TYPES OF AUDIT.

Introduction

The nature of audit work to be performed by the auditor is **dependent on the circumstances that led to his appointment.** In **limited companies** and public institutions an audit is **compulsory** while sole traders and partnerships are not under legal requirements to have their books of accounts audited.

Therefore audit for limited companies and public institutions is a legal requirement and it is known as **statutory audit.** That of sole traders and partnership business are known as private audits because the audit is not compulsory but instead the auditor is appointed for specific purpose. Also on the other hand, both limited and sole trader business may find it necessary to have an independent person in the organisation whose **status is an employee** to carry out a **continuous** appraisal of the activities of the organisation and provide feedback information to the management. The person appointed to undertake work related to these duties is an internal auditor.

Another situation that creates a different role in the work of an auditor is the kind of approach used in the audit work. The circumstances prevailing or terms of reference of the client may necessitate the auditor to use different approaches. This topic looks at the different types of audit.

Classification Of Audits

Audits can be classified into two ways:

1) According to **the nature of work done** e.g. Private, Public or Statutory audits.
2) According to the **method of approach to the work done**-ways of doing either audit in 1 above

According to the Nature of Work Done

a) Statutory Audits

These are performed **according to the law or the Companies Act** Cap 486 of the Laws of Kenya. This audit is conducted within the definitions of the Companies Act, 1948 and 1967 of the Kenya Law. These types of audits are **governed by the statutes and are conducted for limited companies whether Private Ltd or Public Ltd companies**. The above Act requires that the balance sheet and the profit and loss account be laid before the shareholders at the **Annual General Meeting**, thus the annual general meeting is contingent upon the audit report. The same Act outlines the scope and nature of statutory audits. The auditor will do as much as he can to draw an opinion and write a report. This type of audit may have additions by the shareholders. i.e. the shareholders add on the scope of the auditor in these audits but cannot reduce it as per the provisions of same Act.

b) Private audit

These are audits conducted **according to the agreement between the auditor and his client,** and as such they are not governed by any Act. These audits are conducted for such businesses as partnerships, sole traders, clubs etc. The agreement between the auditor and his client is very important because:-

i. It will **define the scope of the work** to be done by the auditor in such an audit

ii. It will be the **basis of charging** his audit fees.

iii. It will be the **basis of the report,** which must be restricted to the scope in the agreement so as to minimize the auditor's liabilities.

However, the auditor must put in his report a disclaimer that he has not covered all the books of accounts so as to enable him to form a balanced opinion and that he did a partial audit. In all, the scope is limited in such audits to those areas where the client wants the auditor to concentrate his effort. Thus, in his report the auditor should also highlight such restrictions otherwise he will be held liable for negligence.

Differences between Public (Statutory Audits) and Private Audits

- In statutory audit, the auditor is liable to third parties unlike in private audit where a disclaimer of opinion is attached to report.
- Statutory audit is **mandatory** and is conducted at end of each financial year while a private audit is not mandatory and may be done even after three years.
- The main **objective** in statutory audit is to prove the true and fair view while that of private audit is to find out the current profit or loss for taxation purposes or detect fraud and errors.
- **Scope of audit is unlimited** in statutory audit unlike in the private audit.
- Auditors perform pure audit work in statutory audit but in private audit, he may do both auditing and accounting.
- Independence from all parties is paramount to statutory audit unlike in the private audit.
- The statutes in statutory audit **define rights and duties** of the auditor while in private audit the management defines or limits them.
- The report in statutory audit is addressed to members while in private audit it's addressed to owners.
- It is a requirement by the Companies Act for the auditors of both public and private companies to report to members in the Annual General Meeting (AGM) in statutory audit; unlike the private audit, which has no such requirements.
- Companies Act governs appointment the auditor in statutory audit whereas in private audit, it is arranged privately by clients.
- Companies Act defines scope in statutory audit unlike in private audit where it's determined by agreement between auditor and clients.

Similarities between statutory and private audits

- Both are **conducted by qualified auditors** who must be qualified according to the provisions of the Companies Act of the laws of Kenya.
- In both audits, the auditor is **supposed to give advice to the client** with regard to the running of their business, in particular their internal control
- Both audits are **used to detect errors and frauds** in a business.
- In both audits, the auditor is supposed to be guided by Auditing Standards and Guidelines.
- Both audits are conducted as a means of certifying the **company's financial position** as well as a means of assessing the company's tax liability.

