. Generally, performing proof of cash reconciliations for the entire year is considered necessary only in special situations, such as when a defalcation is believed to have occurred. Between those two extremes falls the auditor's judgemental discretion.

Review and Test of Client's Reconciliations

If the auditor has assessed control risk as low, then merely reviewing the client's reconciliations at year-end may be appropriate. The steps in reviewing a client's bank reconciliation are:

- i. Obtain copies of the client's bank reconciliations and establish their mathematical accuracy;
- ii. Reconcile the total of the bank balances on the reconciliations to the general ledger balance. This will generally require using a summary of the individual cash account balances in the general ledger account;
- iii. Scan the bank reconciliation for significant unusual reconciling items and adjustments, and obtain evidence to support them by inquiry or examination of appropriate documents.

In addition to the review procedures the auditor may decide to test the client's reconciliations. The tests may be performed at an interim date, if the auditor has assessed that the client's reconciliations are subject to effective supervisory control procedures. If supervision during the intervening period is not considered effective, the auditor would probably perform the tests at year-end.

The following procedures in addition to steps (a) and (b) above are typically performed in testing the client's reconciliations:

Determine that paid cheques, deposits, and debit and credit advices appearing on the cut-off bank statements and issued on or before the balance sheet date appear on the year-end reconciliations;

- i. Trace to the cash disbursements records outstanding cheques listed on bank reconciliations but not returned with the cut-off statements;
- ii. Trace deposits in transit on the bank reconciliations to the cut-off bank statements and the cash receipts records, and determine whether there are any unusual delays between the date received per the books and the date deposited per the bank statements;
- iii. Trace other reconciling items to supporting documentation and entries in the cash records;
- iv. Investigate old or unusual reconciling items. If cheques remain uncashed after a specified period of time, the reason should be determined and the amounts restored to the cash account; and
- v. Determine the exact nature of items on the year-end bank statements not accounted for by the reconciliation procedures, such as debits or credits followed by offsetting entries of identical amounts that appear to be, or are represented by the client to be, bank errors and corrections not so coded. If information in the client's records is inadequate, clarification should be requested from the bank. In these circumstances, the auditor should consider performing a "proof of cash" reconciliation (described below) if the client's reconciliation process does not include one. These procedures assume that the testing is performed as of the balance sheet date and that cut-off statements for a reasonable period after the balance sheet date are obtained from the bank.

Bank Transfer Schedule

To ensure there has been a proper cut-off at year-end, the auditor should determine whether significant transfers of funds occurred among the client's various bank accounts near the balance sheet date. All transfers of funds within the organisation should be considered - whether among branches, divisions, or affiliates - to make sure that cash is not "double counted" in two or more bank accounts and that "kiting" has not occurred.

The auditor should determine:

- i. That each transaction represented as a transfer is in fact an authorised

- transfer;
- ii. That debits and credits representing transfers of cash are recorded in the same period; and
- iii. That the funds are actually deposited in the receiving bank in the appropriate period.

Kiting is a way of concealing cash shortage caused by a defalcation, such as misappropriating cash receipts that were perpetrated previously.

It involves the careful and deliberate use of the “float” (the time necessary for a cheque to clear the bank it was drawn on). Drawing a cheque on one bank, depositing it in another bank just before year-end, so that deposit appears on the bank statement and the recording of the transfer in the receipts is not done until after year-end amounts to kiting. The float period will cause the cheque not to clear the bank it was drawn on until after year-end, and the amount transferred is included in the balances of both bank accounts. Since the transfer is not recorded as a receipt or a disbursement until the following year, it will not appear as an outstanding cheque or a deposit in transit on the reconciliation of either bank account.

The effect is to increase receipts per the bank statement; if the misappropriation of cash receipts and the kiting take place in the same period, receipts per the bank statement will agree with receipt per the cash receipts journal at the date of the bank reconciliation. (If the misappropriation of cash receipts takes place in the period before the kiting, a proof of cash may also reveal the kiting). Kiting requires that the transfer process be repeated continually until the misappropriated funds have been restored. Kiting could have a wider meaning to encompass writing cheques against inadequate funds with the intent of depositing sufficient funds later, but before the cheques clear the bank.

Bank transfer schedule is an effective tool that assists the auditor in ensuring that:

- i. all transfers of funds among bank accounts near the balance sheet date are recorded in the books in the proper accounting period;

- ii. cash has not been double-counted; and
- iii. there is no apparent kiting.

The schedule should indicate, for each transfer:

- i. The date the cheque affecting the transfer was recorded as a cash disbursement;
- ii. The date it was recorded as a cash receipt, the date it cleared the bank it was drawn on; and
- iii. The date it was deposited and cleared in the bank.

When kiting is suspected, the auditor should:

- i. If they are not and the entries are in different fiscal years, an adjusting entry may be necessary to prevent double-counting of cash, depending on the offsetting debit or credit to the entry that was made in the year being audited;
- ii. Compile bank transfers and the client's cash receipts and disbursement records;
- iii. Obtain dates on the bank transfer schedule from the cash records and the dates on the cheque showing when it was received by the bank it was deposited in and when it was paid by the bank it was drawn on;
- iv. Compare date the cheque was recorded as a disbursement with the date it was recorded as a receipt; the dates should be the same;
- v. Compare the bank dates (paid and cleared) with the corresponding dates the transaction was recorded in the books (received and disbursed) for each transfer;
- vi. If those dates are in different accounting periods, the transfer should appear on the bank reconciliation as a reconciling item; and
- vii. Lastly, investigate unusually long time lags between dates recorded and dates for possible holding of cheques at year end - a cut-off problem.

Reviewing Cash Restrictions and Related Disclosures

The auditor should review the evidence previously obtained and, if necessary, perform further procedures to ensure that all appropriate disclosures related to cash have been made. The following may indicate restrictions on the

availability or use of cash that should be disclosed:

- i. Bank confirmations;
- ii. Responses to inquiry letter;
- iii. Loan agreements;
- iv. Minutes of board of directors' meetings; and
- v. Bond indentures.

Inquiry of client management may also indicate the need for disclosures of cash balances that are restricted or the property of others. If the entity has substantial funds in other countries or in foreign currencies, the auditor should determine whether there are any restrictions on their availability and that appropriate disclosures have been made.

5.06 Verification of Fixed Assets

Most businesses use fixed assets, e.g., property, plant, and equipment in the process of generation of income. Expenditure to maintain or improve assets acquired is normal. A major audit consideration is whether such expenditure should be classified as expenses of current period or an addition to the cost of assets.

The general rule is to capitalise expenditure if it will prolong the useful or productive life of the asset into future periods. There should be proper distinction between revenue and capital expenditure. Companies often have policies defining which expenditure is to be capitalized. The auditor must exercise judgement in determining whether the policies are appropriate and being complied with.

Audit Objectives

The audit objectives for fixed assets are :

- i. The fixed assets in the accounts exist;
- ii. The fixed assets are owned or leased under capital leases by the entity;
- iii. No material items were charged to the expense that should have been capitalised;
- iv. Additions and disposals have been duly authorised and accurately recorded;
- v. Cost or other basis of initially recording value is appropriate;
- vi. Appropriate methods of depreciation have been applied, on a consistent basis;
- vii. The carrying value of fixed assets is appropriate in periods subsequent to the

acquisition, considering such factors as utilisation, location and technological changes; and

viii. Assets pledged as collateral are identified and provide audit disclosed.

Verification Methods

Obtain a schedule of each asset showing:

Opening Balance

Review previous year's working papers and the client's records to provide necessary understanding of the accounting principles, policies and methods employed.

Additions

- i. Examine purchase order and other supporting documents;
- ii. Vouch the cost vide invoices, cost includes all expenditures necessary to make an asset ready for its intended use; and
- iii. Vouch the authority for acquisition by review of minutes of the board of directors or other committees to confirm whether major additions were appropriately authorised.

Disposals

- i. Vouch the authority;
- ii. Examine relevant documentation;
- iii. Compare acquisition cost with underlying records, re-compute accumulated depreciation and the resulting gain/loss and balancing charge/allowance;
- iv. Verify proceeds as reasonable;
- v. Pay attention to scrap value;

Depreciation and Other Write Downs

- i. Review client's methods and policies;
- ii. Examine adequacy and appropriateness of policy;
- iii. Vouch authorization policy;
- iv. Vouch revaluations;

- v. Check calculations; and
- vi. Consider changes in business conditions that may warrant reviews of estimated useful life of the assets.
- vii. The stated procedure must agree with the physical assets to the closing Naira values of the assets.
- viii. Internal control procedures as regards additions, disposals, accounting and maintenance of fixed assets are relevant. The auditor should also make use of fixed assets registers.

Presentation, Disclosures and Value

- i. Accounting policies appropriate to the entity must be adopted. This must be consistently applied and adequately disclosed;
- ii. The entity must adhere to relevant Accounting Standards;
- iii. Materiality in the context of the individual company must be considered;
- iv. Proper classification of assets should be done;
- v. There should be proper disclosure and accurate description; and
- vi. Clear distinction between capital and revenue is important. It could be a matter of accounting policy - research and development - or matter of opinion - repair expenditure is a charge against revenue, but may include elements of improvement which is capital.

Other Matters Considered

- i. Letter of representation. Obtain management representation on carrying values and classifications of fixed assets.
- ii. Reasonableness and professional skepticism. Auditors should diligently investigate and seek adequate assurance on the truth and fairness of the financial statements. This he does with professional skepticism. If therefore, he comes across anything that seems wrong, unlikely, unreasonable, or suspicious, he is said to be “put upon enquiry”. In that case, he should diligently investigate the matter and be assured of the truth of the matter.
- iii. Assets pledged as collateral are identified and disclosed, along with other necessary disclosures.

- iv. Appropriate depreciation methods are properly applied, on a basis consistent with the previous year, to all items of assets that should be depreciated.
- v. Taxation. Tax and capital allowances should be in accordance with the asset accounts and the applicable laws.
- vi. Insurance certificates of assets, e.g., motor vehicles, should be examined to provide further corroborative proof of realising audit objectives.
- vii. Assets leased under capital leases by the client are verified and properly described.
- viii. Assets held by third parties are equally included in the balance sheet and properly described.

5.07 Verification of Liabilities

- i. The auditor should approach accrued liabilities with the view, that liabilities are more likely to be understated or omitted from the accounts than overstated. Therefore, audit objectives should focus on ascertaining that accrued liabilities are not understated, but without ignoring the possibility that the opposite may occur.
- ii. The auditor's objectives in examining liability transactions and accounts are to obtain reasonable assurance that:
 - a. All obligations for amounts payable, long-term debt, and capitalized leases and all equity accounts have been properly valued, classified, described, and disclosed;
 - b. All off-balance-sheet obligations have been identified and considered (e.g., operating leases, product financing arrangements, build and operate contracts, etc);
 - c. All liability and equity transactions, accounts, and changes therein have been properly authorised and are obligations of the entity or ownership rights in the entity;
 - d. Interest, discounts, premiums, dividends, and other debt-related and equity-related transactions and accounts have been properly valued, classified, described, and disclosed; and
 - e. All terms, requirements, instructions, commitments, and other debt-related and equity-related matters have been identified, complied with and disclosed, as appropriate.

Substantive Tests of Balances

A convenient way to document substantive tests of liabilities at balance sheet date is obtaining or making detailed schedules of liabilities by categories, showing the movement in each account during the period. The auditor should compare the list with the accounts and reconcile the total to the general ledger. Tests of details of debt and equity transactions and balances consist of obtaining confirmations from third parties, re-performing computations, and examining documents and records. The following are some examples:

i. **Authorization:**

The auditor should trace authorisation to board minutes, or where such authority was delegated, should be traced to the delegated officer's signature.

ii. **Confirmations:**

Confirm debt payable and terms with holder; outstanding stock with holder and registrar; and dividend and interest payable. Ensure the recorded liabilities relate to the values of goods and services received by the entity.

Valuation of Lease Documents

Terms in finance lease must be evaluated to determine whether it should be accounted for as an operating or capital lease. If leases are capitalized, the auditor must test computations of the carrying amounts of assets and debt and compare them with the underlying lease contract.

Rights and Obligations

- i. Ascertain that all accounts payables, accrued expenses and other liabilities are legal obligations of the entity at the balance sheet date;
- ii. Check presentation and disclosure as to amount falling due within or after one year; and
- iii. Consider the description and classification of liabilities in the financial statements. If material loss could arise from unfulfilled purchase commitments, the auditor should identify the commitments and assess

the potential need for a provision. In all, the auditor should ensure compliance with all statutory provisions and other accounting requirements.

5.08 Letter of Representation

Management must explicitly assert the existence, rights and obligations completeness and appropriate presentation, and disclosure in the financial statements. These assertions are made in a letter of representation.

Inclusion of all Liabilities

It is not enough for the auditor to be satisfied that all the liabilities recorded in the books are correct and are incorporated in the financial' statements. Auditors must be satisfied that there are no unrecorded liabilities, transactions or undisclosed items. The auditor should appreciate the possibilities of the existence of undisclosed liabilities. He also has an obligation to take reasonable steps to unearth them.

The auditors discharge these obligations by:

- i. Diligently enquiring of the directors and other officers and by obtaining letter of representation;
- ii. Examining post balance sheet events, where applicable; and
- iii. Examining minutes of meeting of the board and management where the existence of unrecorded liabilities may be mentioned.

Provisions

A clear understanding of the words - provision and reserves - is imperative. The correct usages of these two words are:

Provision - any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

Thus a provision:

- i. Is a debit to profit and loss account reducing profit and therefore deducted
- ii. Is in respect of a likely or certain future payment; and
- iii. Arises where the amount or the rate of payment is uncertain.

Reserve - that part of shareholders' funds not accounted for by the nominal value of issued share capital or by the share premium account.

The need for the creation of provisions is an important consideration for directors who are responsible for the financial statements. Post balance sheet events can often give an indication of the amount of provision required. The auditor has a duty to see that any provisions set up are used for the purpose for which they were set up and that any provisions, which are no longer needed, are written back to profit and loss account. Items should be provided for, only when the company has a firm commitment (not merely an intention) to the expenditure. It should be noted that the only costs to be provided for should be those incremental costs necessary to sort out a past problem. Any costs that will bring benefits in the future should be charged in the future period.

Share Capital

When there are new issues

Share capital is a special sort of liability to a company. When share capital has been issued during the year, auditors should:

- i. Ensure that the issue is within the limits authorised by Memorandum and Articles of Association of the entity;
- ii. Ensure that the issue was subject to directors' minutes and shareholders' approval, where applicable;
- iii. Ascertain and evaluate the system for the control of issue; and
- iv. Verify that the system has been properly operated. This will involve examining the prospectus (where applicable), application and allotment sheets, the share register, cash received records, share certificate counterfoils, and refunds to unsuccessful applicants.

Where Stock Exchange approval was required, the auditors should:

- i. Ensure that permission has been obtained. If it has not been given all the money subscribed is returnable;
- ii. Ensure that all the money is maintained in a separate bank account

- until all conditions were satisfied;
- iii. Ensure that the minimum subscription has been received. If there are not enough subscribers then the whole amount is returnable; and
- iv. Vouch for the payment of underwriting and other fees.

Where there are no new issues

When no new issue of shares has been made, the auditor should:

- i. Determine the total of shares of each class as stated in the balance sheet and obtain a list of shareholdings, which in total should agree with the balance sheet total;
- ii. Test the balances in the share register with the list;
- iii. If this is not possible at the balance sheet date, it may be permissible to do it earlier provided that the auditor is satisfied with the system of control over transfers; and
- iv. Where the share register is maintained by an independent firm of registrars, the auditor should obtain a certificate as to the accuracy and completeness of the shares and their holdings. The certificate should state that the balances on the share registers agree with the issued capital at the balance sheet date.

Accounting Estimates

An important aspect of evaluating the application of accounting principles, particularly as they relate to the valuation objective for many accounts, involves evaluating accounting estimates. Accounting estimates are:

- i. Financial statement approximations that are necessary because the measurement of an account is uncertain until the outcome of future events is known, e.g., uncollectable receivables, obsolete inventory, useful lives of assets, actuarial assumptions in pension plans, and warranty claims; and
- ii. Financial statement approximations that come about in respect of relevant data concerning events which could not be accumulated on a timely, cost-effective basis.

Examples of accounting estimates are:

- i. Allowances to reduce inventory and accounts receivable to their estimated realizable value;
- ii. Provisions to allocate the cost of fixed assets over their estimated useful lives;
- iii. Accrued revenue;
- iv. Deferred tax;
- v. Provision for a loss from a lawsuit;
- vi. Losses on construction contracts in progress; and
- vii. Provision to meet warranty claims.

Management is responsible for making the accounting estimates whilst the auditor is to evaluate their reasonableness. Even when management's estimating process involves competent personnel using relevant and reliable data and the most likely assumptions about the factors that affect an accounting estimate, subjectivity can still creep into those estimates which in turn may lead to bias. As a result, the auditor should evaluate accounting estimates with an attitude of professional skepticism. The auditor's objective in evaluating accounting estimates is to obtain sufficient evidence to provide reasonable assurance that all material accounting estimates have been developed, are reasonable, and are presented and disclosed in conformity with the Nigerian

5.09 Standards on Auditing**Basic Approaches to Establish Reasonableness of an Estimate**

The auditor should use any or a combination of these basic approaches in assessing the reasonableness of an estimate, viz:

- i. Review and test the process management used to develop the estimate;
- ii. Independently develop an expectation of the estimate to corroborate the reasonableness of management's estimate; and
- iii. Review events or transactions occurring after the date of the financial statements (but before the audit is completed) that provide an actual amount to compare the estimate with.

In the application of the approach in (a) above, the auditor should:

- i. Obtain an understanding of the process management established to develop the estimate;
- ii. Assess the inherent and control risks related to management's process for developing the estimate; and
- iii. Identify and evaluate the key factors and assumptions used by management to formulate the estimate.

The following are helpful procedures to identify and evaluate the key factors and assumptions that are unique to auditing accounting estimates:

- I Analysing historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and determining whether it is sufficiently reliable;
- li Considering whether changes in the business or industry or in other facts or circumstances may cause factors different from those considered in the past to become significant to the accounting estimate;
- lii Reviewing available documentation of the assumptions used in developing the accounting estimate, and inquiring about any of the relevant plans, goal, and objectives of the entity; and considering their relationship to the assumptions;
- lv Evaluating whether the assumptions are consistent with one another, with the supporting data, and with relevant historical data;
- V Concentrate on those key factors and assumptions that are:
 - a. Material to the estimate;
 - b. Sensitive to variations; and
 - c. Subject to deviations from historical patterns.
- Vi Considering using the work of a specialist.

