

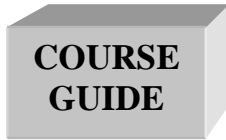


NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: BHM 210

COURSE TITLE: AUDITING



**BHM210
AUDITING**

Course Team

Mr. S. O. Israel-Cookey (Developer/Writer) - NOUN
Dr. Ishola Rufus Akintoye, FCA (Editor) - OSU
Dr. Dimis I. Mai-Lafia (Programme Leader) - NOUN
Mr. Emmanuel U. Abianga (Coordinator) - NOUN



NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
14/16 Ahmadu Bello Way
Victoria Island
Lagos

Abuja Office
5, Dar es Salaam Street
Off Aminu Kano Crescent
Wuse II, Abuja

e-mail: centralinfo@noun.edu.ng

URL: www.noun.edu.ng

Published By:
National Open University of Nigeria

First Printed 2012

ISBN: 978-058-695-4

All Rights Reserved

CONTENTS	PAGE
Introduction	1
Course Contents	1
Course Aims	1
Objectives	1
Course Materials	2
Study Units	2
Assessment	3
Tutor-Marked Assignment	3
Final Examination and Grading	4
Summary.....	4

Introduction

BHM201 Auditing is a semester coursework of two- credit units. It is available to all 200 Level learners in the B.Sc. Cooperatives Management and B.Sc. Entrepreneurial and Business Management programmes of the School of Management Sciences.

The course guide tells you what you will learn in this course, the course aims and objectives, and the materials and support that you require to make your study very successful.

Also, this course guide contains information on assessment which consists of the tutor-marked assignment and the final examination.

Course Contents

The course contents include an overview of auditing – meaning of auditing, concept and audit of financial statements, nature and origin of audit, qualities of a good auditor; classification/types of audit; internal controls and internal check; fraud and errors; audit cycle and procedures; audit planning; audit evidence and procedures; procedures for auditing transactions – fixed assets and investments, current assets, liabilities; audit reports; auditor's importance, responsibility and independence; legal position and liability of auditors; introducing cooperative audit.

Course Aims

This course is aimed at exposing you to the system and techniques of audit, and their applications. This course will also introduce you to the concept of cooperative auditing.

Objectives

At the end of this course, you should be able to:

- define auditing, and explain its nature and origin.
- identify the types, purpose and advantages of audit.
- explain the difference between accounting and auditing.
- trace the development and growth of auditing in Nigeria.
- enumerate the qualities of a good auditor.
- identify the components of financial statement.
- distinguish auditing standards from auditing procedures.
- distinguish between internal control and internal check.
- explain internal control in specific areas of business.

- appraise the limitations of internal control.
 - define fraud, and distinguish between fraud and errors.
 - identify and explain the categories of fraud.
 - highlight fraudulent acts in selected accounts.
 - explain audit cycle, and outline/describe the stages in the audit cycle.
 - highlight matters to be taken into account in planning an audit.
 - explain audit evidence, and enumerate the types of evidence.
 - list the basic techniques for collecting evidence.
 - define audit risk.
 - mention and explain the types of audit risk.
 - identify and explain the procedures for audit transactions.
 - analyse audit reports and financial information.
 - outline the responsibilities of the auditor.
 - explain the concept of auditor's independence.
 - discuss the importance of the auditor in a business organisation.
 - discuss the auditor and the law.
 - explain the concepts of cooperative and cooperative audit.
-
- list the features and objects of cooperative audit.
 - appraise the need for cooperative audit.
 - highlight the duties of a cooperative auditor.

Course Materials

The main components of the course are:

- the course guide
- study units
- references/further reading
- assignment guide.