- Both audits are conducted as a moral booster to the clients staff, thus they will be up to date and vigilant.
- Both audits are used as a **basis of the decision making process** and in particular investment decisions.
- Third parties to gauge the company's performance and thus credibility can use the two audits.

3. Internal audits

This is an independent appraisal of activities within an organization aimed at ensuring that the management operates efficiently so as to manage the business better. Also, it is a managerial tool that acts as a watchdog over the company's entire internal control systems. All in all it is a recent development in the accounting field.

4. External Audit

An external audit is an examination that is conducted by an independent accountant. This type of audit is most commonly intended to result in a certification of the financial statements of an entity. This certification is required by certain investors and lenders, and for all publicly-held businesses.

The objectives of an external audit are to determine:

- The accuracy and completeness of the client's accounting records;
- Whether the client's accounting records have been prepared in accordance with the applicable accounting framework; and
- Whether the client's financial statements present fairly its results and financial position.

Classified according to the method of approach to the audit work

Under this classification we have such audits as: -

a) Continuous Audits
b) Interim Audits
c) Procedural Audits
d) Management Audits
e) Standard Audits
f) Balance Sheet Audits
g) Periodic Audits.

a) Continuous Audits

It is that audit which involves **detailed examination of books** of accounts at **regular intervals** of 1, 2, or 3 months. In this audit, the auditor will check the profit and loss account and the balance sheet items. This audit is not ideal for small businesses whose transactions are few and can be audited at the end of the year and as such, it is left to bigger concerns whose transactions are too numerous that they cannot be checked at one sitting at the end of the year. This type of audit is ideal for such companies as:

1. Banking business whose transactions must be up to date to prevent errors and frauds

2. Where the business is a manufacturing or a trading business and its transactions are too numerous to audit at the end of the financial period

3. Where the business does not have a satisfactory internal control system.

4. Where the business is operating in risky areas and its performance is to be assessed on a continuous basis to ensure timely decision-making process to avert any likelihood of a catastrophe.

Advantages of Continuous Audit (Objectives).

1. Errors and frauds are discovered earlier before it is too late, and corrective measures can be taken immediately to avert any possible losses to the company.

2. It acts as a **preventive measure against errors and frauds** because the officers responsible for the accounting function will not commit errors or frauds as long as they are aware that the auditor will visit the client any time.

3. It enables the auditor to have sufficient knowledge of the business due to his frequent visits and this may assist him in performing efficient audits.

4. It facilitates the **presentation of the report in time** as much of audit work will have been covered in a continuous audit and little is left for final audit.

5. It keeps the client's staff up to date and as such, chances of errors and frauds will be minimized.

6. It imposes a moral check on the client's staff; due to the auditor's surprise visits and this will ensure that the staff has a better sense of duty.

7. It facilitates preparation of interim statements that are necessary for payment of interim dividends.

8. Since the auditor has more time in the business, he will undertake detailed checking of accounts, which will ensure a balanced repot.

9. Audit staff will be kept busy throughout the company's financial period, and this reduces the idleness of slack seasons and its associated unnecessary costs to the auditing firms.

Disadvantages of a continuous Audit (Limitations)

1. Figures already **checked in the accounts may be changed or altered by** dishonest clerks and this may occasion frauds in already checked accounts or items.

2. The frequent visits by the **auditor disrupt the client's work as most books** will have to be checked, thus interrupting the client's work on continuous basis.

3. This type of **audit is very expensive** to the client because of the long hours the auditor takes in the business.

4. **Questions posed by clerks may remain outstanding for quite some** time and may never be answered, which may reduce the amount of audit evidence gathered

5. This type of **audit may induce the client's staff to depend upon audit staff** to solve accounting problems, which may endanger the independence of the audit clerks.

6. **It entails extensive note taking so as to avoid alteration of figures,** which may be tedious to the auditor.

7. This type **audit consumes a lot of auditor's time** and it may inconvenience other clients of the firm in case they have similar year-ends.