When errors or irregularities are found as a result of substantive tests, the auditor should ascertain the reason for them and consider the implications.

5.10 Verification of Intangible Assets

An intangible asset is an asset that is not physical in nature. Examples of intangible assets include Goodwill, licenses, copyrights, patents, mailing lists, trademarks, software, brand

names and so on.

Goodwill

Goodwill is the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets. Separable net assets are those assets (and liabilities) that can be identified and sold (or discharged) separately without necessarily disposing of the business as a whole. They include identifiable intangibles.

Other definitions of goodwill include:

- i. The value attributable to a company's average strength in areas such as technical skill and knowledge;
- ii. The value of the business community's attitudes to the entity; and
- iii. That part of the value of a business which arises from all its advantageous circumstances, which generate earnings above an assumed norm (super profits).

Types of Goodwill

Goodwill can be classified into two,

i. Non-purchased or Inherent Goodwill

All businesses have an element of non-purchased goodwill, in that as going concerns they are worth more (positive goodwill) or less (negative goodwill) than the aggregate of the fair values of their separable net assets.

ii. Purchased Goodwill

Purchased goodwill is goodwill, which is established as a result of the purchase of a business. Purchased goodwill will not always be a positive amount; at some time in the life of a business, its market value may stand at a discount in relation to the fair value of the separable net assets employed. This gives rise to 'negative goodwill'.

Negative goodwill arises from circumstances that are not advantageous to the entity, such as weak markets or marketing.

Factors Contributing to Goodwill

Positive goodwill arises from advantageous circumstances such as an effective management team, weakness of competitors, a prime location or established customers. Other factors that are believed to contribute towards goodwill are good labour relations, a secret or patented manufacturing process, effective advertising, high standing in the society through contributions to and participation in community activities and an excellent reputation for quality and reliability of products. Purchased goodwill will also depend on the acquirer's reasons for the purchase, such as economy of scale, fiscal advantages from tax losses, diversification of risk or combined market dominance and other factors that affect the price such as general economic conditions and cost of financing.

Features of Goodwill

Goodwill is intangible, intrinsic to the business and incapable of realization separate from the business; these characteristics of goodwill distinguish it from most other items in the accounts. Its other characteristics are that:

- i. The value of goodwill has no reliable, predictable relationship to any costs which may have been incurred;
- ii. Individual intangible factors which may contribute to goodwill cannot be valued;
- iii. The value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time; and
- iv. The assessment of the value of goodwill is subjective, in the sense that not only its value but also the assessment of its actual existence is subjective.

Thus, any amount attributed to goodwill is arrived at by estimation to the specific point in time at which it is measured, and is only valid for that point in time, and in the circumstances then prevailing.

Software

Where the amount invested in the development of software has been capitalized as an intangible asset, the risk that amounts capitalized does not meet the criteria for recognition as an asset exists. This would lead to an overstatement of the intangible assets. The recognition criteria as stipulated by IAS 38 should be met in determining costs to be capitalized. Costs incurred in planning and other expenditure before software became

operational must be expensed. It must also be established that the software will generate future economic benefits for the organization.

Audit Objective

The audit emphasis for intangible assets should be on determining that:

- i. The carrying value of the assets can be fully recovered;
- ii. That there has not been permanent impairment of their value; and
- iii. That the remaining period of amortization is appropriate.

On the other hand, the audit objectives of goodwill and related intangible assets accounts are to confirm the assertions by management, explicit or otherwise, embodied in the financial statements as to:

i. Existence

That the goodwill reported in the financial statements through measurement or disclosure exists at the date of the balance sheet. It may be desirable to confirm the existence of certain material intangible assets by direct correspondence with third parties.

ii. Rights and obligations

An asset pertains to the entity at a given date. It must be established that the entity has the rights and obligations associated with the goodwill reported in the financial statements.

iii. Occurrence

A transaction or event took place that pertains to the entity during the period.

For example, the transaction that gave rise to the goodwill occurred within the financial reporting period.

iv. Completeness

There are no unrecorded assets, liabilities, transactions or events, or undisclosed items relating to the matter. For example, all of the entity's goodwill is reported in the financial statements through measurement or disclosure.

v. Valuation

Goodwill is recorded at an appropriate carrying value. Documentation for an account balance seldom provides conclusive evidence of value. Auditors require

extensive judgement to substantiate the values of the intangible asset. For example, the values of the goodwill reported in the financial statements through measurement or disclosures were determined in accordance with the Nigerian Standard on Auditing.

vi. Measurement

A transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period. For example, the amounts associated with the goodwill reported in the financial statements through measurement or disclosure were determined in accordance with the Nigerian Standards on Auditing, and the revenues or expenses associated with the goodwill reported in the financial statements were allocated to the correct financial reporting period.

vii. Presentation and Disclosure

An item is disclosed, classified and described in accordance with the Nigerian Standards on Auditing. For example, the classification, description and disclosure of goodwill in the financial statements are in accordance with the Nigerian standards on Auditing.

Substantive Tests

In performing a substantive test, the auditor should:

- i. Evaluate the desirability of goodwill and determine the need for amortization thereof;
- ii. Quantify the amount of the amortisation where a provision is required.
- iii. Provide details of the calculation of the provision;
- iv. Compare the amount of the provision to the amount established by the entity and quantifies the difference. Summarize the amounts identified;
- v. Obtain a listing of amortisation established at the previous year-end and ensure all significant movements have been reviewed; and
- vi. Discuss findings on the above procedures with management.

Based upon the preceding procedures, the auditor should:

- i. Determine the appropriateness of the client's amortisation of goodwill;
- ii. Review the client's methods and policies of amortization;
- iii. Confirm that the accounting policies applied for determining goodwill

amortization are:

- a) Consistent with those applied in the previous year;
 - b) In accordance with relevant accounting principles; and
 - c) Are appropriately disclosed in the entity's financial statements.
- iv. State whether any exceptions were noted in the steps enumerated above, and if so;
- a. Confirm that they have been recorded on the working papers and that the nature and level of substantive procedures have been amended as necessary; and
 - b. Confirm that all exceptions have been carried forward to the summary of unadjusted differences.
- v. Consider whether the above substantive procedures have provided any evidence that the entity's goodwill amortisation are not fairly stated in its accounts; and
- vi. If there is such evidence, document it and discuss with management.

Disclosure Requirements

- i. The accounting policy followed in respect of goodwill should be properly explained in the notes to the accounts;
- ii. The amount of goodwill recognised as a result of any acquisitions during the year should be shown separately for each acquisition where material;
- iii. Where the amortisation treatment is selected, purchased goodwill should be shown as a separate item under intangible fixed assets in the balance sheet, until fully written off;
- iv. The movement on the goodwill account during the year, showing-
 - a. The cost, accumulated amortization and net book value of goodwill at the beginning and end of the year, and the amount of goodwill amortized through the profit and loss account during the year;
 - b. The period selected for amortizing the goodwill to each major acquisition; and

- c. The abovestated procedures are of equal application to the audit of other intangible assets like patents, trademarks, copyright and franchise

5.11 Debenture Loans and Borrowings

A debenture is a certificate of agreement of loans which is given under the company's stamp and carries an undertaking that the debenture holder will get a fixed return in terms of interest rates and the principal amount whenever the debenture matures. It is a long-term debt instrument used by governments and large companies to obtain funds. It can also be defined as "a debt secured only by the debtor's earning power, not by a lien on any specific asset." A debenture is usually unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties not otherwise pledged. In the case of bankruptcy, debenture holders are considered general creditors.

The advantage of debentures to the issuer is that they leave specific assets burden free, and thereby leave them open for subsequent financing. Debentures are generally freely transferable by the debenture holder. Debenture holders have no voting rights and the interest given to them is a charge against profit.

In auditing, debentures verification is given the same treatment as long term loans.

The following are the verification procedures for debentures:

- i. Request for a schedule of the amounts due at the beginning of the year, additions during the year, and redemptions during the year, and the total sum due at the end of the year;
- ii. Make a record for the audit file the terms and conditions of the debenture loans as evidenced in the debenture deed;
- iii. Agree on opening balances with previous years working papers;
- iv. Vouch for new debenture loans with prospectus, board minutes, memorandum and articles of association, and register of debenture holders;
- v. Vouch payments with debenture deeds, ensure that terms are correctly interpreted, check entries into cash book, and trace repayments to register of debenture holders;
- vi. Interest payments should be checked to debenture deeds; cash book and ensure that the amount paid is agreed to the percentage of the amount outstanding;
- vii. Agree on total amount outstanding with register of debenture holders; and
- viii. Ensure that disclosure is in accordance with the Companies and Allied

5.12 Income and Expenditure

Income

There is a close relationship between income and revenue. In some cases, income is associated with net income which connotes total revenue fewer expenses. Revenue is sometimes associated with nonprofit organizations while income is associated with cash flow derived from business transactions. The amount of money or its equivalent received during a period of time in exchange for labour or services, from the sale of goods or property, or as profit from financial investments may be regarded as income. The International Accounting Standards Board (IASB) "Framework for the Preparation and Presentation of Financial Statements" defines income as "increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants." The IASB definition of income encompasses both revenue and gains. The objective of substantive procedure for income is to confirm the assertions made in the financial is correct, complete, and reported in accordance with the International Accounting Standards and the Statement of Accounting Standards.

The following substantive procedures may be adopted in verifying income:

- i. Obtain schedules of the various classes of income reported in the financial statement; and
- ii. For each of the schedules obtained, carry out the following audit actions:

Sales of Goods

- i. Verify that, the entity has transferred to the purchaser the significant risks and rewards of ownership of the goods;
- ii. Verify that, the entity retains neither continuing managerial involvement to the degree usually associated, with ownership nor effective control over the goods sold;
- iii. Verify that the amount has been measured reliably;

- iv. Verify that it is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and
- v. Verify that the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Interest, Royalties and Dividends

The following substantive procedures may be used:

- i. Verify that it is probable that the economic benefits or service potential associated with the transaction does flow to the entity;
- ii. Verify that the amount of the income has been measured reliably;
- iii. Verify that interest has been recognised on a time proportion basis that takes into account the effective yield on the asset;
- iv. Verify that royalties are recognised as they are earned in accordance with the substance of the relevant agreement; and
- v. Verify that dividends or their equivalents are recognised when the entity's right to receive payment is established.

Disclosure

The requirement should include the following:

- i. Confirm consistency and proper disclosure of the accounting policies adopted for the recognition of income including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- ii. Verify that there is a disclosure of the amount of each significant category of income recognized during the period including income arising from:
 - a. The rendering of services;
 - b. The sale of goods;
 - c. Interest; and
 - d. Royalties.
- iii. Verify that there is a disclosure of the amount of income arising from exchanges of goods or services included in each significant category of income.

Expenditure

Substantive procedures for expenditure aims at ensuring that assertions about expenditure in financial statements are correct, properly recorded and properly disclosed.

The following substantive procedures may be applied in the verification of expenditure:

- i. Obtain schedules of all expenditure in their various classes;
- ii. Obtain specimen signatures of officials mandated to authorise and approve various classes of expenditure;
- iii. Select a representative sample from each class of expenditure for detail substantive testing;
- iv. Verify that each expense is properly authorised and approved including approval limits for each authorizing official;
- v. Verify that expenditure is properly classified;
- vi. Check calculations and additions for all invoices selected;
- vii. Check that value for the expense is received by inspecting delivery documents or performance reports;
- viii. Check entries in expenditure register and verify that they are correctly analyzed;
- ix. Check posting to the general ledger; and
- x. Trace expenditure total to the final accounts.

5.13 Revenue and Expenses

Revenue is the gross inflow of economic benefits or service potentials during the reporting period when those inflows result in an increase in net assets/ equity, other than increases relating to contributions from owners. Revenue includes only the gross inflows of economic benefits or service potential received and receivable by the entity on its own account. Amounts collected as agent of the government or another government organization or on behalf of other third parties are not economic benefits or service potential which flow to the entity, and do not result in increases in assets or decreases in liabilities.

Therefore, they are excluded from revenue. Similarly, in a custodial or agency relationship, the gross inflows of economic benefits or service potential include amounts

collected on behalf of the principal and which do not result in increases in net assets/equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of any commission received or receivable for the collection or handling of the gross flows.

The primary issue in accounting for revenue is determining when to recognize revenue. Revenue is recognized when it is probable that future economic benefits or service potential will flow to the entity and these benefits can be measured reliably.

Substantive procedures for the verification of revenue lay more emphasis on recognition, measurement, classification, timing, and disclosures. Specific classes of revenue may be verified using substantive procedures more suitable for it.

Rendering of Services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the reporting date.

Substantive procedures may include the following:

- i. Verify that the amount of revenue is measured reliably;
- ii. Verify that it is probable that the economic benefits or service potential associated with the transaction will flow to the entity;
- iii. Verify that the stage of completion of the transaction at the reporting date is measured reliably; and
- iv. Verify that the costs incurred for the transaction and the costs to complete the transaction are measured reliably.

Sale of Goods

Substantive procedures may include the following:

- i. Verify that the entity has transferred to the purchaser the significant risks and rewards of ownership of the goods;
- ii. Verify that the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- iii. Verify that the amount of revenue has been measured reliably;

- iv. Verify that it is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and
- v. Verify that the costs incurred or to be incurred in respect of the transaction can be measured reliably.

5.14 Interest, Royalties and Dividends

The following substantive procedures may be used:

- i. a. Verify that it is probable that the economic benefits or service potential associated with the transaction does flow to the entity;
- ii. Verify that the amount of revenue has been measured reliably;
- iii. Verify that interest has been recognised on a time proportion basis that takes into account the effective yield on the asset;
- iv. Verify that royalties are recognised as they are earned in accordance with the substance of the relevant agreement; and
- v. Verify that dividends or their equivalents are recognised when the entity's right to receive payment is established.

Disclosure

Substantive procedures should include the following:

- i. Confirm consistency and characteristics of the accounting policies adopted for the recognition of revenue, including the methods adapted to determine the stage of completion of transactions involving the rendering of services;
- ii. Verify that there is a disclosure of the amount of each significant category of revenue recognised during the period including revenue arising from:
 - a. The rendering of services;
 - b. The sale of goods;
 - c. Interest; and
 - d. Royalties.
- iii. Verify that there is a disclosure of the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

Expenses

Expenses are the economic costs that a business incurs through its operations to earn revenue. Examples of expenses include payments to suppliers, employee wages, factory leases and depreciation. In accounting, 'expense' has a very specific meaning. It is an outflow of cash or other valuable assets from a person or company to another person or company. This outflow of cash is generally one side of a trade for products or services that have equal or better current or future value to the buyer than to the seller. Technically, an expense is an event in which an asset is used up or a liability is incurred. In terms of the accounting equation, expenses reduce owners' equity. Expenses are the decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distribution to equity participants.

Substantive procedures for expenses aim at ensuring that assertions about financial statements are correct, properly recorded and properly disclosed.

The following substantive procedures may be applied in the verification of expenses:

- i. Obtain schedules of all expenses in their various classes;
- ii. Obtain specimen signatures of officials mandated to authorise and approve various classes of expenses;
- iii. Select a representative sample from each class of expenses for detailed substantive testing
- iv. Verify that each expense is properly authorised and approved including approval limits for each authorizing official;
- v. Verify that expenses are properly classified;
- vi. Check calculations and additions for all invoices selected;
- vii. Check that value for the expense is received by inspecting delivery documents or performance reports;
- viii. Check entries in expenses register and verify that they are correctly analyzed;
- ix. Check posting to the general ledger; and
- x. Trace expense total to the final accounts.

5.15 Sales and Purchases

Sales

The audit objective is to ensure that sales invoices are properly authorised, recorded in the books of accounts to avoid understatement or overstatement of sales and delivery made to customers.

The following substantive procedures may be applied:

- i. Verify sales with customer orders;
- ii. Check that invoices are properly authorized;
- iii. Check price charged with official price list;
- iv. Check entries in sales day book with invoices and credit notes;
- v. Verify that the functions of recording sales, maintaining customer accounts, and preparing statements are well segregated;
- vi. Match sales invoices with dispatch notes;
- vii. Check that all sales invoices are recorded;
- viii. Match cash receipts with invoices;
- ix. Verify that sales returns and adjustments are properly recorded and authorized;
- x. Verify that there are proper cut-off procedures and duly complied with;
- xi. Verify that there are proper safeguards to ensure that debtors' statements cannot be altered before dispatch;
- xii. Verify that writing-off of bad debts are properly authorized;
- xiii. Trace sales invoices to summaries;
- xiv. Check summary totals to sales ledger control accounts; and
- xv. Check additions in the sales ledger control accounts.

Purchases

The audit objective is to ensure that all purchases are accounted for, authorised and properly presented. The auditor should adopt the following procedures:

- i. Randomly select a number of invoices and credit notes for detailed checking;
- ii. Obtain specimen signatures of all officials authorised to approve purchases;

- iii. Compile a schedule of the items selected and also the test to be applied;
- iv. Verify that each invoice is supported by a properly signed requisition;
- v. Verify that each invoice is supported by an authorised copy order;
- vi. Verify that each invoice is backed by a goods received notes as evidence of delivery;
- vii. Verify that prices are authorised by the appropriate signatories;
- viii. Re-compute the entries in the invoice;
- ix. Check calculations, extensions, and additions;
- x. Check that invoices are correctly coded for ledger accounts classification;
- xi. Verify that appropriate acknowledgments such as initials or signatures appear on each purchase document;
- xii. Verify that each correct invoice has been passed for payment;
- xiii. Check that each invoice is entered in the invoice register;
- xiv. Check that each invoice has been posted to the purchase ledger account;
- xv. Check for completeness of purchase orders by enquiring into missing numbers;
- xvi. Investigate outstanding orders;
- xvii. Enquire into unmarked Goods Received notes;
- xviii. Enquire into unprocessed invoices
- xix. Check additions of invoice register; and
- xx. Agree invoice register total with purchases total account.