Study Units

There are fifteen (15) units in this course, and they are grouped into four (4) modules as follows:

Module 1

Unit 1	Overview of Auditing
Unit 2	Classification of Audit
Unit 3	Internal Control and Internal Check
Unit 4	Fraud and Errors

Module 2

Unit 1	Audit Cycle and Procedures
Unit 2	Audit Planning
Unit 3	Audit Evidence and Procedures
Unit 4	Audit Risk

Module 3

Unit 1	Procedures for Auditing Transactions I – Fixed Assets and Investments
Unit 2	Procedures for Auditing Transactions II – Current Assets (Cash, Debtors, Stock/Inventory)
Unit 3	Procedures for Auditing Transactions III – Liability Verification
Unit 4	Audit Reports

Module 4

Unit 1	Auditor's Importance, Responsibility and Independence
Unit 2	Legal Position and Liability of Auditors
Unit 3	Introducing Cooperative Auditing

Each study unit is made up of the introduction, objectives, main content, self assessment exercises, conclusion, summary, tutor-marked assignment, and references/ further reading. This will take at least two hours. You are expected to study the materials carefully and attempt the exercises. You are also expected to consult the textbooks under references/further reading, for additional information. Practise the tutor-marked assignment questions as well.

Assessment

The assessment for this course will be in two parts:

- tutor-marked assignments
- final examination

Tutor-Marked Assignment

The tutor-marked assignments form the basis for continuous assessment for this course.

The NOUN will direct further on the number of tutor-marked assignments you are to attempt, when to attempt them and when to turn them in to your facilitator for grading.

You are expected to use the information gathered from the study material and the references in attempting the assignments. The assignments will account for 30% of the total course marks.

Final Examination and Grading

The final examination in the course will attract the remaining 70% of the total course marks. You are advised to note that all areas of the course will be assessed during the examination.

Summary

Auditing is systematic. On the successful completion of this course, you would have been exposed to the system and techniques of auditing as well as their applications. Also, you would have been exposed to the concept of cooperative auditing.

The National Open University of Nigeria wishes you the best of luck!!!

Course Code BHM210
Course Title Auditing

Course Team Mr. S. O. Israel-Cookey (Developer/Writer) - NOUN
 Dr. Ishola Rufus Akintoye, FCA (Editor) - OSU
 Dr. Dimis I. Mai-Lafia (Programme Leader) - NOUN
 Mr. Emmanuel U. Abianga (Coordinator) - NOUN



NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
14/16 Ahmadu Bello Way
Victoria Island
Lagos

Abuja Office
5, Dar es Salaam Street
Off Aminu Kano Crescent
Wuse II, Abuja

e-mail: centralinfo@noun.edu.ng
URL: www.noun.edu.ng

Published By:
National Open University of Nigeria

First Printed 2012

ISBN: 978-058-695-4

All Rights Reserved

CONTENTS	PAGE
Module 1	1
Unit 1 Overview of Auditing.....	1
Unit 2 Classification of Audit.....	14
Unit 3 Internal Control and Internal Check.....	22
Unit 4 Fraud and Errors.....	43
Module 2	49
Unit 1 Audit Cycle and Procedures.....	49
Unit 2 Audit Planning.....	58
Unit 3 Audit Evidence and Procedures.....	64
Unit 4 Audit Risk.....	78
Module 3	88
Unit 1 Procedures for Auditing Transactions I - Fixed Assets and Investments.....	88
Unit 2 Procedures for Auditing Transactions II - Current Assets (Cash, Debtors, Stock/Inventor.....	95
Unit 3 Procedures for Auditing Transactions III - Liability Verification.....	102
Unit 4 Audit Reports.....	108
Module 4	117
Unit 1 Auditor's Importance, Responsibility and Independence.....	117
Unit 2 Legal Position and Liability of Auditors	125
Unit 3 Introducing Cooperative Auditing.....	133

MODULE 1

Unit 1	Overview of Auditing
Unit 2	Classification of Audit
Unit 3	Internal Control and Internal Check
Unit 4	Fraud and Errors

UNIT 1 OVERVIEW OF AUDITING

CONTENTS

1.0	Introduction
2.0	Objectives
3.0	Main Content
3.1	Meaning, Nature and Origin of Audit
3.1.1	Meaning of Auditing
3.1.2	Nature of Auditing
3.1.3	Origin of Auditing
3.2	Types, Purpose and Advantages of Audit
3.2.1	Types of Audit
3.2.2	Purpose of Audit
3.2.3	Advantages of Audit
3.3	Distinction between Accounting and Auditing
3.4	Development and Growth of Auditing in Nigeria
3.5	Qualities of a Good Auditor
3.5.1	Professional Independence
3.5.2	Competence
3.5.3	Confidentiality
3.6	Components of Financial Statements
4.0	Conclusion
5.0	Summary
6.0	Tutor-Marked Assignment
7.0	References/Further Reading

1.0 INTRODUCTION

Auditing is a process of examining and reviewing the accounting transactions in order to give assurance that the financial statements present the financial position of the firm fairly, as at a particular period. We can also refer to auditing as attestation to the true and fair view of financial statements of a business. The relevance of auditing in the business world of today needs no emphasis as the solution to the problem of credibility in reports and accounts lies in appointing an independent person, called an auditor, to examine and report on his findings.