Safeguards to these Disadvantages

1. The auditor should give instructions that no alterations should be made without his consent.
2. If any changes is necessary, it must be done using journal entries
3. Checking of the entries must be complete to a specific point in time and noted down; and accounts balanced up to that date.
4. The auditor should use well-drawn audit programs. An Audit program is a set of audit instructions (detailed plan of audit work), which must be followed by audit assistants during the course of their audit work.
5. Notes of questions not answered must be recorded in the auditor's notebook.
6. If there has been any alteration in the company's figures, the auditor should place secret ticks on such figures so as to ensure that these are the figures that had alterations in accounts during the course of his previous continuous audit.
7. Before checking any audit work, the auditor should glance over for any alterations without his secret marks and these must be investigated.
8. Same audit clerks should be used so as to facilitate the smooth flow of audit work.
9. The visits to the client must be surprise visits. (They should not be aware of the auditor's next visit).
10. Audit of impersonal or private ledgers should be left out until the final audit at the end of
the financial period as these stand high chances of being manipulated for fraudulent reasons.

b) Interim Audits

This is that **type of audit conducted within the accounting** period and is aimed at assessing the company's performance so as to **pay/declare interim divided**. These are paid mid of the financial period. However, the balance sheet items are left until the end of the year, thus this audit will concentrate on the profit and loss account items.

Advantages if Interim Audits

1. It is ideal for situations under which the company is required to publish figures for the purposes of paying interim dividends. (Articles of Association of the company must allow for this).
2. It facilitates completion of the final audit, as part of the company's financial accounts will have been covered in the interim audit.
3. Errors and frauds that have been perpetrated will be revealed in this interim audit before they are extensive to occasion heavy loss to the company.
4. It has a moral effect on the staff of the client in that they will be up to date in as much as they expect this interim audit to be undertaken, which will disclose their inefficiencies.
5. In case of partnership business, this audit will serve as a basis for settlement of claims from the company's assets in case of a partner retiring in mid financial periods.
6. It is less expensive than continuous audits because the auditor will spend less time.

7. It is useful under conditions of contemplated mergers and takes over, as the auditor will certify the company's performance up to midyear, which will serve as a basis for negotiations during mergers and take over.

8. Interim audits are useful to those businesses whose nature of operations is dynamic, as this audit will reveal the adaptability of the company's management to changing conditions. For example, motor vehicle manufacturing, textile industry, computer manufacturers, music industry and electronic companies.

Disadvantages of Interim audits

1. Figures already audited can be changed/altered after this audit.
2. It entails a lot of note taking in particular of balances up to mid-financial period to minimize any alterations later
3. It will interrupt the client's work, as his books will be taken away for the purpose of audit.
4. The client's staff may develop the habits of depending upon the audit staff to solve their accounting problems, which may endanger the independence of the latter.
5. Questions raised may not be answered at this period and chances are that this will distort the impression on the accounts at the end of the financial period.
6. It may reveal frauds and errors when they are very extensive; at their advanced stages i.e. mid financial period.
7. Since it is aimed at the declaration of interim dividends, the management may manipulate the accounts to show more profits so as to declare better dividends, which will amount to a big fraud.
8. The auditor undertaking interim audits may not have enough time to gather sufficient evidence from third parties such as debtors, creditors, banks, agents etc, because these parties may delay to answer the auditor's letters leading to an unbalanced opinion

c) Procedural Audits

This is an examination and review of the internal procedures and records of an organization in order to ascertain their accuracy and reliability, as a basis of decision making process and to ascertain whether these are economic in their operations. These types of audits are applicable to big business organizations with complex operations and the auditor's report will relate only to these procedures and will suggest: -

- Those procedures which should be scrapped off or improved/ modified.
- New procedures that can replace old ones.

During the audit, particular attention should be paid to: -

- The company's internal control systems on the procedures.
- Check whether the laid down guidelines are followed on procedures.
- To ensure that no changes have been made to the internal control system (over the procedures) without notification to the auditor.
- To ensure that the company's records are reliable as a means of preparing final accounts and for decision making

Advantages of Procedural Audits

1. This audit will provide a feedback that are outdated and uneconomical and which calls for replacement or modification to suit the company's needs.