5.16 Wages and Salaries

Following are the substantive tests that may be conducted on these –

Wages

- i. Check gross pay with approved pay rate;
- ii. Check calculation of gross pay with number of hours worked;
- iii. Check that extra hours such as overtime are properly authorized;
- iv. Check calculation of approved deductions;
- v. Trace deductions to check-off ledgers;
- vi. Check totals of wage sheets to wages summary;
- vii. Check additions in the summary sheet;
- viii. Check posting of summary sheet total to wages nominal ledger;
- ix. Check net cash payments to cash book;
- x. Check that there is proper approval for wage payment; and
- xi. Verify that there is adequate procedure for the treatment of unclaimed wages and ensure that this is properly complied with.

Salaries

- i. Verify that the engagement of new employees and discharges have been carried out in line with the organization's policies;
- ii. Check gross salaries to employee records;
- iii. Verify proper authorization of overtime;
- iv. Check calculation of employee salaries including re-computation of deductions;
- v. Confirm receipt of cash paid to employees;
- vi. Confirm payment of salaries through bank transfers to employees;
- vii. Re-compute payroll sheet;
- viii. Trace totals of salary sheets to summaries;
- ix. Check additions of the summary sheet;
- x. Trace summary sheet total to nominal ledger;
- xi. Trace total of net pay to cash book;
- xii. Trace total of deductions to check-off accounts; and
- xiii. Verify that there is proper approval for the payment of salaries.

5.17 Other Income and Expenditure Account Items

Other income refers to income derived from activities not in the normal course

of business of an entity; sometimes called other revenue. Examples are interest on customers' notes, dividends and interest from investments, profit from the disposal of assets other than inventory, gain on foreign exchange, and miscellaneous rent income.

Substantive procedures to verify other income may include the following:

- i. Obtain schedule of classes of other income;
- ii. Verify the sources of the income;
- iii. Verify that the income is properly lodged in the bank and classified;
- iv. Verify that the entity has right to the receipt of the income;
- v. Check posting to the General Ledger; and
- vi. Verify that the income is properly disclosed in the financial statement.

5.18 Audit Documentation

Audit documentation means the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

The International Standards on Auditing (ISA 230), Audit Documentation, emphasizes the following areas as key points for audit documentation:

Objectives of Audit Documentation

- i. The auditor should prepare, on a timely basis, audit documentation that provides:
 - a. A sufficient and appropriate record of the basis for the auditor's report;
 - b. That the audit was performed in accordance with ISAs (International Standards on Auditing) and applicable legal and regulatory requirements.
- ii. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared subsequently;
- iii. Compliance with the requirements of this ISA together with the specific documentation requirements of other relevant ISAs is ordinarily sufficient to achieve the objectives in (b) above.
- iv. In addition to these objectives, audit documentation serves a number of purposes,

including:

- a. Assisting the audit team to plan and perform the audit;
- b. Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220, "Quality Control for Audits of Historical Financial Information;"
- v. Enabling the audit team to be accountable for its work;
- vi. Retaining a record of matters of continuing significance to future audits;
- vii. Enabling an experienced auditor to conduct quality control reviews and inspections in accordance with ISQC 1 (International Standards on Quality Control), "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"; and
- viii. Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements.

Nature of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media.

It includes, for example, audit programs, analyses, issues memoranda, summaries of significant matters, letters of confirmation and representation, checklists, and correspondence (including e-mail) concerning significant matters. Abstracts or copies of the entity's records, for example, significant and specific contracts and agreements, may be included as part of audit documentation if considered appropriate.

Audit documentation, however, is not a substitute for the entity's accounting records. The audit documentation for a specific audit engagement is assembled in an audit file.

The auditor ordinarily excludes from audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Form, Content and Extent of Audit Documentation

The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

- i. The nature, timing, and extent of the audit procedures performed to comply with ISAs
- ii. and applicable legal and regulatory requirements;

Audit procedures performed include audit planning, as addressed in ISA 300, “Planning an Audit of Financial Statements”;

- i. The results of the audit procedures and the audit evidence obtained; and
- ii. Significant matters arising during the audit and the conclusions reached thereon.

The form, content and extent of audit documentation depend on factors such as:

- i. The nature of the audit procedures to be performed;
- ii. The identified risks of material misstatement;
- iii. The extent of judgement required in performing the work and evaluating the results;
- iv. The significance of the audit evidence obtained;
- v. The nature and extent of exceptions identified;
- vi. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained;
- vii. The audit methodology and tools used; and
- viii. It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of the Identifying Characteristics of Specific Items or Matters Being Tested

In documenting the nature, timing and extent of audit procedures performed, the auditor should record the identifying characteristics of the specific items or matters being tested. Recording the identifying characteristics serves a number

of purposes. For example, it enables the audit team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies.

Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested. For example:

- i. For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers;
- ii. For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register);
- iii. For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report);
- iv. For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel; and
- v. For an observation procedure, the auditor may record the process or subject matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

Significant Matters

Judging the significance of a matter requires an objective analysis of the facts and circumstances. Significant matters include, amongst others:

- i. Matters that give rise to significant risks (as defined in ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement”);
- ii. Results of audit procedures indicating:
 - a. that the financial information could be materially misstated, or a need to revise the auditor’s previous assessment of the risks of material miss-

- statement and the auditor's responses to those risks;
- b. Circumstances that cause the auditor significant difficulty in applying necessary audit procedures; and
- c. Findings that could result in a modification to the auditor's report.

The auditor may consider it helpful, to prepare and retain as part of the audit documentation, a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters.

The auditor should document, discussions of significant matters with management and others on a timely basis.

The audit documentation includes records of the significant matters discussed, and when and with whom the discussions took place. It is not limited to records prepared by the auditor but may include other appropriate records such as agreed minutes of meetings, prepared by the entity's personnel. Others with whom the auditor may discuss significant matters include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion. The documentation of how the auditor addressed the contradiction or inconsistency, however, does not imply that the auditor needs to retain documentation that is incorrect or superseded.

5.19 Recording of Departures from Basic Principles or Essential Procedures

The basic principles and essential procedures in ISAs are designed to assist

the auditor in meeting the overall objective of the audit. Accordingly, other than, in exceptional circumstances, the auditor complies with each basic principle and essential procedure that is relevant in the circumstances of the audit.

Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure, that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed to achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure. This involves the auditor documenting how the alternative audit procedures performed were sufficient and appropriate to replace that basic principle or essential procedure.

The documentation requirement does not apply to basic principles and essential procedures that are not relevant in the circumstances, i.e., where the circumstances envisaged in the specified basic principle or essential procedure do not apply.

Identification of Preparer and Reviewer

In documenting the nature, timing and extent of audit procedures performed, the auditor should record:

- i. Who performed the audit work and the date such work was completed; and
- ii. Who reviewed the audit work performed and the date and extent of such review.

The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The audit documentation, however, evidences who reviewed specified elements of the audit work performed and when.

Assembly of the Final Audit File

The auditor should complete the assembly of the final audit file on a timely basis, after the date of the auditor's report. ISQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. As ISQC 1 indicates, 60 days after the date of the auditor's report is ordinarily an appropriate time limit within which to complete the assembly of the final audit file.

The completion of the assembly of the final audit file after the date of the auditor's report

is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Changes may however, be made to the audit documentation during the final assembly process if they are administrative in nature.

Examples of such changes include:

- i. Deleting or discarding superseded documentation;
- ii. Sorting, collating and cross-referencing working papers;
- iii. Signing off on completion checklists relating to the file assembly process;
- iv. Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the audit team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period.

ISQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. As ISQC 1 indicates, the retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report. When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:

- i. When and by whom they were made, and (where applicable) reviewed;
- ii. The specific reasons for making them; and
- iii. Their effect, if any, on the auditor's conclusions.

When exceptional circumstances arise after the date of the auditor's report that require the auditor to perform new or additional audit procedures or that lead the auditor to reach new conclusions, the auditor should document:

- i. The circumstances encountered;
- ii. The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and

- ii. When and by whom the resulting changes to audit documentation were made, and reviewed (where applicable).

Such exceptional circumstances include the discovery of facts regarding the audited financial information that existed at the date of the auditor's report that might have affected the auditor's report had the auditor then been aware of them.

5.20 Revision Questions

1. Explain the form, content and extent of audit documentation in general (15 Marks)
2. (a) What are the objectives of physical inventory verification? (10 Marks)
(b) Enumerate the purpose of test counts in physical inspection. (8 Marks)
3. List and explain the methods of obtaining audit evidence by auditors. (15 Marks)
4. Describe the procedures to be adopted when conducting substantive tests in respect of cash balances. (20 Marks)

MODULE 6

6.00 AUDIT EXECUTION: OTHER CONSIDERATIONS

6.01 Learning Outcomes

On successful completion of this module, students should be able to;

- i. Recognise and analyse the importance of sampling in an audit verification exercise;
- ii. Design an audit sampling frame and apply it in determining appropriate samples for purposes of audit verification;
- iii. Describe the various types of audit risks associated with sampling and their audit implications;
- iv. Design and apply letters of representation for purposes of generating audit evidence;
- v. Indicate the extent to which an audit can rely on the work of other auditors and experts;
- vi. Explain the contents of various types of audit reports and draft samples of such reports

6.02 Audit Sampling Methods

SAS No. 39 defines audit sampling as the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristics of the balance or class (AU 350.01).

Advantages of Statistical Audit Planning

- i. Design efficient samples
- ii. Measure the sufficiency of evidence
- iii. Objectively evaluate sample results

Requirements for Audit sampling Plan

- i. When planning the sample, items to consider include:
 - a. The relationship of the sample to the relevant audit objective
 - b. Materiality or the maximum tolerable misstatement or deviation rate

- c. Allowable sampling risk
- d. Characteristics of the population
- ii. Select sample items in such a manner that they can be expected to be representative of the population
- iii. Sample results should be projected to the population
- iv. Items that cannot be audited should be treated as misstatements or deviations in evaluating the sample result
- v. Nature and cause of misstatements or deviations should be evaluated

The advances of computer aided audit tools have made sampling redundant in many situations, as it becomes possible to test 100% of a population. However, there are still many situations where the only option is to pick an audit sample and test these items to gain some comfort over the population as a whole. Despite sampling being unavoidable during most audits, it is one area that many auditors struggle with.

When it comes to picking the audit sample there are many factors to consider, such as what sampling method to use (statistical vs. non-statistical sampling), how big the sample should be, what the required comfort level is, etc. There can also be some fairly complex mathematics involved if you don't have access to sample size calculators or tables.

This website is all about sampling in the audit. We'll talk about choosing the most appropriate sampling method, picking the audit sample, testing the audit sample and then evaluating the results of the audit sample. Our goal is to help auditors understand sampling within the audit process, to ensure that the work they are performing is valid.

There is no point in spending time picking an audit sample, testing the sample and not having sufficient appropriate audit evidence (e.g. the audit sample may not be representative of the population).

The biggest risk is that the auditor doesn't know that the results of their testing are not valid, and they rely on those results to form an audit opinion. There is also a risk of "over-auditing" by picking an audit sample that is too large - the goal should be to pick and test

the smallest audit sample possible that will lead to statistically valid results.

Although geared up towards financial statement audits and internal audits much of the information contained in this site is appropriate to sampling in general. If you're interested in sampling, please feel free to browse this site and we hope that you find its contents useful!

Statistics simplify these problems by using a technique called sampling. By conducting a statistical sample, our workload can be cut down immensely. Rather than tracking the behaviours of billions or millions, we only need to examine those of thousands or hundreds. As we will see, this simplification comes at a price.

Types of Samples in Audit Execution

The gold standard of statistical experiments is the simple random sample. In such a sample of size n individuals, every member of the population has the same likelihood of being selected for the sample, and every group of n individuals has the same likelihood of being selected. There are a variety of ways to sample a population. Some of the most common are:

- i. Random sample
- ii. Simple random sample
- iii. Voluntary response sample
- iv. Convenience sample
- v. Systematic sample
- vi. Cluster sample
- vii. Stratified sample

6.03 Populations and Censuses

The population of a statistical study is what we're trying to find out something about. It consists of all of the individuals who are being examined. A population can really be anything. Californians, caribous, computers, cars or counties could all be considered populations, depending on the statistical question. Although most populations being researched are large, they do not necessarily have to be.

One strategy to research the population is to conduct a census. In a census, we examine each and every member of the population in our study. For example, every ten years the Census Bureau sends a questionnaire to everyone in the country. Those who do not return the form are visited by census workers

Censuses are fraught with difficulties. They are typically expensive in terms of time and resources. In addition to this, it's difficult to guarantee that everyone in the population has been reached. Other populations are even more difficult to conduct a census with. If we wanted to study the habits of stray dogs in the state of New York, good luck rounding up all of those transient canines.

Samples

Since it's normally either impossible or impractical to track down every member of a population, the next option available is to sample the population. A sample is any subset of a population, so its size can be small or large. We want a sample small enough to be manageable by our computing power, yet large enough to give us statistically significant results.

6.04 Audit Sampling Requires Auditor's Judgement

The goal of an agency audit is to ensure compliance with the client's work standards, evaluate performance and maximize profits. Obviously, no matter how competent the auditor or how sophisticated the collection software, reviewing each account is a physical impossibility. Even if 100 percent of the information could be tested, the cost of testing would likely exceed the expected benefits (the assurance that accompanies examining 100 percent of the total) to be derived. What is required is a sampling of the accounts.

To accomplish this, the auditor needs to examine a representative sample or cross-section of the various type of accounts (e.g., legal, good telephone, skip, payment arrangements, settled, closed) as well a review of the remittance history. How the sample should be selected and how large the sample should be being critical issues for researchers as well as auditors.

According to researchers M. Hanson and P. Hauser, in their article "Principles of Sample Design," "The science of sampling design involves:

- i. looking at the resources available, the restrictions under which one must work, the mathematical and statistical tools available, the accumulated knowledge of certain characteristics of the populations to be sampled; and
- ii. Putting these together to arrive at the optimum design for the purpose at hand.

Hanson and Hauser point out that the overall criterion that should be applied in choosing a sampling design is to design the sample so that it will yield the desired information with the reliability required at a minimum cost; or conversely, that "at a fixed cost it will yield estimates of the statistics desired with the maximum reliability possible."

6.05 Statistical Vs. Non-Statistical Sampling

Simply stated, a sampling plan is non-statistical when it fails to meet at least one of the criteria required of a statistical sampling plan. Auditors should know the requirements of statistical plans, because, by definition, any deviation constitutes a non-statistical approach.

The difference between the two types of sampling is that the sampling risk of a statistical plan can be measured and controlled, while even a perfectly designed non-statistical plan cannot provide for the measurement of sampling risk.

The basic similarity between the two types is that both sampling approaches require the exercise of auditor judgement during the planning, implementation and evaluation of the sampling plan. In other words, the use of statistical methods does not eliminate the need to exercise judgement. In addition, the actual audit procedures performed on the items in the sample will be the same, whether a statistical or non-statistical approach is used. The employment of a statistical plan does not mean the auditor can alter the procedures designed to collect evidence to draw an audit conclusion.

The auditor should evaluate the individual and situational costs and benefits associated with each sampling approach before making a determination. In some circumstances, statistical sampling is more appropriate than judgement sampling. Before deciding whether to use statistical or judgemental sampling, the auditor must determine the audit objectives; identify the population characteristics of interest; and state the degree of risk that is acceptable. After making those determinations, it is advisable to use statistical sampling if

the auditor has a well-defined population and can easily access the necessary documentation. Obviously, if the audit methodology and parameters limit the on-site portion of an agency audit to one or two days, the sample design and size must be a realistic reflection of this time constraint.

It is a fallacy that the "statistical rule of thumb" is to sample 10% of the accounts. There is no such magic number. If the entire population is 10, a 10% sample equals one account -- not very representative. Therefore, it is the absolute numbers, not the percentage that is important.

Statistical Probability Sampling

Accounts to be reviewed during an audit are normally selected through one of the probability sampling methods -- random, systematic or stratified. Probability sampling provides an objective method of determining sample size and selecting the items to be examined. Unlike non-statistical sampling, it also provides a means of quantitatively assessing precision (how closely the sample represents the population) and reliability (confidence level, the percentage of times the sample will reflect the population).

Simple Random Sampling

In auditing, this method uses sampling without replacement; that is, once an item has been selected for testing it is removed from the population and is not subject to re-selection. An auditor can implement simple random sampling in one of two ways: computer programs or random number tables.

I Systematic (Interval) Sampling

This method provides for the selection of sample items in such a way that there is a uniform interval between each sample item. Under this method of sampling, every "Nth" item is selected with a random start.

ii Stratified (Cluster) Sampling

This method provides for the selection of sample items by breaking the population down into strata's, or clusters. Each stratum is then treated separately. For this plan to be effective, dispersion within clusters should be greater than dispersion among clusters. An example of cluster sampling is the inclusion in the sample of all remittances or cash disbursements for a particular month. If blocks of homogeneous samples are selected, the sample will be biased. Remember, an essential feature of probability sampling

methods is that each element of the population being sampled has an equal chance of being included in the sample and, moreover, that the chance of probability is known. Only in this way, is a probability sample representative of a population.

Non-statistical Sampling

Some selection methods can be used only with non-statistical sampling plans.

i Haphazard Selection

In this method, the auditor selects the sample items without intentional bias to include or exclude certain items in the population. It represents the auditor's best estimate of a representative sample and may, in fact, be representative. Defined probability concepts are not employed. As a result, such a sample may not be used for statistical inferences. Haphazard selection is permitted for non-statistical samples when the auditor believes it produces a fairly representative sample.

ii Block Selection

Block selection is performed by applying audit procedures to items, such as accounts, all of which occurred in the same "block" of time or sequence of accounts. For example, all remittances in the month of November, alternatively, remittances 300-350 may be examined in their entirety. Block selection should be used with caution because valid references cannot be made beyond the period or block examined. If block sampling is used, many blocks should be selected to help minimize sampling risk.

iii Judgement Selection

Judgement sample selection is based on the auditor's sound and seasoned judgement.

Three basic issues determine which items are selected:

- i. Value of items. A sufficient number of extensively worked or older accounts should be included to provide adequate audit coverage.
- ii. Relative risk. Items prone to error due to their nature or age should be given special attention.
- iii. Representativeness. Besides value and risk considerations, the auditor should be satisfied that the sample provides breadth and coverage over all types of items in the population.