The purpose of this unit is to give you an overview of auditing with emphasis on the meaning, nature and origin of audit, types, purpose and advantages of audit, distinction between accounting and auditing, as well as the development and growth of auditing in Nigeria. In addition, the qualities of a good auditor and the components of financial statements will be discussed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define auditing and explain its nature and origin
- identify the types, purpose and advantages of audit
- distinguish between accounting and auditing
- trace the development and growth of auditing in Nigeria
- enumerate the qualities of a good auditor
- identify the components of financial statements.

3.0 MAIN CONTENT

3.1 Meaning, Nature and Origin of Audit

3.1.1 Meaning of Auditing

According to Messier (1999), “Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users”.

Wikipedia (2006), defines audit as an evaluation of an organisation, system, process, or product. It is performed by competent, objective, and unbiased persons, known as auditors.

The American Accounting Association (AAA,1973), in a study entitled, "A Statement of Basic Auditing Concepts", defined auditing as, "A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events; to ascertain the degree of correspondence between those assertions and established criteria and , communicating the results to interested users."

From the above, one can deduce that auditing is an independent examination of, and the expression of opinions, on accounts of a business (be it a sole proprietorship, partnerships, company or public enterprises) as presented by the management by a duly appointed auditor

in pursuance of that appointment, and in keeping with the relevant legislations and other requirements whether in his opinion the accounts show:

- (a) a true and fair view of the state of affairs of the business;
- (b) that the accounts have been properly prepared and are in accordance with the provisions of the Companies and Allied Matters Act (CAMA) of 1990 as amended.

3.1.2 Nature of Auditing

The auditor must consider and report on the followings.

- (a) Whether proper accounting records have been kept by the business in the opinion of the auditor. These records must include:
 - (i) a record of purchases and sales of goods in sufficient details to identify the goods and their sellers and buyers (except in normal retail trade).
 - (ii) day-to-day payments and receipts of cash.
 - (iii) details of assets and liabilities.
 - (iv) statement of stock and supporting stocktaking schedule.
- (b) Whether proper returns adequate for audit purposes, have been received from branches not visited by them.
- (c) Whether profit and loss accounts and balance sheet are in agreement with the other records.
- (d) Whether he has received all information and explanations for the purpose of his audit.

In consideration of the above, essentially, the main function of an auditor is to express an opinion on the truth and fairness of the accounts laid before him and not the detection of fraud and errors which are essentially secondary.

3.1.3 Origin of Auditing

Prior to the medieval times, auditing was referred to as a process of public hearing in which financial statements or financial records were read aloud. The auditor was referred to as someone who has sole authority to hear and comment on the readings.

In medieval times, audit was made to determine whether the persons in positions of fiscal responsibilities in governments were acting and reporting in good faith or in an honest manner.

However, auditing has taken a new dimension in our society today, and it will continue to be improved upon as a result of growth and expansion of businesses.

SELF-ASSESSMENT EXERCISE 1

1. Define auditing.
2. Appraise the primary functions of an auditor.
3. What are secondary purposes of an audit?

3.2 Types, Purpose and Advantages of Audit

3.2.1 Types of Audit

Basically, there are two types of audit, and these are:

- i. statutory audit
- ii. non-statutory audit.

(a) Statutory audit

This is an expression of an opinion on the financial statements by an independent chartered accountant. This is governed by the provisions of the Companies and Allied Matters Act of 1990.

It states that “the financial statements are true and fair”. It is referred to as statutory because it is an audit required by law, and is conducted under the terms set out by the legal regulations.

(b) Non-statutory audit

This can be classified under the following.

(i) Operational audit

This is referred to as internal audit, which purpose is to assess management’s effectiveness in achieving the organisational goals and objectives.

It deals with evaluation of compliance with some set of specifications.