2. It will identify the **strengths and weakness** in the internal control system regarding these procedures and steps can be taken to rectify any weakness.
3. Since it is part of the final audit, it will reveal the management's weakness in supervising the company's operations and as such it may act as a morale booster to supervision.
4. It will reveal whether procedures in accounting departments are working properly so as to ensure greater financial controls, which will serve to keep the accounts department up to date, and these will facilitate the company's decision-making process.
5. This audit will ensure harmony and co-ordination of the company's operations, which may boost its profitability.
6. This audit will highlight which areas of the company are bureaucratic and such tendencies may be corrected.
7. This audit will reveal any variance from planned or budgeted performance and this will enable the company to take precautions aimed at correcting the imbalances.
8. These procedural audits will involve assessment of the internal control system in a business and this will reveal whether it can be depended upon in the final audit; to use tests on selected samples of items in accounts.
9. This type of audit may be a basis of writing a management letter, as it will reveal which procedures are not being followed as per the laid down company policies and these can be rectified accordingly.

Disadvantages of Procedural Audits

1. It may be a very expensive audit because the auditor will have to be in the business for quite some time so as to be familiar with the procedures used for this audit.
2. The management may frustrate it, as they can't reveal their inefficiency in the presence of the auditor, leading to a biased opinion.
3. It may mean duplication of effort if the same procedures are examined in the final audit.
4. In businesses where the procedures are too technical or sophisticated the auditor will not be able to undertake audits in that, some of these procedures may be beyond his understanding.
5. This type of audit may be tedious, in particular if the company has numerous procedures.
6. In procedural audits, some procedures may become outdated faster and these may limit the auditor's ability to give a balanced opinion if such changes take place immediately after his audit.
7. Some procedural audits may be expensive to undertake, in particular, if the management and the staff are not well conversant with these procedures.
8. There could be changes in economic conditions, tastes, management structures, etc. all of which may call for an overhaul in the company's procedures, which may make it to achieve good procedural audit.
9. This type of audit is ideal for big companies, which are dynamic in nature, and thus ignores the needs of small businesses.
10. Where the internal control system is weak, the procedural audit will be limited in its applicability thus, almost impossible to have under a weak internal control system.

d) Management Audits:

This type of audit is aimed at investigating managerial aspects of the business from the highest governing executives to the rank and file personnel. It is geared at assessing the efficiency of the management in running of the business, which is essential for its profitability. In addition, it gauges the managerial decision making process such that it will reveal the system of decision making in the business which is necessary for the company's efficiency and thus its profitability.

Advantages of Management Audit:

1. This audit will **improve the quality of the management** in the business and boost its profitability, as the management can't relax if the audit is to be conducted.
2. The audit wil**l identify how decisions are made in a business and if there are any bureaucracies** these can be solved immediately.
3. It will reveal the weakness of the management to manage a viable company and any weakness to this end can be identified.
4. It will reveal the strengths and weaknesses of the internal control system from the top management point of view, which will reveal whether the business' internal control system is in full control and any weakness can be rectified.
5. It will reveal the efficiency of the budgetary systems and how these affect the company's direction.
6. If the auditor gives unqualified report to the effect that the company is doing well, i.e. that it is well managed, this will have a positive impact from third parties' point of view, e.g. bankers, creditors, potential investors, etc., which will allow the company to raise further finance as and when it is needed and thus better negotiating position from its financing endeavors.
7. It does not interrupt the company's operations as fewer of its books, if any, are checked.
8. If the management is efficient as evidenced by this audit, this will be an indication of strong internal control system upon which the auditor will place reliance in his final audit to reduce the volume of its tests.
9. Where the management audit report reveals strength in the internal control systems, this will serve as an indication that there are lesser errors in the business which will enable the auditor to carry out fewer tests in his final audit.
10. The management audit repot will identify which areas have not been managed properly as laid down in the company's policies, and corrective measures can be taken to rectify this situation.

Disadvantages of a Management Audit (Dangers/Limitations)

1. It may lower the morale of top management, which may lead to apathy if this is not conducted properly.
2. It is not possible for the management and audit staff to reveal their inefficiencies during the auditor's presence and those may lead to a biased report.
3. Inefficiencies of one department may usually be due to those of other departments and great care must be exercised to identify which areas or department is inefficient, otherwise this audit may lead to a biased report.
4. Some company's' organization chart to identify who is who in the business may be non-existent or vague in which case the line of authority will not be specific, thus making it difficult to analyze the causes of inefficiencies.
5. The auditor has limited time in the business and human beings, being what they are, may not understand why they do what they did and this may lead to unbalanced reports.