6.06 Sampling Statistics and the Agency Audit

An agency audit need not be based on a statistical sample to be considered valid. In fact, to

concentrate on a statistical selection method is to miss the point of the agency audit. It is more important to be able to identify areas in need of improvement than to identify the standard deviation of the population mean. It is more valid to address issues of concern than calculate the confidence level of the sampling statistic.

With these goals clearly in view, experienced auditors balance the resource available, the restrictions of each audit, the mathematical and statistical tools available, and his or her accumulated knowledge of the characteristics of the population being sampled and arrive at the optimum audit design for the purpose at hand.

Audit Sampling Procedures

Companies often undergo audits to assure business stakeholders that the company is properly accounting for financial transactions. Audits are internal or external. Internal audits are an informal review for business owners and managers. External audits provide information to outside individuals about the company's financial health. Audits are unable to review a company's entire information. Therefore, auditors use sampling procedures to select information for the audit.

Personal Judgement

Experienced auditors often select samples based on personal judgement and experience. Judgement sampling takes into account the value of the information and the amount of risk when selecting a representative group of financial transactions. Information value sampling requires auditors to select financial accounts with numerous transactions relating to important financial transactions, such as cash transactions or accounts payable. Risk sampling examines the accounts or information where frequent errors may exist. A representative sample is a broad sample that includes enough information to accurately audit the company's financial operations.

Statistical Sampling

Statistical sampling procedures often involve the use of a computer to select information. Procedures include random, interval and cluster sampling. Random sampling involves selecting items out of a list or group. Computer programs will select items with no rhyme or reason for the audit sample. Interval sampling involves selecting audit items in a uniform

manner. Computer programs will select an item after skipping so many in a series. Cluster sampling separates a company's information into groups or "clusters." Clusters will include a large group of information, which auditors can test for accuracy and validity.

Non-Statistical Sampling

Non-statistical sampling procedures include haphazard and block selection techniques. Haphazard selection allows auditors to pick items without using any special technique. Auditors use this method if they believe reaching an accurate representation of the company's financial operations is achievable. Block selection allows auditors to select information from the same time frame or sequence in a company's financial information. For example, auditors may select all inventory purchases for a month or a specific numerical range from the company's information. Auditors must be able to select a large enough sample using block procedures to create an accurate sample

6.07 How to determine Audit Sample Size

According to the Comptroller of the Currency, sampling is a method of utilizing scarce audit resources when the population of items to be tested is large. Although using knowledge and judgement to select a non-statistical sample is acceptable for many audit purposes, statistical sampling provides objectivity in sample selection and greater accuracy when drawing conclusions about the entire population of test items.

Determining sample size takes some patience and the use of a calculator or statistical tables. An auditor must determine the test group's population size and decide what confidence level and expected deviation rate are acceptable.

Determine the following:

- i. Population of items to test
- ii. Statistical calculator (optional)
- iii. Statistical tables (optional)

Guidelines for Determining Sample Size;

- I Define the characteristics of items to be tested to determine the testing population size. Using common characteristics helps ensure that each item in the population has the same chance of selection. For example, the UK National Audit Office recommends using characteristics such as all items included in a payroll report on a given date, or all post or ZIP codes in a given geographic area. Determining the

population size will result in a whole number, such as 534 payroll entries or 271 ZIP codes.

- ii. Establish the confidence level to be applied to the sample results. The Institute of Internal Auditors notes that confidence levels usually range between 90 and 99 percent. The term confidence level refers to an auditor's degree of requirement that the sample will reflect the true values in the population. The higher the confidence level required, the larger the sample size. If an auditor has a high degree of confidence in the effectiveness of the control environment-- usually established through observation, interviews and procedural walk-throughs--the lower the confidence level he will select.
- iii. Use prior year test results or the results from a preliminary sample to determine the sample's expected deviation rate, or confidence interval, to estimate the expected rate of control failure in the population. For example, an auditor may expect a two percent deviation rate of missing sales order forms relative to total orders taken.
- iv. Use the population size, confidence level and expected deviation rate established above to determine the sample size. Use statistical tables or a handheld statistical calculator to perform the calculation. Research Systems and input the population size, confidence level and confidence interval or expected deviation rate to quickly calculate the audit sample size.

6.08 Obtaining the Management Representation Letter

ISA 580, management Representations, requires auditors to obtain written representations from management. The objectives of these representations are to:

- i. Confirm oral representations given to the auditors
- ii. Document the continuing appropriateness of such representations
- iii. Reduce the possibility that there might be misunderstandings concerning management's representations
- iv. Impress upon management that it has the primary responsibility for the financial statements.

As has been described in the preceding sections, a management representation letter

may complement other auditing procedures (for example, in connection with (i) the completeness of identified contingent liabilities and (ii) the existence of mitigating factors in the presence of going-concern problems). In some cases, however, a representation letter may be the primary source of audit evidence. For instance, when a client plans to discontinue a line of business, the auditors may not be able to corroborate this event through other auditing procedures. Accordingly, the auditors should ask management to indicate its intent in the representation letter.

Contents of Management Representation Letter

It is written representations from management, where they pertain directly to financial statement amounts, should be limited to matters that either individually or collectively are considered to be material to the financial statements. Representation letters should be prepared on the entity's stationery, addressed to the auditors, signed by appropriate officers (usually the senior executive officer and the senior financial officer) and dated with the date of auditor's report. In many audits, the auditors will draft the representations, which subsequently become the responsibility of officers who sign the letter.

Effects on the Auditors' report

A management representation letter is not a substitute for any auditing procedures necessary to provide a reasonable basis for an opinion on the financial statements. The representation is a form of documentary evidence from an internal source. Such evidence is judged to have relatively low reliability because of possible management bias. Whether it represents sufficient, appropriate evidence for the matters concerned depends on:

- i. The materiality of the matters concerned, the availability of other evidence and the cumulative effect of the representation and other evidence
- ii. Whether the representations are consistent with such other audit evidence as is available
- iii. The auditor's assessment of management integrity and the degree of professional skepticism appropriate to the engagement.

The refusal of management to furnish a written representation constitutes a Limitation on the scope of the auditor's examination. In such circumstances, the auditors may express a qualified ('except for-scope limitation') or a disclaimer of opinion.

At the same time, the auditors may draw management's attention to the statutory and regulatory provisions that give the auditor a statutory right of access to records and information (Companies Act 2006, s. 499 and s. 500). Also, providing misleading, false or deceptive information to the auditor or failing to provide information requested is a criminal offence under the Companies Act 2006 (s. 501) and the penalty is a fine and/ or up to two years imprisonment.

The proposed ED ISA 580, (Revised and Redrafted) Written Representations, distinguishes between the requirement of the auditor to obtain 'general representations' in respect of management's general responsibilities (for example, that for financial statements in accordance with the applicable reporting framework, and those relating to internal controls) and specific assertions in the financial statements (specific written representations') when the auditor considers it necessary to corroborate other audit evidence. If generally representations are not provided or the auditor doubts their reliability the revised ISA automatically leads to the conclusion that the auditor has not obtained sufficient appropriate evidence resulting in persuasive limitation of scope and a disclaimer of opinion. Specific written representations are in addition to those required in accordance with the other ISAs and are particularly relevant in relation to assertions that involve judgement or intent, or that may not be complete and if not provided would invoke a limitation of scope modification.

A scope limitation may also exist when the auditors are not able to perform audit procedures considered necessary in the circumstance to verify essential data in the management representation letter.

Learning Check

- i. The auditors are required to identify and evaluate events occurring up to the date of report.
- ii. Events occurring after the reporting data can be classified as:

- a. type 1 events, which require adjustment of the financial statements; and
- b. type 2 events, which require disclosure.
- iii. A representation letter obtained from the entity's outside solicitor(s) is the primary means of obtaining corroboration information as to management's assertions in relation to the status of litigation, claims and unrecorded or contingent liabilities.
- iv. The auditors should assess the appropriateness of the going - concern assumption; during the final review. Additional audit procedures must be performed if the company's ability to continue as a going concern is doubtful.
- v. A management representation letter:
 - c. impresses upon management their primary responsibility for the financial statements;
 - d. may be the primary source of audit evidence, where appropriate audit evidence cannot reasonably be expected to exist.
 - e. The auditors should read all minutes of board meetings held during the period under audit and during the period from the reporting date to the end of the audit examination.

6.09 Review and Evaluating Findings

Having completed the substantive audit procedures, before final audit conclusions are drawn and an audit opinion is formulated, the audit is required to carry out a final overall review to ensure that the financial statements are supported by sufficient and appropriate audit evidence. The review will include ensuring that the financial statements are consistent and reasonably presented, and that accounting and other regulations have been complied with. Before formulating the audit opinion, the auditor is required to reconsider the risk and effect of likely material misstatements in the financial statements (as a result of audit procedures undertaken), and whether the audit working papers are competent, support the conclusions drawn and in accordance with all professional requirements.

Convenience Sampling for Auditors

Convenience sampling is a non-probability sampling where the sample is selected from the part of the population that is near to hand. I.e. the sample is selected because it is convenient and readily available. Convenience sampling is also known as "grab sampling" or

“opportunity sampling”. In the vast majority of situations, an auditor cannot draw conclusions about the total population from a convenience sampling approach, because it is not likely to be representative of the population. For example, if an auditor is agreeing with an audit sample of invoices to the purchase ledger, to ensure the amounts/names/etc. agree, they may be tempted to choose the invoices that are on the purchase ledger clerk’s desk, and it doesn’t involve trawling through filing cabinets. This would be an inappropriate use of convenience sampling because:

- i. The clerk may have known the auditor was coming and ensured that those invoices close at hand were all correct
- ii. The invoices close to hand are likely to be recent, and if the clerk knew an audit was imminent may have ensured all recent invoices were correct
- iii. The invoices close to hand may only be from a few suppliers, and hence this sample wouldn’t identify problems with other suppliers
- iv. The clerk you are speaking to may only deal with part of the ledger (certain suppliers)

In this situation, it may be more appropriate to use a random sample or use probability proportional to size sampling. Another example of poor use of convenience sampling is when attending a stock take. If the auditor only tests those items which are easy to count (i.e. are close by, or there are only a few items) then there is the risk that the counters will count those that are easy to count but make up numbers for those that are harder to count. In this case, the auditor should pick a random audit sample of items from the inventory listing (to agree from book to floor), and a random sample of inventory locations (to agree from floor to book).

One situation where it may be appropriate for an auditor to use convenience sampling is when performing a walkthrough to test IT controls. Where an IT system performs certain controls and the auditor can be sure that if the controls work once they will always work as specified, it may be acceptable to pick an item close to hand to use for the sample. In general, auditors should be very careful of using convenience sampling, and where they do use it they should ask themselves:

- i. Is there a good reason that a particular convenience sample should be representative of the population?

- ii Would a random sample from the population deliver the same conclusions as a convenience sample?
- iii Can the question being asked by the auditor be adequately answered by convenience sampling?

Audit Sample and Sampling Risk

Whenever a sampling approach is used (as opposed to testing an entire population) sampling risk is introduced. Sampling risk arises from the possibility that the conclusions that the auditor draws from testing the audit sample may be different from the conclusions that they would draw if the entire population had been tested. In an audit context, we are usually testing a population to determine whether an account balance is materially misstated. Sampling risk can be split into two areas, the risk of incorrect acceptance and the risk of incorrect rejection.

The risk of incorrect acceptance is the risk that the conclusion drawn from the audit sample is that the account balance is not materially misstated when the population is actually materially misstated. The risk of incorrect rejection is the risk that the conclusion drawn from the audit sample is that the account balance is materially misstates, when in reality the population is not materially misstated. Sampling risk can also be thought of in terms of detection risk - the possibility that the audit sample will not detect a misstatement that exceeds the maximum tolerable error (materiality). Detection risk is a planning concept and the auditor specifies it before selecting and testing the audit sample. It is one of the factors that must be considered in determining the sample size. It is easiest to explain this with the help of an example:

If you have a population of 10 items and are selecting a sample of 2 from this population there are 45 possible combinations that you could select. If there is one “bad item” in the population, there are 9 possible combinations that you could select that contain the bad item, or 36 possible combinations that do not contain the bad item. In this very simple situation, the risk of selecting a sample that does not contain the bad item is 36/45 or 80% - far higher than the 10% you might assume given that there is only 1 bad item out of the population of 10.

This example also highlights the impact of the audit sample size on the detection risk. If we sample 3 items, there are 120 possible combinations and 84 possible combinations that do not contain the bad item. In this case, the sampling risk is $84/120$ or 70%. In practice the auditor will specify the level of detection risk that they are comfortable with, and use this to determine the audit sample size.

Probability proportional to size sampling

Probability proportional to size sampling is also known as monetary unit sampling or dollar unit sampling. It is a method of sampling that takes the varying size of each item within the population into account when selecting the audit sample. The audit sample size is calculated based on the population itself and risk factors such as materiality, expected error and required reliability level (these are judgemental factors that the auditor sets based on the engagement and specific risks). The sample size is then used to calculate the Sampling Interval, which is $\text{Population}/\text{Sample Size}$. Note that the population is the sum (total) of the “Amount” column, not the number of items in the population.

Each Dollar/Pound/Euro/Monetary Unit within the population then has an equal chance of being selected in the audit sample. There are various different ways of selecting the sample, and the 2 most common are Fixed Interval and Cell Selection Method. In Fixed Interval, a random starting point is selected (between 1 and the sampling interval), and this is the first “Dollar” selected. The count is then incremented by the sampling interval to select the next and subsequent items for the audit sample. This is best explained with an example. Here we have a population of 10 items, with a total value of 1200, and we have a sample size of 3:

Table 6.1 Sample selection interval

	Value	Cumulative Total
Invoice 1	100	100
Invoice 2	34	134
Invoice 3	23	157
Invoice 4	403	560
Invoice 5	108	668
Invoice 6	78	746
Invoice 7	61	807
Invoice 8	19	826
Invoice 9	285	1111
Invoice 10	89	1200

Source:

Author's compilation

The sampling interval is 400 ($1200/3$), so we'd pick a random start point between 1 and 400, let's say 263 (in reality you would use a random number generator to pick this start point).

So our first item selected would be Invoice 4, as the cumulative total for 263 lies within item 4. The second sample item would be at 663 ($263+400$), or Invoice 5. Our final item would be at 1063, so Invoice 9. When the Cell Selection Method is used the population is split into "Cells", which are the same size as the sampling interval, and a random Dollar is picked from within each cell. In the above example, a random Dollar would be selected from the first cell (1-400), another from the second (401-800) and the final from 801-1200. So, you might for example select Dollar 102 (Invoice 2), Dollar 799 (Invoice 7) and Dollar 820 (Invoice 8).

When there are large items in the population (larger than the sampling interval), these are usually extracted first and will definitely be selected for testing. The remainder of the audit sample is then selected using either cell selection or fixed interval. In the above example, Invoice 4 would be considered a large item and would be stripped out. Once the audit sample has been selected, the auditor then tests the items and records any difference between the books (recorded) value, and the actual value. These differences are then extrapolated over the population to provide the auditor with estimated error levels.

Audit Risk Assessment

Audit risk assessment is a stage in the audit planning process. During the assessment, an

auditor determines the likelihood of audit risk, defined as the possibility of recording an inappropriate opinion on an audit as a result of a misstatement in the financial documents examined. Audit risk assessment is part of the series of controls which are used to manage the integrity of an audit, and to determine when and how audits should be conducted, and by whom.

While many people fear audits from tax authorities, they are actually a valuable tool when used internally. During an audit, a company can identify financial issues such as funds where they shouldn't be, abnormal numbers, signs of fraud or theft, and so forth. Auditing is used to control costs, to ensure that accounting is accurate, and to hold employees accountable for their activities. It can be performed across an entire company, or in specific departments. Audit risk consists of several components. The first is the likelihood that a material misstatement will be made in financial documents.

The second is the risk that the misstatement will not be caught by internal controls, and the third is that the misstatement will not be caught by an auditor. These components are examined during an audit risk assessment to come up with a numerical score that can be used to make decisions about the auditing process.

If the audit risk is high, it may indicate that audits should be performed more frequently, to increase the chance that errors and misstatements will be caught. A high audit risk may also suggest that it may be time to change some of the factors to lower the risk.

For example, an auditor could recommend changes to internal controls which would lower the risk by increasing the chances of catching a misstatement internally. Risk-based auditing is an approach to audit management that is informed by an audit risk assessment. It's important to remember that the assessment is not an audit; the audit still needs to be completed, keeping the findings of the assessment in mind. In addition to being valuable for internal accounting, regular audits can also be useful from a customer relations standpoint. People tend to trust businesses that perform regular audits more, as auditing demonstrates a commitment to ethical standards. In some regions, internal auditing and transparency in the auditing process may be legally required of companies that wish to be traded publicly.

- i. Risk-based auditing is an approach to audit management that is informed by an audit

risk assessment. It's important to remember that the assessment is not an audit; the audit still needs to be completed, keeping the findings of the assessment in mind.

- ii. Though this determination provides a definitive starting point in risk assessment, this tool is certainly not dispositive of actual audit risk. During the planning stages of an audit, auditors typically will assess the various factors that can increase or decrease the audit risk associated with a particular engagement
- iii. A company's internal controls are commonly a review area during an audit risk assessment. Controls that are too lax or non-existent are often red flags for increased audit risk.

Risk-based auditing is an approach to audit management that is informed by an audit risk assessment. It's important to remember that the assessment is not an audit; the audit still needs to be completed, keeping the findings of the assessment in mind. Internal Audit Risk Assessment can be enhanced by:

- i. Address the organisation's strategic risks.
- ii. Target emerging risks.
- iii. Focus more on cyber-risks
- iv. Address management and audit committee expectations

6.10 Management Representation Letter

This is a letter written by a company management which attests to the accuracy of an audit. In this letter, management confirms that all information contained within the company's financial statements is true and accurate and that all information has been disclosed. As discussed earlier, [Audit Process for Non-public Audits] that SAS No. 85, "Management Representations" (AU 333), requires that the auditor obtain written representations from management. Here I post a management representation letter example.

Example of a Management Letter

XYZ FOODS AND DRUGS LTD

[Date]

To [Independent Auditor]

We are providing this letter in connection with your audit(s) of the [identification of

financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the [consolidated] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the [consolidated] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgement of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [as of (date of auditor's report),] the following representations made to you during your audit(s).