(ii) Pre-audit

Also known as administrative audit, this speaks to an examination of financial transactions prior to their completion.

(iii) Post audit

This covers financial transactions that have been fully completed at the end of an accounting period.

(iv) General audit

General audit covers all financial transactions and records of a government unit, and is made after the close of financial period.

(v) Special audit

This is an audit that is restricted to some segments of the unit's financial transactions.

(vi) Limited audit

This is one in which the mathematical accuracy, legality, propriety and completeness of a governmental unit's financial transactions were determined by examining only a sample of selected transactions.

(vii) Complete audit

Complete audit is also referred to as general audit. It is an examination of the details of all financial transactions by a governmental unit during an account period.

3.2.2 Purpose of Audit

Scott (2003), stated that the purpose of audit is to verify that the subject of the audit was completed or operated according to approved and accepted standards, statutes, regulations, or practices. It also evaluates controls to determine if conformance will continue. Auditing is a part of some quality control certifications such as ISO 9000. Audit evaluates conformance now and in the future. An inspection evaluates conformance in the past. Both are important parts of management.

Basically, the purpose of audit includes the following:

- (a) the expression of an opinion on the financial statements to show whether the statements are true and fair as required by the CAMA of 1990.
- (b) to give credibility on the statements audited in accordance with the terms of the auditor's appointment.
- (c) to produce a report.

However, the following can be regarded as secondary purposes:

- (a) to detect errors and fraud.
- (b) to prevent errors and fraud.

3.2.3 Advantages of Audit

Let us highlight the advantages of audit as follows:

- (a) gives confirmation of the actual financial position of the organisation being audited;
- (b) gives credibility to the financial statements;
- (c) makes it easy to negotiate for insurance claims;
- (d) brings up-to-date the financial records of an organisation;
- (e) reveals some of the internal control weaknesses;
- (f) gives assurance to shareholders and users of financial statements that the accounts are true and fair;
- (g) ensures that accounts are produced according to the best practices;
- (h) helps to improve the system of internal control;
- (i) applications for loans are greatly enhanced if supported by audited accounts;
- (j) facilitates the admission of new partners into a business.

SELF-ASSESSMENT EXERCISE 2

1. Why is auditing necessary?
2. Audit gives credibility to the financial statements. Explain.

3.3 Distinction between Accounting and Auditing

Here, let us attempt to differentiate between accounting and auditing based on their specific concerns and requirements.

S/N	Areas	Accounting	Auditing
1.	Governance	Governed by the Generally Accepted Accounting Principles(GAAP)	Governed by the Generally Accepted Auditing Standards (GAAS)
2.	Tasks	Maintenance of accounting records and documents as well as providing information about the economic resources and obligations of a business.	Verification of figures in the accounting records and books and to ensure that they are reasonable.
3.	Obligations	Measures the economic effects and communicates economic results to decision makers.	Makes sure that the economic events reported in the financial statements occurred.
4.	Reporting	Balancing of books and preparation of financial statements.	Expression of opinion as to the truth and fairness of the financial statements.

The above distinctions notwithstanding, it is necessary to find out where accounting ends and where auditing begins. Strictly speaking, an auditor can only commence auditing when necessary accounting work had been completed.

In practice, however, especially in the case of non-statutory and small company clients, the distinction between auditing and accounting work is not clearly appreciated. The confusion usually arises between the bookkeeping and accounting capabilities of those individuals who run small businesses, and it is always tempting to the auditor to complete the preparation of the accounts which is not part of his work. Accountancy work is clearly different from auditing, and when the two are undertaken by the same person, integrity of records is put in doubt.

It has been viewed, and strongly too, that an independent audit is impossible if the auditor has been very well involved in the preparation of the accounts audited. A separate fee for each is normally negotiated when an accountant undertakes both the accounts and audit work.

SELF-ASSESSMENT EXERCISE 3

List and explain the areas of differences between accounting and auditing.

3.4 Development and Growth of Auditing in Nigeria

In Nigeria, the Institutions of Public Auditors was established in 1888. Until 1910, history has it that it remained a part of the United Kingdom's Auditor-General's office. The control of the office passed on to the Colonial Office. It was from the Colonial Audit Department that the Federal Audit Department grew.