6. Better management performance is a relative phenomenon in that the management may appear to be doing well at present and may change abruptly due to situations which may render them inefficient, e.g.

- Personal problems of a few top managers.
- Changes in managerial staff.
- If the company has undertaken ambitious expansion programs which may render
- some managers "obsolete'' in the sense that they may not be able to supervise the new process, in particular if these are technical.
- If there is an abrupt output into the market, or sales which changes are over and above planned performance, this may be beyond the capability of some line managers to cope with leading to the inefficiency.

7. In case the auditor pin-points out an inefficient line managers, such may be demoted and this may leave a gap in the management co-ordination and may at the extreme frustrate other line managers whose performance may fall to low levels.
8. The management audit may be frustrated by biased responses to audit questions, observations, etc. all of which may lead to biased opinion.
9. In case the audit is conducted for companies with many branches, this may prove to be expensive if the auditor is to cover all areas of management in the parent company and in its branches

e) Standard Audits:
This audit entails a **complete check of all kinds of entries** and this is aimed at **ascertaining the correctness** of such entries. It is ideal for situations under which the client company has very good **accounting system** and **strong internal control systems.** This audit is very **expensive** because it will take **quite some time to finish**. It is ideal under such conditions as contemplated mergers, amalgamations and acquisitions as contemplated mergers, amalgamations and acquisition. This audit covers a period equivalent to one financial period.

f) Balance Sheet Audit:
This audit falls under partial audits and is a phenomenon of U.S.A. Accounting systems. In this audit, the auditor sta**rts his work from the balance sheet working backwards.** It is a limited audit, which can only be conducted after testing the strength of internal control systems. This audit is based on the verification of assets in the balance sheet. The balance sheet is verified by checking
(DOVE).

D = Description (recording of entries of assets).
O = Ownership (check the title deeds and documents of title e.g. receipts);
V = Value (check cost less depreciation. Compare with physical asset);
E = Existence (Physical check whether the asset really exists).

Materiality and sensitivity of items is given paramount importance in this audit. The auditor will also vouch the entries in the ledger.

Advantages of Balance sheet Audit:
It may not be as expensive as a few entries are checked on condition that the internal control system is wrong. It will result in a balanced opinion because the balance sheet contains the

most important items the auditor's report is based on. Chances of changing figures are limited after such audit

Disadvantages of a balance sheet audit:

It is a partial audit and thus may not be ideal for limited companies.

It is applicable only to businesses with strong internal control systems, which are unquestionable, and as such it may not work for all companies in particular small ones whose internal control is weak.

The advice given to the management by the auditor may fall short of some facts, as this audit may not cover all areas. The auditor's liability may be increased because fewer entries will have been checked.

f) Final Audits (Also known as Periodic/ Detailed/Complete Audits)

It is conducted at the **end of the financial period** when accounts have been balanced, and profit and loss account and a balanced sheet prepared. However, this type of audit may as well commence before the end of the financial period and will continue non-stop until the end of the financial period. In this audit, the auditor will take possession of all books of accounts and will these and finally form an opinion and write a report to the shareholders (owners) of the company regarding the true and fair view of the company's performance. Thus, dividend will be approved and paid on the basis of this report.

Advantages of Final Audit: (Advantages of an Audit)

1. It eliminates note taking which is a phenomenon of other audits.
2. It is flexible as the auditor can prepare good programs to cover all areas as well.
3. Chances of figures being changed are minimal because this change may not help any one as the auditor may not check such figures again
4. It is very ideal for small businesses whose transactions are few and can be audited at one sitting.
5. The audit does not interrupt the client's work as it is conducted at the end of the financial period when the books are no longer used by the client as these are closed ready for the audit.
6. It is not very expensive because the auditor will not spend a lot of time and do a lot of work as is true for other audits.
7. The audit will enable the auditor to conduct his subsequent audit as the plan used in this audit may also be used in such subsequent audits.

Disadvantages of Final Audit

1. If the auditing firm has several firms with similar financial year ends, it may be difficult for the auditor to schedule his staff to cover all his clients' work in time properly.
2. The final audit is ideal for small companies whose transactions are few and thus may not meet the needs of big companies.
3. It may increase the auditors' liabilities if the samples tested are small due to limited time available at the end of the financial period.
4. The final audits may take a long time to finish if the internal control system is weak and this may delay the report, thus delaying the annual general meeting, loans development plans, dividends, etc.