- i The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
- ii We have made available to you all—
 - a. Financial records and related data
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
- iii There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
- iv There has been no:
 - a. Fraud involving management or employees who have significant roles in internal control.
 - b. Fraud involving others that could have a material effect on the financial statements.

- c. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
- v. The following have been properly recorded or disclosed in the financial statements:
 - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
 - b. Guarantees, whether written or oral, under which the company is contingently liable.
- vi. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, "Disclosure of Significant Risks and Uncertainties."
- vii. There are no—
 - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, "Accounting for Contingencies."
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- viii. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
- ix. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

6.11 Using the Work of an Auditor's Expert - ISA 300

Planning an Audit of Financial Statements sets out the matters that an auditor should

consider, prior to the identification and assessment of the risk of material misstatements. One of these matters is the involvement of experts.

ISA 500

Audit Evidence confirms that if the information to be used as evidence has been prepared using the work of a management's expert, then the auditor should:

- i evaluate the competence, capabilities and objectivity of that expert
- ii obtain an understanding of the work of that expert evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Clearly, if the preparation of an entity's financial statement has required input from an expert, then the competence of the expert and appropriateness of the work carried out are important considerations when assessing the risk of material misstatement. ISA 500 does not refer to the work of an auditor's own expert as there is no correlation between the work of that expert and the risk of material misstatement in the financial statements.

ISA 620

Using the Work of an Auditor's Expert defines an auditor's expert as: 'An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.' Auditors are experts in accounting and auditing matters, but they are not reasonably expected to be experts in any other field. However, candidates should appreciate that in certain situations auditors do need to employ their own expert in order to decrease the risk that material misstatement will not be detected. Such expertise may be required in relation to such matters as:

The valuation of and buildings plant and machinery

An auditor's expert needs to be competent, capable and objective if their services are to be

deemed adequate for the audit purpose:

Competence - this relates to the nature and level of expertise of the expert. Clearly, any expert employed should have widespread recognition of their expertise in the stated discipline.

Capability relates to the expert's ability to exercise that competence in the circumstance of the audit engagement. For example, the expert must have the time and resources available to perform the task in hand.

Objectivity

This relates to the possible effects that bias, conflict of interest or the influence of others may have on the judgement of the expert. If an expert has a vested interest in expressing anything other than an objective opinion with regard to the subject matter, then their opinion will be of no value to the auditor.

If an auditor's expert does not fulfill the requirement in respect of each of the above attributes, the risk of error or inaccuracy in the work carried out is increased and therefore.

The objective of minimising the risk of not detecting material misstatement may not be achieved. Consequently, the auditor's quality control procedures should ensure that internal experts (who are part of the audit engagement team) are capable, competent and objective.

Where an audit firm is seeking to engage a new internal expert, or alternatively rely on the services of an external expert, information about the competence, capability and objectivity of the expert may be sought from various sources. These include:

- j. personal experience with previous work of the expert
- k. discussion with the expert
- l. discussion with other auditors who are familiar with the expert's work
- m. knowledge of the expert's qualifications, membership of a professional body or industry association, licence to practise, or other forms of external recognition published papers or books written by the expert.

6.12 Audit Reports

The auditor's report is a formal opinion, or disclaimer thereof, issued by either an internal

auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on a legal entity or subdivision thereof (called an "auditee"). The report is subsequently provided to a "user" (such as an individual, a group of persons, a company, a government, or even the general public, among others) as an assurance service in order for the user to make decisions based on the results of the audit. It is important to note that auditor's reports on financial statements are neither evaluations nor any other similar determination used to evaluate entities in order to make a decision. The report is only an opinion on whether the information presented is correct and free from material misstatements, whereas all other determinations are left for the user to decide.

Unqualified Opinion

An opinion is said to be unqualified when the Auditor concludes that the Financial Statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the Financial Statements.

An Auditor gives a Clean opinion or Unqualified Opinion when he or she does not have any significant reservation in respect of matters contained in the Financial Statements. The most frequent type of report is referred to as the "Unqualified Opinion", and is regarded by many as the equivalent of a "clean bill of health" to a patient, which has led many to call it the "Clean Opinion", but in reality it is not a clean bill of health, because the Auditor can only provide reasonable assurance regarding the Financial Statements, not the health of the company itself, or the integrity of company records not part of the foundation of the Financial Statements.

This type of report is issued by an auditor when the financial statements presented are free of material misstatements and are represented fairly in accordance with the Generally Accepted Accounting Principles (GAAP), which in other words means that the company's financial condition, position, and operations are fairly presented in the financial statements. It is the best type of report an audit may receive from an external auditor.

An Unqualified Opinion indicates the following -

1. The Financial Statements have been prepared using the Generally Accepted Accounting Principles which have been consistently applied;
 - (1) The Financial Statements comply with relevant statutory requirements and

regulations;

- (2) There is adequate disclosure of all material matters relevant to the proper presentation of the financial information subject to statutory requirements, where applicable;
- (3) Any changes in the accounting principles or in the method of their application and the effects thereof have been properly determined and disclosed in the Financial Statements

There are four common types of auditor's reports, each one presenting a different situation encountered during the auditor's work. The four reports are as follows:

An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor's report is "essentially worthless" for investing purposes. An audit report is a summary of accounts submitted by either an external independent auditor or internal audit officer. It contains the findings of an audit done on the financial records of a company. This report is a significant tool used in evaluating whether quality standards are met by the company.

An audit report is a financial report issued by the auditor that expresses a high level of assurance of the validity and accuracy of a firm's financial information and conformity with accepted accounting practices.

6.13 Review Questions

1. Of what significance is the use of statistical sampling in general to the work of auditors? (15 Marks)
2. Using cash counting procedures as an example explain the process of sampling application in audit and the risks involved (12 Marks)
3. Use ISA 300 as a reference point to discuss the conditions under an auditor can use and rely on the work of other experts (10 Marks)
4. Auditors may require letters of representation in support of evidences coming from management. Requirement;
Use any suitable example to draft a sample of such a letter (18 Marks)

MODULE 7

7.00 AUDIT EXECUTION: COMPUTER INFORMATION SYSTEMS (CIS) AUDITING

7.01 Learning Outcomes

On the successful study of this module, students should be able to:

- i. Plan and describe the audit procedures that are appropriate in a computer data processing environment;
- ii. Evaluate the specific challenges auditors usually face with regards to controls and audit trail when working with computerized accounting records;
- iii. Describe the procedures that can be adopted to achieve successful compliance and substantive testing procedures under EDP conditions and
- iv. Design and apply measures to assess the types of administrative and application controls required to effectively guarantee audit quality under EDP conditions.

7.02 Electronic Auditing - The Nature and Development of E-Commerce

This is the form of the conceptual framework of the information economy, e-Commerce activities can be regarded as an integral process of the modern economy, which combines the layers of the structure, applications and intermediaries to achieve the optimum performance of business transactions. E-Commerce has tremendous scope for strategic impact across an enterprise. The extent to which it is adopted across functional departments on the form; and nature of the enterprise and the commercial environment within which it operates. The function affected by e-Commerce may include product development, resourcing, promotion, marketing, sales, contractor, finance, transaction processing, system procurement, transport and logistics, accounting and administration, financing reporting and insurance. Thus, to appreciate its impact, we must understand the strategic implications of e-Commerce.

The core of e-Commerce lies in its commercial transaction cycle. Surrounding this core is the use of electronic methods to advertise and promote products; the facilitation of contracts, market intelligence and sales support. The full development of e-commerce requires giving users certain guarantees in respect of privacy, information, security and

integrates. Managers of organisation need to assess the strategic impact of e-Commerce.

They must possess the business knowledge that helps them to assess the best strategy as well as gauge the knowledge of competitors and the changes in the market. They will rely on the following core information resource to identify the relevant strategic implication:

- vi. Human resource and management embody corporate knowledge, intellectual property and project/product-based knowledge. Having knowledge of its human resources can help an entity formulate policies relating to its workforce. Skilling, staff recruitment and retention policies and supporting structures.
- vii. Marketing and product knowledge encompasses knowledge of the value chain concept, production costs, productivity, competitive dynamics, partnerships, market locations, operational strategies and workplace support.
- viii. Infrastructure and structural comprises support activities used in Porter's value chain. An entity's infrastructural includes firm infrastructure such as accounts, finance and quality management; technology development and procurement; physical processes such as inventory; data storage; product development; hardware, software and electronic data links, and security system.
- ix. The customer/supplier element concerns all the entity's interactions with customers, prospective, prospective markets, suppliers and banks, along with its relationship enhancement programmers and databases.

E-commerce builds on the structures of traditional commerce by adding the flexibilities offered by electronic networks. In turn, electronic networks create new opportunities so commercial transactions can be conducted more efficiently, involving more interactive activities among interested groups and using more innovative processes. This section discusses the nature and development of e-commerce with a view to identifying the implications for auditors.

7.03 The Evolution of E-Commerce

With its fast-developing features, e-Commerce has evolved through many forms and there is little agreement on what constitutes it. For some time, large business enterprises have used e-Commerce to conduct their business (B2B) transactions. Electronic data interchange

(EDI) on private networks began the 1960s, and banks have been using dedicated networks for electronic funds transfer (EFT) for almost as long.

However, with the increased awareness and popularity of the internet, e-Commerce now also encompasses individual customers in business-to-consumer (B2C) transactions with businesses of all sizes. E-Commerce can be defined as the use of electronic networks to facilitate commercial transactions. It includes:

- i. On-line purchasing of tangible and intangible products, including on-line ordering (with or without online access to catalogues) and direct delivery to the customer, bypassing traditional retailers. Such activity includes the sale of intangible and digitized content of items where payment and delivery are made via the personal computer at home.
- ii. Online advertising and marketing for purposes of promoting sales.
- iii. Fund management and transfers via the Internet.
- iv. On-line transactions and information transfers between information aggregators and intermediaries, including business-to-business transactions such as telecommunications systems, facilitating hardware and software, Internet access services, information accreditation agencies and on-line service providers.

Specific themes in E-Commerce

To help managers evaluate their business positions, Merrill Lynch identified specific themes that tend to characterize electronic marketplaces. These themes can be described as improved customer status, low entry barriers, the disintermediation of business processes and the scaling of matters. Let us look at these in more details.

- i. Customers are powerful on the Internet because they can gather and demand information about rival products.
- ii. Entry to the market is relatively easy; although a real cost is the cost of sustainable development.
- iii. Intermediaries, such as the distributor, can be easily eliminated, to be replaced by new intermediaries, who find products and aggregate resources for potential customers.
- iv. Because of the incremental cost of the incremental transaction is

negligible, matters are scaled to allow for the incremental transaction.

Different business models of e-Commerce

There broadly two types of e-Commerce business-to-business and business-to-consumer. For purposes of simplicity, we will not discuss the regulatory aspects, such as online filing of tax returns. Business-to-business applications include the sell side where goods or services are sold to business customers to create revenue. These applications provide the capability to integrate inventory and production systems with ease of use and access. They buy-side focus on helping enterprises is make procurements and these applications are designed primarily for internal staff so they can process spending and acquisitions more efficiently. Marketplace applications bring together both sell and buy sides using a community of network and common resources.

Business-to-consumer's commerce is considered secondary to Business-to-business commerce in terms of volume. The impact of Business-to-business applications can be seen in the volume of digital content available free of charge to the public. The offer of on-line content is mostly a complement physical form of business, with some providers offering additional advantages from online transacting. Common applications are travel reservations, banking, insurance, online securities trading and investment, and retail such as books, compact discs, apparel and cars. However, in many cases, e-Commerce in consumer markets encounters impediments to its growth, including concerns regarding the security of payment, the potential for the fraud, the privacy of personal data and problems in assessing on-line merchants. The take-up in the market for business-to-consumer transactions has been slow, and its future development depends on a maturing a generation who possess a strong familiarity with information and communication technologies.

7.04 Disintermediation and the Emergence of Intermediaries

The Internet can effectively remove bottlenecks (as represented in the intermediaries such as distributors), so it stimulates disintermediation by decreasing search costs, reducing user entry barriers and automating activity. Enterprises are bypassing the need for sales representatives and costly house calls; for example, Encyclopaedia Britannica effectively disintermediated its door-to-door sales force when it offered its product over the Internet. Internally, people can share information and corporate knowledge more readily and act on

it more quickly through the Internet and intranet. Consequently, adjusting systems to take disintermediation into consideration may prove essential to sustaining a competitive advantage in the long term.

7.05 Audit and Assurance Service

Electronic commerce provides organisations and enterprises with new tools and techniques for reducing costs, communicating more effectively, promoting and increasing sales, and improving operational efficiency and effectiveness. To keep pace with the electronic revolution in business, auditors must acquire an understanding of new technologies. New audit approaches should be developed to ensure the enterprise's e-Commerce objectives are achieved in an adequate manner. For independent auditors, entity's e-Commerce environment will most likely require electronic audit tools. Audit plans must be developed to understand the e-Commerce characteristics and its limitations. Internal auditors, on the other hand, must be fully involved in the e-Commerce system from the outset of implementation to maintenance and support. Both types of auditor are also concerned with the reliability of the management and financial reports generated on the e-Commerce transactions. The e-Commerce environment opens up enormous opportunities for professional accountants in the range of assurance service they can provide. Types of audit and assurance services related to the e-Commerce environment are described below. Note, however, that the following discussions pertain to professional services whose scope is beyond the financial statement audit.

7.06 Risk Analysis

Enterprises and organisations may choose to participate in different levels of e-Commerce activities. Lower involvement is about a basic network presence, entity promotion, and presales and post-sales support. These services often rely on Web hosting services, which are convenient and cheap for small enterprises. They typically provide the speed, reliability and scalability of the powerful Web server but with minimal administrative support. The more advanced e-Commerce services are used by expanding enterprises that are concerned with building customer base and retaining relationships with existing customers. Control systems, technical support and an understanding of the technical aspects, together with legal and cultural developments, are essential.

At the information-sharing stage, a professional accountant may add value by conducting a risk analysis, security and operational issues are the key aspects of risk analysis, an enterprise initiating an e-Commerce system must determine how it is going to assure the confidentiality of information such as prices, inventory quantities and other trading data of value to competitors, the integrity of the transaction details must be maintained so only authorised personnel have access to the identity of customers and users and so the transmission of data is secured and not vulnerable to tampering.

The key operational concern is that investment in e-Commerce should be justified from a cost and strategic perspective. Web site design issues such as speed, currency of information, follow-up of enquires, excessive information, lack of resources and inability to protect customers from intruders are the related risks. E-Commerce risks can be classified to include: strategic risk, economic risks, reliability risk, description risk, image risk, legal risk and moral risk. Strategic concerns the use of the Internet to gain a complete advantage. Economic risk refers to the justifiable returns on the cost of investment in e-Commerce. Reliability risk is about the adequacy of a well-tested and monitored e-Commerce system. Disruption risk relates to the probability of the integrity of the system being disrupted. Image risk arises from the fear of hackers vandalizing the Web sites and requires proof that security measures are competent and protected. Thus, legal compliance and attention to staff capability are necessary to overcome such risks in implementing e-Commerce.

7.07 System Selection and Justification

The professional accountant or auditor should be involved during the early stages of the e-Commerce project by performing reviews of the proposal internal control systems, carrying out pilot tests, assessing the e-Commerce business model and participating in project management. Specific areas for assessment include the proposed communication system, the network data generation and maintenance system, access controls, change authorization and controls; the professional accountant should ensure that the model details the financial resource needed to implement the staffing, technical and equipment requirements. The business model should also identify the strengths and weaknesses (or risks) of e-Commerce, detailing the changes that the business processes will undergo and

the expected timing or staging of those changes. The model should also consider working conditions, job specifications, and the physical layout of office and operational areas. The professional accountant should assess how well the emerging e-Commerce model will interact with future business models or existing ones during the transactional period.

Project management tasks should include verifying that the organisation has established a skilled project team representing the entity's and information technology personnel. The team must have a thorough understanding of the legal and security implications of the proposed system. Interactions with other business partners may also be essential when shared knowledge and linked networks are involved.

Customer service

Interactions with customers are an essential part of e-Commerce. Applications should be as self-service oriented as possible. Customer's service may include user's ability to:

- v. Review the database to identify changes in personnel information, banking instructions and so on;
- vi. Enter their own orders and receive confirmations;
- vii. Carry out claims on-line speedily;
- viii. Propose changes to delivery dates and order quantities, with amended confirmations;
- ix. Review the transaction/account status;
- x. Access accounts receivable details;
- xi. Search for, request and download on-line information and documentation;
- xii. Download reports.

The system should be able to review pricing and other procedures for follow-up inquiries by customers.

Security Reviews

The professional accountant carrying out security reviews should procedures examine procedures surrounding the confidentiality of data, transmission of information, periodical reconciliation procedures, authenticating procedures and the arrangements with outside contractors such as information aggregators and brokers? He or she should

also conduct server security reviews. Web-based information may be certified using producer such as “Web trusts”. The examination of on-line security is an ongoing procedure, which sometimes becomes part of the on-line auditing.

7.08 On-line Audits

The professional accountant may provide an on-line audit. Such an audit evaluates the likely acceptance of on-line sites or services among targeted users. It includes:

- i. On-line market analysis and overview;
- ii. Technology evaluation;
- iii. On-line content audit;
- iv. Target audience identification and analysis;
- v. Site upgrade and enhancement recommendations;
- vi. Traffic monitoring and server log analysis.

The components of an on-line content audit comprise the content or service offering, review of the competitors’ content or service offering, a site review with the entity joint audit with a review questionnaire and recommendations for content or service improvements. An on-line audit is appropriate both before and after a Web site for on-line service is build. It involves checking each on-line activity against set goals to provide for specific and actionable recommendations in terms of communication, security and customer relationships.

The on-line auditor should be familiar with software copyright information and ensure compliance is achieved. Audit software is available in the market for auditors to integrate entities; systems with that of the auditor’s so they can interact on-line. Based on Microsoft Access, Audit Leverage is an example of a package designed for internal auditors.

This audit software enables all audit work to be done on-line.

Maintenance and Monitoring

The professional accountant’s review should confirm that the enterprise is monitoring its Web site performance in terms of criteria such as download time, transaction time, availability and access. Errors such as failed connection, missing information or pages and

broken links must be listed and investigated. The accountant may use or prepare comparative Web performance statistics to evaluate overall performance. Also relevant is a view of other Web information to ascertain its currency, the accuracy of management reports and data for analysis.

The accountant may recommend a reference material repository. This is a part of the Web site that contains information related to the business cycle, econometric reports and forecasts, industry trends, media releases and/or links to other relevant Web sites. The presence of the repository may enhance customer relationships and maintain competitive advantage.

Internal Control Audit

This is a typical audit examination of the adequacy of internal controls within the e-Commerce environment. The audit may encompass the control environment, the control features relating to transaction details and transaction security, risk assessment and controls to minimize such risks, information and communication technology, and the competency and sufficiency of human resources. The approach to this audit is similar to that for normal business; only the audit or examination focuses more on the risks associated with e-Commerce.

Continuous Audit

Continuous auditing was named one of the top five emerging issues for 1999, selected by the task force charged with defining the American Institute of Certified Public Accountants Top Technology Lists. The electronic revolution has created a demand for more timely assurance on a broader range of information than that provided by the annual audit of historical financial statements. In a continuous audit, entity information would be released in a very short time frame (via the Internet) and audit reports on that information would follow the release of the information almost immediately. Thus, a continuous audit is a process or method that enables independent auditors to provide written assurance on a subject matter using a series of auditors' reports issued simultaneously with, or a short time after, the occurrence of events underlying the subject matter. It would be conducted on continuous financial and nonfinancial information made available to users in formats defined by management.

Auditors could be requested to audit continuously and report on:

- i. Financial statements available on-demand via Web site.
- ii. Specific financial information in conjunction with a debt covenant agreement.
- iii. Compliance with published policies and practices regarding e-Commerce transactions (for example, reliance on secure encrypted systems for credit card processing)
- iv. The effectiveness of controls operating in key systems or processes.

A continuous audit presents a number of auditing issues. There would be little time for the auditors to gather audit evidence in verifying and substantiating the subject matter (s) concerned. The auditors could not rely on normal audit procedures and as obtaining independent confirmations and addressing material misstatements, so a reliable and well-controlled application system would be vital. The auditors would have to employ fully automated audit software such as IDEA or ACL to read, manipulate and generate the information required. Other conditions necessary to ensure a successful continuous audit would be:

- I. Effective communication (and technology) between the entity and the auditors
- li. Prior agreement as to the form, content and scope of the audit
- lii. A sound knowledge by the auditors of the operating systems employed by the entity.

The above discussion examined the e-Commerce environment in terms of the implications of e-Commerce and the related strategies and business processes. The above introduction to e-Commerce audit and assurance service enables the emerging role of the accountant in this environment to be appreciated.

7.09 Audit Risk and Control Considerations

In view of the increasing likelihood that auditors will be working in an Internet-driven environment, this section offers a framework for the conduct of auditing and assurance services in e-Commerce. IAPS 1013, Electronic Commerce - Effect on the Audit of Financial Statement, provides the backbone of this section. It describes the skills and knowledge required of auditors in establishing the knowledge of the business and its internal control

and assessing the risks of material misstatements. Where other parties are involved (for example an outsourced party in the electronic transaction cycle), further considerations will be necessary to evaluate the security infrastructure. IAPS 1013 identifies five areas of concern for the auditor. They are skills and knowledge, knowledge of the business, risk identifications, internal control considerations, and the effect of electronic records on audit evidence. Each of these areas is discussed below.

7.10 Origin of Computer Audit

The absence of a common definition of computer audit may, in part, be due to the relative newness of computer audit. The history of traditional auditing or inspection can be traced back many hundreds of years. In contrast, computer audit is a relatively recent development. It was not until the late 1970's that the majority of major organisations in the UK established a computer audit capability for the first time. The use of IT in business is also a relatively recent development. The father of modern day computing is generally regarded as being Charles Babbage, who produced his Difference Calculator in 1833. It was not until the outbreak of the Second World War and the widespread development of valve technology, that the 1st Generation computers were used. Even then, it was many years later that they became common place in business.

Definition

Computer audit" can mean many different things to different people. What may be regarded as computer auditing in one organisation, and very much the realm of the specialist computer auditor, may be undertaken by business auditors in another similar organisation. For example, computer audit may be restricted to auditing systems software in one organisation, whilst areas such as auditing systems under development may be the responsibility of the business auditor. Similarly, in some organisations, it is not uncommon for the role of computer audit to be extended to include the review of clerical procedures and the production of compliance-based audit work programmes for field auditors, thereby providing a wider systems audit service.

A key feature of many organisations today is change. Although not necessarily the driver of

change, IT is invariably an intrinsic component and much of the change would not be possible without IT. IT has had a major impact on social, economic and political factors throughout the world. Not only has it led to the creation of new professions but it has also revolutionised others, such as office work, or, when combined with robotics, manufacturing industries. Computer audit operates in a climate of constant and rapid change. Computer auditors are continually faced with the prospect of faster, smaller and cheaper IT systems.

Nature of Computer Audit

Although an IT system may achieve the same end result as a manual system, the way in which it does so, and hence the level of security and control required, can differ considerably. There are a number of significant risks associated with the processing of IT systems. It is important, therefore, that high standards of security and control are maintained to minimise the potential impact on the organisation. Computer fraud and abuse can have a detrimental effect on an organisation. Periodic surveys undertaken by organisations such as the NCC (National Computing Centre) and the Audit Commission indicate the following common instances of computer fraud and abuse: this include;

- i. unauthorised disclosure of confidential information
- ii. unavailability of key IT systems
- iii. unauthorised modification/destruction of software
- iv. unauthorised modification/destruction of data
- v. theft of IT hardware and software
- vi. use of IT facilities for personal business

When considering computer audit, it should be noted that the basic control objectives and principles do not change. The manner in which those objectives are achieved, however, does change fundamentally. Specifically, there is a need for greater preventative controls rather than a reliance on the more detective and corrective control mechanisms which would usually be found in manual systems. The development of on-line real-time systems, where the immediacy of processing can result in millions of pounds being transferred away in a funds transfer system, requires a robust level of security

Computer Audit

In the UK for instance, most organisations were known to have established computer audit capabilities in the late 1970s. This primarily arose out of the need to provide business auditors with independent data from the IT system. This in turn progressed to a wider review of the IT applications and infrastructure to provide an assurance that the organisation's assets were protected and that suitable security and control mechanisms were in place. The high level of technical knowledge required resulted in the birth of the computer auditor. It is important when considering computer audit to note that it is an integral part of the overall audit activity. It is usually separated to enable specialised security and control issues to be dealt with more effectively and to make better use of specialist staff. Computer auditing, therefore, is a means to an end rather than an end in itself. There is always a temptation when dealing with IT to become engrossed in the technical complexities of an operating system or application and to ignore the business realities of the organisation. Risk-based computer auditing, integrated as appropriate with business audit, is essential if computer audit is to add value to the organisation and to deliver the effective service demanded of it by senior management.

The role of the computer auditor has changed to being more consultative and value-adding. Clearly, where a new system is being developed, it is more cost effective for audit comments to be provided prior to a system being implemented, when improved security and control features can be included more easily and cheaply. Similarly, although computer auditors regularly undertake audits of say logical access controls, there is considerable scope for computer auditors to be involved in the design of those components.

There is an issue of independence if the computer auditor becomes involved in the design process as this may be compromised if the same individual subsequently audits that system. It is generally recognised, however, that the costs of not getting involved are so great that this is not an option. It is unlikely, for example, that senior management will be happy to receive an audit report just after a new IT system has gone live which details significant security and control exposures.

7.11 Review Questions

1. When organizations move from traditional to electronic or computer data processing, auditors tend to face certain challenges. Requirement;
 - a. identify three of these challenges (6 Marks)
 - b. how these challenges addressed by the auditors? (6 Marks)
2. Because of the problems of loss of controls and audit trail, auditors involved with computerized operations often attach importance to administrative and application controls. Requirement;

Explain the two types of control mentioned above and outline their importance in achieving qualitative EDP audit (18 Marks)
3. Write short explanatory notes on the following;
 - a. Audit Trial (5 Marks)
 - b. Input Controls (5 Marks)
 - c. Output controls (5 Marks)
 - d. Auditing through the Computer (5 Marks)

MODULE 8

8.00

AUDIT REPORTING

8.01 Learning Outcomes

On successful completion of this module, students should be able to:

- i. Apply and explain the basic component elements of the auditors' report
- ii. Explain the basic features of Standard audit reports
- iii. Distinguish between unqualified and other types of audit reports
- iv. Draft out samples of all types of audit reports
- v. Explain the audit liabilities tied to audit reports issued by auditors from the perspectives of both clients and third parties.

8.02 Reporting on Audited Financial Statements

Auditing is expressing an independent opinion on the financial statements and other annual reports prepared and presented by the management of the company. The auditor's report is the end product of the audit. An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor's report is "essentially worthless" for investment purposes.

Audit of financial statements involves obtaining and evaluating evidence on management's financial statement assertions. Auditing culminates in the issue of an auditors' report that contains the auditor's opinion on whether the financial information gives a true and fair view. In Nigeria, auditors are responsible for adhering to auditing standards as issued from time to time by the International Financial Reporting Standards (IFRS) and the Financial Reporting Council of Nigeria (FRC-N), both in gathering and evaluating evidence, and in issuing an auditors' report that contains the auditors' conclusion. This conclusion is

expressed in the form of an opinion on the financial information. This helps to add credibility to the financial statements prepared by management. Some audit reports may contain an opinion with some reservations. This is called 'qualified audit report'.

8.03 Key Concepts in Audit Reports

Opinion - This could be defined as a belief or judgement that rests on grounds insufficient to produce complete certainty. It could also mean a personal view, attitude, appraisal or the formal expression of a professional judgement.

In Law, it could mean the formal statement by a judge or court of the reasoning and the principles of law used in reaching a decision of a case.

Unqualified Opinion

An opinion is said to be unqualified when the Auditor concludes that the Financial Statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the Financial Statements. An Auditor gives a clean opinion or Unqualified Opinion when he or she does not have any significant reservation in respect of matters contained in the Financial Statements. The most frequent type of report is referred to as the "Unqualified Opinion", and is regarded by many as the equivalent of a "clean bill of health" to a patient, which has led many to call it the "Clean Opinion", but in reality it is not a clean bill of health, because the Auditor can only provide reasonable assurance regarding the Financial Statements, not the health of the company itself, or the integrity of company records not part of the foundation of the Financial Statements.

This type of report is issued by an auditor when the financial statements presented are free of material misstatements and are represented fairly in accordance with the Generally Accepted Accounting Principles (GAAP), which in other words means that the company's financial condition, position, and operations are fairly presented in the financial statements. It is the best type of report an auditee may receive from an external auditor.

An Unqualified Opinion indicates the following:

- v. The Financial Statements have been prepared using the Generally Accepted Accounting Principles which have been consistently applied;
- vi. The Financial Statements comply with relevant statutory requirements and regulations;
- vii. There is adequate disclosure of all material matters relevant to the proper presentation of the financial information subject to statutory requirements, where applicable;
- viii. Any changes in the accounting principles or in the method of their application and the effects thereof have been properly determined and disclosed in the Financial Statements.

The report consists of a title and header, the main body, the auditor's signature and address, and the report's issuance date. US auditing standards require that the title includes "independent" to convey to the user that the report was unbiased in all respects. Traditionally, the main body of the unqualified report consists of three main paragraphs, each with distinct standard wording and individual purpose. The first paragraph (commonly referred to as the introductory paragraph) states the audit work performed and identifies the responsibilities of the auditor and the auditee in relation to the financial statements. The second paragraph (commonly referred to as the scope paragraph) details the scope of audit work, provides a general description of the nature of the work, examples of procedures performed, and any limitations the audit faced based on the nature of the work. This paragraph also states that the audit was performed in accordance with the country's prevailing generally accepted auditing standards and regulations. The third paragraph (commonly referred to as the opinion paragraph) simply states the auditor's opinion on the financial statements and whether they are in accordance with generally accepted accounting principles.

Qualified Opinion

Audit report is issued when the auditor encountered one of two types of situations which do not comply with generally accepted accounting principles, however, the rest of the financial

statements are fairly presented. This type of opinion is very similar to an unqualified or "clean opinion", but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated. The two types of situations which would cause an auditor to issue this opinion over the unqualified opinion are:

- i. **Single deviation from GAAP** – this type of qualification occurs when one or more areas of the financial statements do not conform with GAAP (e.g. are misstated), but do not affect the rest of the financial statements from being fairly presented when taken as a whole. Examples of this include a company dedicated to a retail business that did not correctly calculate the depreciation expense of its building. Even if this expense is considered material, since the rest of the financial statements do conform with the gap, then the auditor qualifies the opinion by describing the depreciation misstatement in the report and continues to issue a clean opinion on the rest of the financial statements.
- ii. **Limitation of scope** – this type of qualification occurs when the auditor could not audit one or more areas of the financial statements, and although they could not be verified, the rest of the financial statements were audited and they conform to Generally Accepted Auditing Practice (GAAP). Examples of this include an auditor not being able to observe and test a company's inventory of goods. If the auditor audited the rest of the financial statements and is reasonably sure that they conform to Generally Accepted Auditing Practice (GAAP), then the auditor simply states that the financial statements are fairly presented, with the exception of the inventory which could not be audited.

The wording of the qualified report is very similar to the unqualified opinion, but an explanatory paragraph is added to explain the reasons for the qualification after the scope paragraph but before the opinion paragraph. The introductory paragraph is left exactly the same as in the unqualified opinion, while the scope and the opinion paragraphs receive a slight modification in line with the qualification in the explanatory paragraph.

The scope paragraph is edited to include the following phrase in the first sentence, so that the user may be immediately aware of the qualification. This placement also informs the

user that, except for the qualification, the rest of the audit was performed without qualifications:

"Except as discussed in the following paragraph, we conducted our audit..."

The opinion paragraph is also edited to include an additional phrase in the first sentence, so that the user is reminded that the auditor's opinion explicitly excludes the qualification expressed. Depending on the type of qualification, the phrase is edited to either state the qualification and the adjustments needed to correct it, or state the scope limitation and that adjustment could have but not necessarily been required in order to correct it.

For a qualification arising from a deviation from GAAP, the following phrase is added to the opinion paragraph, using the depreciation example mentioned above:

"In our opinion, except for the effects of the Company's incorrect determination of depreciation expense, the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of..."

For a qualification arising from a scope of limitation, the following phrase is added to the opinion paragraph, using the inventory example mentioned above:

"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 perform proper tests and procedures on the Company's inventory, the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of..."

Adverse Opinion Report

An adverse opinion report is issued on the financial statements of a company when the financial statements are materially misstated and such misstatements have a pervasive effect on the financial statements.

In Audit Report after Scope paragraph but before Opinion paragraph, Basis for Adverse Opinion paragraph is added. In Opinion paragraph, the wording changes to, "Because of situations mentioned in Basis for Adverse Opinion paragraph, in our opinion, the financial statements of XYZ Co. Ltd. as mentioned in first paragraph does not give true and fair view/are not free from material misstatements."

An adverse opinion is issued when the auditor determines that the financial statements of an auditee are materially misstated and, when considered as a whole, do not conform with GAAP. It is considered the opposite of an unqualified or clean opinion, essentially stating that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the auditee's financial position and results of operations. Investors, lending institutions, and governments very rarely accept an auditee's financial statements if the auditor issued an adverse opinion, and usually request the auditee to correct the financial statements and obtain another audit report.

The wording of the adverse report is similar to the qualified report. The scope paragraph is modified accordingly and an explanatory paragraph is added to explain the reason for the adverse opinion after the scope paragraph but before the opinion paragraph. However, the most significant change in the adverse report from the qualified report is in the opinion paragraph, where the auditor clearly states that the financial statements are not in accordance with GAAP, which means that they, as a whole, are unreliable, inaccurate, and do not present a fair view of the auditee's position and operations.

"In our opinion, because of the situations mentioned above (in the explanatory paragraph), the financial statements referred to in the first paragraph do not present fairly, in all material respects, the financial position of..."

Disclaimer of Opinion report

A Disclaimer of Opinion is issued in either of the following cases:

- i. When the auditor is not independent or when there is a conflict of interest.
- ii. When the limitation on the scope is imposed by client, as a result the auditor is unable to obtain sufficient appropriate audit evidence.
- iii. When the circumstances indicate a substantial problem of going concern in client.
- iv. When there are significant uncertainties in the business of the client

ILLUSTRATION QUESTIONS

You have just taken over the audit of Ashaka Cement Co. Ltd and while carrying out the audit of the financial statement for the year ended 31st Dec. 2015, the following were observed.

- i. The information on the financial statement does not conform to GAAP.

- ii. Two trailers reported having an accident in Okeene near Lokoja and Busoga near Gombe were not seen at the accident sites upon visit by your team.
- iii. The financial statement is materially misstated.

Required:

- a) Name the type of Audit Report necessary for this type of audit findings (2 Marks)
- b) Draft a sample of such a report (20 Marks)

2 Write short explanatory notes on the following

- i. Scope limitation (5 Marks)
- ii. Disclaimer opinion (5 Marks)
- iii. Qualified 'except for' report (5 Marks)
- iv. Qualified 'subject to' report (5 Marks)

Suggested solutions

1 (a) the type of report to be issued under such circumstances is an adverse or negative report in which the auditor will indicate that in view of the above observations, the accounts do not show a true and fair view.

(c) A sample of the report will appear as follows:

Auditors Report to Members of Ashaka Cement Plc

We have reviewed the financial statements set out on pages.... Of this report in respect of the year ended.....

The directors are responsible for the preparation of the financial statement while our role as auditors is to review the accounts.

We have obtained all the information and explanations necessary for purposes of our audit from both the head office and all branches of the company.

Our review suggests that the accounts are not in conformity with GAAP while some assets were not accounted for. This suggests that the financial statements are misstated.

We conducted our audit in line with the requirements of professional requirements and the provisions of international auditing standards and guidelines.

In our opinion, the accounts as presented do not show a true and fair view of the financial and operational positions of the company as at

ABB and Co.

(Public National Accountants)

Abuja.

15th April 2018

2 (i) Scope limitation:

This is a situation where an auditor is not fully allowed to decide the scope of his verification or review as a result of circumstances either created by the client or other factors. For example where an auditor is prevented from observing stock taking exercise or where operations are concluded before the arrival of the auditor. Scope limitation can also arise where management limits the areas that the auditor is allowed to work within such as restricting him to particular branches or operations within the firm.