5. Errors and frauds detected at the end of the year may be too enormous for the company to contain

Advantages of an Audit (GENERAL)

1. It provides assurance and credibility to the accounts in the audit repot, and this is crucial to all parties who have an interest in the company.
2. Third parties who do not take active part in the running of the business are protected by the auditor's presence in the business and thus, their financial interests will be safeguarded.
3. The audit will serve as a detective and preventive measure against errors and frauds in the business.
4. An audit keeps the client's audit clerks vigilant and up to date because if they are not the auditor will report such and they can be apprehended.
5. Audited accounts by independent auditor minimize chances of disputes among partners in a business e.g. in profit and assets sharing.
6. Incase a new partner wants to join the existing partners, audited accounts will serve as a basis for admission, to determine how much such a partner has to contribute to existing capital.
7. Incase of a retiring or a dead partner, the audited balance sheet and profit and loss account will serve as a basis of determining what is due to the beneficiaries of the deceased and that that due to the retiring.
8. Incase of joint-stock companies, the shareholders who do not take part in the management of their business are assured by the audited accounts that directors have not taken undue advantages of their position in the business to defraud and misuse their assets (shareholders' assets); both money and material assets.
9. Incase of fire or any other catastrophe, the insurance companies will settle the claim of the business on the basis of audited accounts of the previous year.
10. The audited accounts are used as a basis for borrowing finance from banks and other financial institutions, as these will highlight the company's present financial performance, which is crucial to lenders.
11. If the business is to be sold as a going concern, its price can be fixed on the basis of the audited balance sheet of the previous year.
12. Audited accounts are acceptable as a basis of ascertaining tax liability and these are usually accepted by the income tax department for the settlement of income tax for the year.
13. During the course of the audit, the auditor will provide general advice to the management, e.g. advice on financial planning, and the general management of the business; such may be given to the management free of charge.
14. Audited accounts provide assurance to all parties that statutory requirements have been observed by the company during its operations e.g. Co-operative Act, Partnership Act, Companies Act, Societies Act, etc.

Disadvantages of an Audit (GENERAL)

1. Incase an auditor has so many clients, such audit may be tedious and planning these audits may be difficult, which may leave some clients work partly checked, and this may leave some errors or even frauds undetected in some clients' accounts.
2. It is an expensive operation and some small companies may not afford an audit and if they do, they may not be able to have an auditor in the business for many hours.

3. The audit report is a big financial leak to competitors who can use it to out-compete the company whose accounts they have been exposed to, in particular, public companies.
4. In case the audit gives rise to a qualified report, this will reveal the weaknesses of the company under audit and this will reduce its goodwill from third parties' point of view and at worst this will tend to lower the company's share prices in the stock exchange in particular for quoted companies.
5. The client's staff may over-rely on the auditor's staff to solve the accounting problems, which may compromise their independence and lead to a biased report.
6. An audit may disrupt the client's work, in particular if an audit is conducted on a continuous session. This may cost the client many hours lost in the accounting department due to such interruptions.
7. The audit report may delay due to problems with the audit staff and this may delay the;

- Annual general meeting.
- Payment of final dividends.
- Acquisition of loans.
- Statutory payments e.g. tax.
- Merger and acquisitions.

8. There are chances that dishonest employees may alter audited figures and this may lead to a wrong opinion at the end of the year.
9. An audit report may induce trade unions to ask for higher salaries for unionized employees of the company, in particular if the company's retained earnings have been high.
10. An audit may cause conflicts between the company's internal auditor and managers, in particular if the internal auditor cooperates with the external (statutory) auditor in his examination; thus leading to bad working atmosphere and inability by the external auditor to undertake his constant appraisals as these will be frustrated by the managers.
11. An audit will reveal problems (highlighted in the management letter) and this may erode the credibility of the top management from the point of view of directors who may sack some line managers thus leaving apathy in the whole company.

Summary.

There will still be questions as to which type of audit or approach to audit work is satisfactory. The circumstances of the audit and the type of the organisation will be the major determining factor. The type of audit to be conducted may also be influenced by the size of the business and the management attitude to the various types of audit.

c) Procedural audit

d) Management audit