(ii) Disclaimer opinion

Disclaimer opinion is a kind of opinion in which an auditor declines to suggest whether the accounts show a true and fair view or not. That is to say, he refused to take a stand because of certain reasons. Mostly such opinions are issued under circumstances of uncertainty. Where for instance there is pending litigation and the effect of such litigation is considered material and or fundamental, a disclaimer opinion becomes appropriate.

(iii) Qualified 'except for' report

A qualified report is a type of report in which an auditor uses an emphasis of matter to suggest that the accounts contain some reservations which he would like to bring to the notice of the members of the company. The meaning of such a report is that the accounts as presented can be considered to have shown a true and fair view but that there is a particular matter to be taken cognizance of at the same time. For example, where adequate provisions for doubtful debts are not made and the auditor considers such understatements to be 'material', he issues a report indicating that the accounts show a true and fair view, except for the 'Inability to make adequate provisions for

doubtful debts’.

Iv Qualified ‘subject to’ report

As it is with item (iii), a qualified ‘subject to’ report is a kind of report in which the auditor emphasizes that the accounts can only show a true and fair view of the matter he has pointed has been addressed. Here also, the auditor must indicate the issue he wants to see being addressed before the accounts are considered true and fair. For example where different methods of stock valuation are used and the auditor insists on a particular choice, he can issue a ‘qualified subject’ to report indicating that the accounts show a true and fair view’Subject to’ the use ofmethod of stock valuation.

8.04 Review Questions

1. Assuming you are the external auditor appointed by Zamani Plc to audit their accounts for the year ended December 2017 and at the end of all your verifications and other substantive procedures, you are satisfied and convinced of the need to issue an unqualified report, you are required to;
 - a. Explain the various features of such a report (7 Marks)
 - b. Draft a sample of such a report (13 Marks)

2. Analyse the technical meanings of the following terms as applied in audit report writing.
 - a. Scope limitation (5 Marks)
 - b. Emphasis of Matter (5 Marks)
 - c. Disclaimer Opinion (5 Marks)
 - d. International Auditing Standards and Guidelines (5 Marks)

3. What is a qualified audit report, and under what circumstances are auditors likely to issue such a report? (15 Marks)

MODULE 9

9.00

ASSURANCE SERVICES

Learning outcomes

On successful completion of this module, students should be able to;

- i) Define and interpret audit assurance services.
- ii) Review OF Interim Financial Information
- iii) Understand the general principles of assurance review, procedures for the review of interim financial information.
- iv) Understand assurance engagements; types of Assurance Engagements.
- v) Explain the concept of prospective financial statements.

9.01. DEFINITION: International standard on Auditing (ISA 100) defines Assurance services as;

“One in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria.”

Assurance services are like statutory audit where the auditor expresses a professional opinion on a set of financial statements of a company to enhance the degree of confidence of the shareholders, management and other users. Assurance services are independent professional services that improve the quality of information or its content for decision makers.

9.02. REVIEW OF INTERIM FINANCIAL INFORMATION

The main reason for a review is to enable the creditor to state whether all necessary procedures with evidence have been followed in the preparation of the financial statement as required by the auditing standard (Law) for a good financial reporting frame work.

There are two types of assurance review of financial information:

- (i) An Attestation: This is where the auditor declares that a given premise is either correct or not. E.g. Auditors may be asked to review interim financial information and attest to the assertions that;
 - a) The accounting policies used are consistent with those used in the prior year financial statements.
 - b) That no material modifications to the interim financial information as it has been presented are required.

- (ii) Direct Reporting: This is where the auditor reports on issues that have come to his attention during the course of his review. E.g. “*Due diligence*” engagements, where an auditor is engaged by one company planning to take over another company to perform an assessment of the material risks associated with the transaction to ensure that the acquirer has all the necessary facts in the transaction.

In all review engagements, the auditor will rely more on procedures such as inquiry and analytical review than on detailed substantive testing.

9.03. GENERAL PRINCIPLES OF ASSURANCE REVIEW

Auditors should comply with ethical principles relevant to the audit when carrying out an interim review of financial information. He should apply professional quality control procedures applicable to every engagement. The auditor will agree the terms of the engagement with his client though in a lesser term than as for audit.

PROCEDURES FOR REVIEW OF INTERIM FINANCIAL INFORMATION

The procedures follow the same pattern as an audit but not as detailed as in audit procedures.

The auditor should understand the client entity and its environment to understand the types of misstatement that might arise in interim financial information and to plan the relevant procedures which are mainly inquiry and analytical reviews. This is to ensure that the financial information is prepared in accordance with the applicable financial reporting framework. They include:

- i) Reading last year’s audit and review of previous files;
- ii) Considering any significant risks that were identified in the prior year audit.
- iii) Reading the most recent and comparable interim financial information.
- iv) Considering materiality
- v) Considering the nature of any corrected or uncorrected misstatement in the last year’s financial statements.
- vi) Considering significant financial accounting and reporting matters of ongoing importance.
- vii) Considering the results of any interim audit work for this year’s audit.
- viii) Considering the work of internal audit.
- ix) Asking management what their assessment is of the risk that the interim financial statements might be affected by fraud.
- x) Asking managing whether there have been any significant changes in business activity and what effect it has.
- xi) Asking management about any significant changes in internal control and the effect it has on preparing the interim financial information.

- xii) Asking management how the interim financial information has been prepared and the reliability of the accounting records.

9.04. ASSURANCE ENGAGEMENTS

As earlier defined, assurance engagement is;

“one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria”.

Like in a statutory audit, assurance engagement is a type of assurance service that is aimed at giving an independent opinion on the truth and fairness of financial statements.

TYPES OF ASSURANCE ENGAGEMENTS

There are two types:

- i) **Assertion – Based Engagement:** Here the auditor declares that a given assertion that is claim or declaration is in his opinion true. An example of this type is the statutory audit.
- ii) **Direct Reporting:** Here the auditor reports on issues that have come to his attention during his evaluation. An example of this type is in a management performance report.

Other types:

- a) Statutory Audit
- b) Management Performance
- c) Risk Assessment
- d) Corporate Governance
- e) Performance Related Data
- f) System and Controls
- g) Corporate Social Responsibility Performance
- h) Prospective Financial Information
- i) Environmental Performance
- j) Report for Lenders and other Investors
- k) Reports Relating to e-commerce
- l) Non-statutory Audits and Reviews

9.05. PROSPECTIVE FINANCIAL STATEMENTS

Prospective Financial Information means financial information based on assumptions about events that may occur in the future and possible procedures that allow them to generate reliable prospective financial information, compare it to market

expectations, publish it when necessary and subsequent report actual performance against it.

The audit firm should obtain sufficient appropriate evidence as to whether,

- i) Management's assumptions on which prospective financial information is based are not reasonable.
- ii) The information is properly prepared on the basis of the assumption.
- iii) The information is properly presented and all material assumptions are adequately disclosed.

PRACTICE QUESTION ON ASSURANCE SERVICES

Auditing and Assurance Services recently merged to register a formidable Audit firm with ANAN. As a manager in the firm, you are required to;

- a) *Define Assurance Engagement in line with International Standard Auditing (ISA) 100.*
- b) *Give five examples of Assurance Engagements.*
- c) *What do you understand by Prospective Financial Information (PFI)?*

MODULE 10

10.0. FRAUD AND FORENSIC ACCOUNTING

10.01. Learning outcomes

On successful completion of this module the students should be able to;

- i) Define and Explain what is Fraud in an Organization
- ii) Understand the condition for Fraud
- iii) Distinguish between the different types of fraud, internal and external fraud.

- iv) Fraud Detection
- v) Define forensic accounting and the roles of the forensic accountants
- vi) Be able to Identify the skills and roles of a forensic accountant
- vii) Be able to list and explain the uses of Forensic Accounting in an Organization.

10.01. FRAUD: The term “Fraud” refers to an intentional act by one or more individuals among management, employees, or third parties, which results in a misrepresentation of financial statements.

Fraud can be defined as an act of dishonesty in which illegal means are used to acquire or benefit from resources belonging to others. It is a common knowledge that fraudulent individuals in organizations have from time to time continued to engage in fraudulent acts ranging from small or petty theft to large scale swindles involving very huge amounts.

Fraud may involve:

1. Manipulation, falsification or alteration of records or documents
2. Misappropriation of assets
3. Suppression or omission of the effects of transactions from record or documents.
4. Recording of transaction without substance
5. Misapplication of accounting policies.

Among the many definitions of fraud, probably the most common is the following:

“Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery.”

Fraud is deception that includes the following elements:

- i. A Representation
- ii. About a material point
- iii. Which is false?

- iv. And intentionally or recklessly so
- v. Which is believed?
- vi. And *acted* upon by the victim
- vii. To the victim's damage

10.02. CONDITIONS OR CAUSES OF FRAUD

In view of its long history, fraud as a phenomenon appears to have become a very notorious part of the ever-turbulent global corporate life. This is more so when one considers the fact that there is hardly any organization that can claim to be invincible to fraud and malpractices in totality. Therefore given, the reality about corporate fraud and the often-devastating consequences, it is very vital for us as auditors to get fully acquainted with the factors that account for fraudulent activities in organizations. In addition to what the literature has already documented, what would appear to be the main causes of fraud particularly in the developing countries, are the following:-

- (i) Basic societal values system of defining respectability by the amount of money one is able to throw about.
- (ii) Deficiency in the recruitment policy of an organization can lead to fraud.
- (iii) Inadequate internal control system.
- (iv) Failure by organizations to design and apply good and effective organizational policies.
- (v) Failure to design and maintain good systems of accounting and record keeping.
- (vi) The employment and retention of employees and staff of questionable characters.
- (vii) Inadequate staffing and over reliance on the integrity of personnel
- (viii) Poor security arrangement for security documents
- (ix) Poor and ineffective supervision of staff by supervisors
- (x) Chaotic accounting system and irregular balancing of book.
- (xi) Allowing staff to stay too long on a job or task.
- (xii) Poor salaries and conditions of services could lead to frustration
- (xiii) Failure to carry out the provision of internal check system and recommendation
- (xiv) Failure to proceed on annual leave.
- (xv) Inadequate staffing of the Internal Audit Department
- (xvi) Management attitude to audit queries and follow-up of audit recommendation.
- (xvii) God-Fatherism or protection of defaulting staff.
- (xviii) Police Factors: -
 - (a) Slow investigation system
 - (b) Outright corruption (settlement syndrome)

- (c) Delay in prosecuting fraudsters
- (xix) Personal greed by individuals towards material wealth
- (xx) **Judicial Factors**
 - a) Incessant adjournment of fraud case until the complainant loses interest.
 - b) Disproportionate penalty for fraud e.g. when one embezzles N1,000,000.00 and he/she is fined N20,000.00 each of the two count charge, with an option of six months imprisonment.
 - c) Congestion of courts.

10.03. TYPES OF FRAUD

1. **GENERAL:** A common way to classify fraud is to divide frauds into those committed against organizations and those committed on behalf of organizations.

In employee fraud, the victim of the fraud is the employee's organization. On the other hand, with financial statement fraud, for example, executives usually commit fraud "on behalf" of an organization, often to make its reported financial results look better than they actually were. In this case, the executives of a company are usually indirect winners because a company's stock price increases or remains artificially high and the victims are investors in the company's stock. Sometimes, executives misstate earnings in order to ensure a larger year-end bonus. Financial statement fraud often occurs in companies that are experiencing net losses or have profits much less than expectations.

A more inclusive classification scheme divides fraud into the following six types:

1. Employee embezzlement
2. Management fraud
3. Investment scams
4. Vendor fraud
5. Customer fraud
6. Miscellaneous fraud

Fraud that doesn't fall into one of the first five types and may have committed for reasons other than financial gain is simply labeled miscellaneous fraud. The other five types of fraud are summarized and are discussed below;

Table 1: Types of Fraud

FRAUD	VICTIM	PERPETRATOR	EXPLANATION
1. Employee embezzlement	Employers	Employees	Employees directly or indirectly steal from their employers
2. Management fraud	Stockholders, lenders, and others who rely on financial statement	Top management	Top management provides misrepresentation, usually in financial information
3. Investment scams	Investors	Individuals	Individuals trick investors into putting money into fraudulent investments
4. Vendor Fraud	Organizations that buy goods or services	Organizations or individuals that sell goods or services	Organizations overcharge for goods or services or non-shipment of goods, even though payment is made
5. Customers fraud	Organizations that sell goods or services	Customers	Customers deceive sellers into giving customers something they should not have or charging them less than they should

2) SPECIFIC TYPES OF FRAUD

- (1) Embezzlement or outright theft of cash collected by cashiers and senior cashiers.
- (2) Manipulation of cash receipting machine to conceal fraud:-
 - (a) Printing of zero's instead of the amount of cash received on the audit roll and pocketing the amount involved.
 - (b) Jumping of receipt numbers on audit rolls.
 - (c) Cleverly rewinding the receipting machine cubicle to conceal receipt numbers legally used and misappropriating the cash involved.
- (3) Teeming and leading
- (4) Inclusion of non-negotiable cheques in cash collection and taking away the equivalent amount of cash.
- (5) Misappropriation of consumers security deposits
- (6) Posting of fictitious credits into consumers accounts
- (7) Failure to obtain discounts for the organization from suppliers.
- (8) Inflation of contract amounts.
- (9) Unauthorized withdrawal of cash from impress account through forged cheques.
- (10) Bringing forward of wrong balances on consumer's ledger.

- (11) Fraudulent transfer of balances or amounts from a consumer's account into another consumer's account.
- (12) Willful destruction of consumer's ledger or supplier's ledger
- (13) Inclusion of Dummy names on pay-roll
- (14) Overstating amount payable on pay-roll
- (15) Overstating staff allowance on pay-roll
- (16) Forging signatures on overtime sheet and getting paid for overtime not done.
- (17) Failure to recover loans and advance
- (18) Failure to deduct tax from staff salary
- (19) Theft of stores materials:
 - (a) By staff
 - (b) By outsider
 - (c) By both staff and outsiders
- (20) Illegal sale of scrap
- (21) Illegal withdrawal of materials from stores for fictitious maintenance
- (22) Embezzlement of unclaimed wages
- (23) Inflation of medical bills
- (24) False declaration of age
- (25) False declaration of marriage
- (26) Abuse of tender procedure

INTERNAL AND EXTERNAL FRAUD

- 1) **Internal Fraud** refers to a type of fraud that is committed by an individual against an organization. In this type of fraud, a perpetrator of fraud engages in activities that are designed to defraud, misappropriate property, or circumvent the regulations, law, or policies of a company. E.g. Fraud by employees which include:
 - i. Theft of cash or stock
 - ii. Theft from other employees
 - iii. Not charging friends, family or accomplices
 - iv. Supplying receipts for refunds
 - v. Allowing friends to steal, or
 - vi. Participating in delivery scams.

- 2) **External Fraud** is the risk of unexpected financial, material or reputational loss as the result of fraudulent action of persons external to the firm. External fraud is a recognized risk category in regulatory framework worldwide. E.g. fraud by customers which include:
 - i. Short or inferior of goods
 - ii. Payment of services and good not supplied

- iii. Kickbacks for biased selections of suppliers
- iv. Payment to bogus vendors for false claims
- v. Cheques written for cash only or not property authorized
- vi. Purchase of goods for private use.
- vii. Money laundering
- viii. Tax fraud

10.04. Fraud Detection

Although it is not expected that auditors on getting into organizations will start to suspect every staff or officer, they come in contact with, it is still very necessary while undergoing their assignments to open up their minds and watch out for those signals that may be indicative of the possibilities of fraud. In general, it has been observed that fraudulent acts are likely to thrive under the following conditions.

- (i) Complete absence of key accounting records or books.
- (ii) Absence of essential internal control policies and checks such as regular supervision of staff, internal auditing of operations, regular rotation of staff in sensitive positions, etc.
- (iii) Lack of regular balancing of accounts; the common fact is that wherever accounts are not balanced, anything can happen.
- (iv) High number of alterations and corrections to accounting records particularly the use of tip-ex and painting of figures.
- (v) Unusual mutilation of documents and records
- (vi) Exceptionally clean state of records, e.g. a Cashier's book appearing too new, despite being in use, for some considerable period of time. The tendency here is that it must have been changed.
- (vii) Excess hospitality on the part of management or staff. Such gestures may be in anticipation of an auditor's cooperation as regards frauds or other malpractice committed.
- (viii) Unexplained hostility by management or staff. This may be aimed at distracting the auditor or giving him less room to probe issues properly.
- (ix) Inconsistencies in responses to audit queries by staff or management.
- (x) Unusual concentration of functions on a particular individual.
- (xi) Failures to abide by operation policies in the execution of transactions.
- (xii) Payments of excessive amounts by cash, rather than other instruments.
- (xiii) Insider transactions like loans to staff or to organizations in which staff have interests.

In addition to the above signals or indicators, auditors can obtain vital information regarding fraudulent practices through careful observation of operations and taking notes of unusual transactions, movement of assets, communication with outsiders, etc. It is very vital to note that most of the time; certain actions are taken just for the

sake of covering up frauds and malpractices. For example, fixed assets may be moved from one location to another in order to cover up for unaccounted assets. Similarly, money or cash hitherto held illegally may be quickly rushed and lodged in a bank just to avoid being uncovered at the time of audit.

On the other hand, sensitive information can also be obtained informally from willing and relevant officers and other employees particularly those that are aggrieved or appeared to have been maltreated.

10.05. DEFINITION OF FORENSIC ACCOUNTING

Forensic accounting can be defined as the science of gathering and presenting financial information in a form that will be accepted by a court of jurisprudence against perpetrators of economic crimes. Although relatively new to the accounting profession, the role of a forensic expert in other professions has been in place for some time. Webster's Dictionary defines the word forensic as "*belonging to used in, or suitable to courts of judicature or public discussions and debate.*" Accordingly, the term forensic in the accounting profession deals with the relation and application of financial facts to legal problems. Forensic accounting evidence is oriented to a court of law.

The involvement of the forensic accountant is almost always reactive; this distinguishes forensic accountants from fraud auditors, who tend to be actively involved in prevention and detection in a corporate or regulatory environment. Forensic accountants are trained to react to complaints arising in criminal matters, statement of claim arising in civil litigation, and rumour and inquiries arising in corporate investigations. The investigative findings of the forensic accountant will impact an individual and/or company in terms of their freedom or a financial award or loss.

10.06. ROLE OF THE FORENSIC ACCOUNTANT IN INVESTIGATION

To understand the Forensic accountant's role in deterring, detecting and investigating fraud, as distinct from the independent auditor's role as a financial statement examiner, we need to first recall the differences between what auditors do and what forensic accountants do and why. In addition, their professional worlds have changed in recent years, in ways that bear close examination.

According to Steven L. Skalak, the auditors' concern is that the financial statements of an entity be stated fairly in all material respects. Accordingly, the auditor's responsibility is to design and implement audit procedures of sufficient scope and depth to detect material deficiencies in financial statements essentially, without regard to the source or origin of the deficiency. Auditors are charged with:-

- i) Making appropriate, reasonable efforts to detect material misstatements in financial statements, and
- ii) Causing management to correct material misstatements or misrepresentations before the financial statements are shared with the user community, or alternatively, altering investors not to place reliance on the statements through qualification of their professional opinion issued as part of the company's public filings.

Even this seemingly simple statement of the auditor's mission brings into play a series of interrelated and complex concepts, including:-

- Reasonable assurance;
- Material misstatement
- Detection, as distinct from deterrence and investigation
- Expectations about the efficacy of the audit process.

The forensic accountant has largely separate set of concerns based on a different role that calls for different tools, different thought processes, and different attitudes. The forensic accountant's concern is not with reaching a general opinion on financial statements taken as a whole, derived from reasonable efforts within a reasonable materiality boundary. Instead, the forensic accountant's concern is, at a much more granular level, with the *detailed development of factual information derived from both documentary evidence and testimonial evidence – about the who, what, when, where, how and why of a suspect or known impropriety*. Sampling and material concepts are generally not used in determining the scope of forensic accounting procedures. Instead all relevant evidence is sought and examined.

Based on the investigative findings, the forensic accountant assesses and measures losses or other forms of damage to the organization and recommends and implements corrective actions, often including changes in accounting processes and policies and/or personal actions. In addition, the forensic investigator takes preventive actions to eliminate recurrence of the problem. The forensic accountant's findings and recommendations may form the basis of testimony in litigation proceedings or criminal actions against the perpetrators. They may also be used in testimony to Government agencies such as the Security and Exchange Commission in the United States or the Serious Fraud Office in the United Kingdom. Accordingly, the scope of the investigation and the evidence gathered and documented must be capable of withstanding challenges that may be brought by adversely affected parties or skeptical regulators.

10.07. QUALITIES AND SKILLS OF THE FORENSIC ACCOUNTANT

A good forensic accountant is the thorough-bred accountant with special skills, knowledge, strong investigative and legal understanding, the expert armed with an accounting stethoscope to diagnose and correctly interpret accounting information, and reduce discoveries to reports acceptable in law courts in aid of adjudication. Knowledge of computer application with accounting packages is critical to his function. Credibility, good name and professional discipline are all tools of the forensic accountant's practice. He should help the attorney understand the intricacies of the case related to accounting. He must have a fundamental grasp of the attorney-client initial process. He is the one to provide the scientific foundation critical to the case and must understand both the client's arguments and the general legal principles involved in the case.

A good forensic accountant should be creative: he must have the ability to venture into new things and depart from the norm, with that he can invent better ideas and uncover hidden scams. He must be independent, and have a good idea of human psychology to be able to interpret body and sign movements. Calm, collected and good listeners make wonderful forensic experts.

A Forensic accountant has the following skills;

1. Analytical Proficiency
2. Creative thinking
3. Investigative Mind
4. Unstructured Problem solving
5. Oral Communication
6. Written Communication
7. Legal Knowledge
8. Personal Composure

10.08. USES OF FORENSIC ACCOUNTING

- 1) A Forensic Accountant interprets and summarizes complex financial and business matters. They compile financial evidence, develop computer applications to manage the information collected and communicate their findings in the form of reports or presentations. Along with testifying in court, a forensic accountant may be asked to prepare visual aids to support trial evidence. For business investigations, forensic accounting entails the use of tracing funds, asset identification, and asset recovery and due diligence reviews.
- 2) Forensic accounting is also utilized in litigation when qualification of damages is needed. Parties involved in the legal disputes use the quantification to

assist in resolving disputes through settlements or court decision. E.g. this may arise due to compensation and benefit disputes.

- 3) Forensic accounting is also used to discover whether a crime occurred and assess the likelihood of criminal intent, e.g.
 - i) Employee theft,
 - ii) Securities fraud
 - iii) Insurance fraud
 - iv) Credit card and cheque fraud
 - v) Tax fraud
 - vi) Consumer fraud and money laundering
 - vii) Falsification of financial statement information

- 4) Forensic accounting is often brought to bear in complex and high profile financial crimes. Forensic accounting may assist in searching for hidden assets in divorce cases or provide their services for other civil matters such as breach of contracts and disagreements relating to company acquisition, breaches of warranty or business valuation disputes.

Organization that will require the services of Forensic Accountants;

- 1) Insurance Companies
- 2) Banks
- 3) Police Forces
- 4) Government Agencies
- 5) Public Accounting Firms

MODULE 11

11.0. AUDIT EVIDENCE GATHERING

11.01. Learning outcomes

On successful completion of this module, student should be able to:-

- i) Define Audit Evidence and Explain what it means to auditors.
- ii) Ability to explain the qualities of audit evidence,
- iii) Understand the various methods of gathering evidence for legal purposes
- iv) Know the different types of audit evidence that can be tenable before an adjudicatory body.

11.02. WHAT IS EVIDENCE?

A dictionary definition of evidence is: *something (including testimony, documents and tangible objects) that tends to prove or disprove the existence of an alleged fact ... the collective mass of things especially testimony and exhibits, presented before a tribunal in a given dispute. The body of law regulating the admissibility of what is offered as proof into the record of legal proceedings*".

Other learned text-writers have defined evidence in various ways.

A.A Aguda says that evidence is *a fact which can be proved by the oral testimony of persons who perceived the fact, or by the production of documents, or by the inspection of things or places- all these come within the meaning of judicial evidence. Judicial evidence is the means by which the facts are proved, but excluding inferences and arguments. On a very broad view it is sometimes permissible to include in the list such other means of proving a fact as admissions and confessions, judicial notice, presumptions and estoppels.*

According to Phibson, evidence is *"testimony, which could be oral, documentary or real which may be legally received in order to prove or disprove some facts in dispute and that evidence in the real sense, is that which may be placed before the court in order that it may decide the issue of facts."* Much earlier, Taylor in his legal work defined evidence as: *"all the legal means exclusive of mere agreements, which tend*

to prove or disapprove any matter of facts the truth of which is submitted to judicial investigation.”

Audit evidence is any piece of information obtained either verbally or through reference to written documents based on which an auditor is able to form an opinion. Where for instance an auditor wishes to confirm whether or not a particular asset was actually purchased by an organization, the auditor can call for such documentary evidence relating to the transaction like:

- i) The relevant Local Purchase Order (LPO),
- ii) Invoice from the supplier,
- iii) The receipt issued and
- iv) The delivery note among others.

A study of these documents will accord the auditor the basis on which to form an opinion about the purchase transaction. An audit evidence can also be obtained out of verbal explanations from an official of a company or from appreciate outside parties.

11.03. QUALITIES OF AUDIT EVIDENCE

- Relevance
- Reliability
- Sufficiency

- 1) **Relevance:** This means that the evidence referred to must relate or have bearing with the event or transaction, which the auditor is trying to verify. The problem is that in practice, the operations of organizations give rise to all kinds of facts and information some of which the author may not have to consult. That means all the procedures and verification that are to be carried out by an auditor have to be done with the right form of audit evidence. Where for instance, an auditor is conducting compliance testing, the relevant evidence is that which will enable him establish the existence of a system. He should therefore concentrate on procedural evidence. On the other hand, if he is to carry out substantive procedures like the verification of an asset, he should go for documentary type of evidence.
- 2) **Reliability:** This refers to the degree of reliance that an auditor can place on evidence if it is to be used. Normally, the reliability of evidence is determined by factors like the source and form, of the evidence. Source means the origin of the evidence, which may be internal or external. For the purpose of auditing more often

than not, evidence from external sources or third parties tend to be more reliable than those internal sources. For example, when verifying bank account balances, the information contained in a bank statement can be more reliable than the client's cash book details relating to the same bank account. In terms of the form taken by an evidence, it is usual to accord more reliability to written than oral evidence. After all, the source of written evidence can always be traced unlike verbal evidence, which the provider, can always deny if the need arises.

- 3) **Sufficiency:** This is all about the adequacy of a given evidence to enable an auditor draws conclusion. On many occasions auditors get tangled in the problem of having to select appropriate evidence out of many. At the same time, they may not always have enough time to go through all available evidence. At the end of the day, what matters most is that the auditor should be able to obtain as much evidence as possible to convince himself that the facts available are enough to support the opinion he intends to express. For example if an auditor intends to verify his client's ownership claim over some particular values of receivables, in addition to reviewing such documents like the sales invoices, goods dispatch vouchers, goods received notes, etc, he can decide to pay personal visit to some of the listed debtors or write to them.

11.04. METHODS OF OBTAINING AUDIT EVIDENCE

Audit evidence can be obtained through a number of ways depending on the type desired and the conclusions that the auditor wishes to arrive at. Among the common ways of obtaining evidence by auditors are the following:

- (i) Inspection (Physical examination)
- (ii) Observation
- (iii) Computation
- (iv) Analytical review techniques
- (v) Inquiry/Conformation
- (vi) Scanning
- (vii) Interviewing
- (viii) Undercover

- i) **Inspection (Physical Examination):** Is a means of obtaining audit evidence by physically inspecting of the particular item in order to gather enough facts about it. For example where an auditor comes across asset items like Motor vehicles, Stock, Buildings, etc in the balance of sheet of a client, he can decide to pay personal visit to the particular locations where such assets are kept. The physical examination of items will enable him to obtain evidence as to the colour, serial numbers, models, condition of the assets, etc. However,

auditors on physical examination exercise must watch out for possibilities of deliberate movement of assets just to satisfy the inspecting team. Some assets may not exist physically, but probably diverted by some officials and on getting the news of the arrival of auditors such officials may try to smuggle some assets into the organization for the purpose of expected inspection only. It is therefore necessary for the auditor to confirm that all details contained in the accounting books about particular assets are correct and are in agreement with what exists physically.

- ii) **Observation** involves an auditor keeping watch on the operations or activities carried out in an organization so as to determine whether or not things are done in the right way. An auditor can observe the stock taking exercise of his client to ensure that fictitious items are not included in inventory. However, the problem here is that once a client is aware of being observed, activities may be stage managed in order to satisfy the auditor. After the auditor's departure, the organization then goes back to its old methods. It is therefore advisable that the client is not made aware that its operations are under observation. For example where a client claims that dual control system is kept in respect of its cash and the strong room, the auditor can simply keep watch any time cash is taken in or out which will enable him determine the degree to which the client is complying with its dual control arrangement.
- iii) **Computation** is a means by which auditors can obtain relevant evidence particularly where the needs to confirm the correctness of some particular accounting figures arise. For example, in order to confirm the correctness of the interest income charged by a client, an auditor can recomputed such charges using client's input data. What this means is that where an auditor comes across figures that need confirmation, a re computation by him is essential.
- iv) **Analytical Review Techniques** have to do with attempts made to establish trend of events in a given organization so as to convince the auditor that the conditions found on ground existed for a particular period of time. Some times organizations may window dress their records to portray promising performances, in view of this, auditors on seeing sudden changes in the pattern of events should seek to find out the reasons for the sudden changes. For instance, an organization might have been making losses for a number of years and all of a sudden the income statement starts to show profits. Such a situation can require the auditor to prepare a trend statement to ascertain whether or not the profit suddenly declared is genuine.

- v) **Confirmation (Inquiry)** is a means of obtaining evidence with the auditor communicating either with the client or with third parties. Debtors, creditors, and the bankers to a client are among the principal parties that an auditor may have to inquire from. For precautionary reasons, when trying to obtain evidence through inquiry, an auditor should ensure that the confidentiality doctrine is adhered to. In fact the preferred method is to route the inquiry through the client but with caution so as not to allow the client influence the response from the third parties.
- vi) **Scanning** this is somewhat indefinite but it is widely used, especially in seeking the usual or the unlikely.
- vii) **Interviewing** is an important evidence-gathering technique. It helps obtain information, which establishes elements of a crime, provides additional leads, get cooperation of witnesses and victims, and obtains the economic motives behind a perpetrator.
- viii) **Undercover** operations require an agent or informant. This technique could be used for major criminal acts, i.e. organized crime activities. It is important that the operation remains secret. It is also very dangerous for the undercover agent.

11.05. TYPES OF AUDIT EVIDENCE

- (i) **Opinion Evidence:** At law, generally, the opinion of witness or a party to a dispute is irrelevant and for that reason, the general rule is that opinion evidence is inadmissible. This is so because opinion refers to belief had or conclusion arrived at which is based on ideas, imaginations, understanding, discernment, perception, knowledge and wisdom. It is the function of any adjudicatory body to arrive at a conclusion based **on facts** not on such opinions; hence what a witness can bring to adjudication are facts and facts alone. Stressing this point, Nwadialo writes:
An opinion is a sort of conclusion. It is this nature of opinion which provides the basis of the rule of its exclusion. If the opinion is not based on any evidence, it is logically worthless. If it is based on evidence, then it is a usurpation of the function of the court, for it is for the court and not for a witness to draw conclusion from facts proved.

Where two or more experts give conflicting opinions or report of a matter, a court has the right to accept one and reject or discard the others. In *Odiawa vs FR*, the court gave some grounds upon which the court would rely in doing so as:

- a) Where such expert evidence or opinion is apparently illogical and unreasonable.
- b) Where the expert fails to provide enough data analysis or basis to support his conclusion;
- c) Where the court itself makes its own comparison under section 107 of the Evidence Act and reaches a different conclusion from that of the expert.
- d) Where the expert who claims to have special skill in the field in question gives evidence in the court but fails to give account of his skill, qualification or experience in the said field for which he is called upon to give his opinion.

(ii) **Documentary Evidence**: The major forms of evidence dealt with in forensic accounting matters are records. In the banking sector there are provisions in respect of banker's book and records in the Evidence Act. Documentary evidence is defined in Section 2 of the Act thus:

Document includes books, maps, drawings, photographs and also includes any matter expressed or inscribed upon any substance by the means of letters, figures or marks or by more than one of these means intended to be used or which may be used for the purpose of recording that matter.

There are two types of documents viz. public and private documents. Public documents are: -

- a) Documents forming the acts or records of the acts
 - i) Of the sovereign authority;
 - ii) Of official bodies and tribunals; and
 - iii) Of public officers, legislative, judicial and executive, whether of Nigeria or elsewhere.
- b) Public Records kept in Nigeria of private documents.

Section 110 speaks of private document as "all documents other than public documents". The essential difference between the two is that private document consists of records produced or kept by companies and a person qua person that is to say acting in their private capacity. Therefore, accounting records of private and public companies incorporated under the Companies and Allied Matters Act are all private documents, whereas records of ministries, the police, courts and governmental commissions form the bulk of public documents.

The contents of a document are proved either by primary evidence or secondary evidence. Proof by primary evidence means the production of the document itself for inspection. On the other hand proof by secondary evidence includes;

- a) Certified copies given under the provisions herein contained;
- b) Copies made from the original by mechanical process which in themselves ensure the accuracy of copy, and copies compared with such copies;
- c) Copies made from or compared with the original;
- d) Counterparts of documents as against the parties that did not execute them;
- e) Oral accounts of the contents of a document given by some person who has himself seen it.

Secondary evidence can be proved in any of the following manner by tendering:

- Certified copies;
- Copies made from original by mechanical process which in themselves ensure the accuracy of the copy and copies compared with such copies (e.g. photocopy);
- Copies made from or compared with the original;
- Counterparts of documents as against the party who did not execute them;
- Oral account of the contents of a document given by some person who has himself seen the document.

The occasions on which secondary evidence may be resorted to are laid down in section 97(1) of the Evidence Act:

- a) Where the original is in custody or possession of the person against whom it is sought to be proved, or in custody or possession of a person legally bound to produce it and notice to produce has been given him and he has not produced the document.
- b) When the existence, condition or contents of the original is proved to have been admitted in writing by the person against whom it is proved or his representative in interest;
- c) Where the original is destroyed or lost and all possible search has been made for it;
- d) Where the original is not easily moveable e.g. inscriptions on tomb stone or wall;
- e) Where the original is a public document;

- f) Where the original is a document of which a certified copy is permitted by the Act or other Law in Nigeria;
 - g) When the original consists of numerous accounts or other documents which cannot conveniently be examined in court and the fact to provide is the general result of the whole collection – an audit report may be a good example here;
 - h) When the document is an entry in a banker’s book.
- (iii) **Expert’s Evidence:** The question in the first place is who qualifies as an expert? The Act is not helpful in this wise except that Section 57(2) refers to persons specially skilled in the areas referred to as experts. This uncertainty reflected in this state of affairs has been noted by the Supreme Court in *Agbadion vs State*. In this case, the Supreme Court held that “expert” as a term of law is elusive because statute has not provided guidance for identification of an expert with certainty. However, from the foregoing, we note that where the court has to form an opinion upon a point of science or art of as to identity of handwriting or finger, the opinions *upon that point*, of persons specially skilled in such science or art are relevant and such persons are called experts. Clearly members of the accounting profession are experts in the field of accountancy.

Notwithstanding the foregoing, the mode of acquisition of the required special skill is not stated and for such reason, it is not restricted to academic qualifications or training in a formal institution. Such skills may be acquired by practical experience. Early in the 19th century, an English court held in *R vs Silverlock* that a solicitor who became knowledgeable in deciphering handwriting as an amateur could be treated as an expert in the field of hand writing.

PRACTICE QUESTIONS

- 1) What do you understand by audit evidence and explain the requisite qualities of audit evidence?
- 2) You are a team leader of Linigboi & Associates Audit Firm going into the audit of Jos Flour Mills Ltd.
Your Managing Partner has asked you to explain to the team how you intend to collect five (5) audit evidences.
- 3) Explain the approach you would adopt to obtain sufficient evidence about:
 - (i) Assets of the company
 - (ii) Bank balance

(iii) Authenticity of stock taking

RECOMMENDED FURTHER READINGS

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