The then Controller of Audit (now Auditor-General) was given the discretion to accept as correct, vouchers which had been examined and certified correct by the Audit Department, and the audit took the form of an examination of the system of departmental internal control together with test-checks to ascertain the level of efficiency and dependence.

From 1956, the audit of most public accounts in Nigeria became the responsibility of the Director of Audit. Also, in 1956, the first state authority for audit came with the publication of the Audit Ordinance. The Ordinance was superseded by the constitutional provisions when Nigeria became independent in 1960.

The growth of audit in the private sectors arose as a result of the formation of the Institute of Chartered Accountants of Nigeria (ICAN) by the Parliamentary Act of 1965, the requirements of the then Companies Decree of 1968 (now CAMA of 1990 with amendments) as well as the Income Policy Guidelines of 1987, that is, the Productivity, Prices and Income Board Guidelines (PPIBG).

Under the CAMA of 1990 (as well as the Companies Decree of 1968), every public limited liability company is required by law to have its financial records audited by external auditors annually. Today, therefore, the following have made impact on the growth and development of audit in Nigeria.

- (a) The activities/relevance of professional accounting bodies, notably, ICAN (The Institute of Chartered Accountants of Nigeria) and ANAN (Association of National Accountants of Nigeria);
- (b) The relevant provisions of the law (CAMA, 1990 etc.);
- (c) Stipulations and adherence to the relevant statement on auditing standards.

SELF-ASSESSMENT EXERCISE 4

Trace the history of growth and development of auditing in Nigeria.

3.5 Qualities of a Good Auditor

In fact, the word “audit” is a Latin word which means “to hear”. The word was derived in this way because in the ancient time, the accounts of an estate were checked by having them read out by those who had compiled them to those in authority. At that time, the auditor’s objective was merely to ascertain the correctness of the sums of money received and expended.

In those days, the basic qualification for the position of an auditor was his reputation. A person was known for his integrity and independence of mind, and the matter of technical ability was entirely secondary. Today, however, the position is reversed: the auditor must be a professionally qualified individual and one who abides by the code of conduct of the professional body.

The ethical guides that currently regulate audit practice are as follows.

- (a) Professional independence;
- (b) Competence;
- (c) Confidentiality;
- (d) Morality involved in determining fees and restriction of competition among members.

3.5.1 Professional Independence

Professional independence is essentially an attitude of the mind characterised by integrity and objective approach to professional work. An auditor is expected to check the work of others and to express his opinion thereon. Therefore, it is necessary that he is independent of those who appointed him.

In auditing, therefore, independence means the possession of integrity, ability to be self-reliant and honest, freedom from bias and the avoidance of relationships which, to a reasonable observer, would suggest a conflict of interest on the auditor’s part. It also means the avoidance of any relationship which might impair the auditor’s objectivity in expressing his opinion. In a nutshell, the auditor must have the independence of mind. He must not only be independent, he must be seen to be independent.

However, situations can arise that may lead to a loss or impairment of the auditor’s independence. Let us note that there are significant relationships which can appear to compromise an auditor’s independence. These are as follows.

- (i) Shareholding in a client's company.
- (ii) Making of loans to, or by clients.
- (iii) Presence of personal ties or blood relationships in the company being audited.
- (iv) Involvement in a managerial capacity in the client's business.
- (v) Provision of a number of services to the same client.

3.5.2 Competence

This is the application of technical knowledge. It is the ability to apply knowledge to a particular engagement, supervise and evaluate the work performed by the staff members. The auditor must observe the profession's general technical standards and endeavour to improve competence and the quality of services. The confidence of the public in his work depends on his competence.

3.5.3 Confidentiality

An auditor should respect the confidentiality of information of his client and should not disclose any such information to the third party without permission from his client unless:

- (i) he knows or suspects his client to have committed the offence of treason or treasonable felony when the duty to disclose is obligatory.
- (ii) the disclosure is reasonably necessary to protect the interest of members (of the professional body).
- (iii) he is required to disclose by due legal process or the interest of the public by the order of a court.

SELF-ASSESSMENT EXERCISE 5

1. Identify and explain relationships that can impair the auditor's independence.
2. Explain the relevance of "competence" as a quality which an auditor should possess.

3.5.4 Components of Financial Statements

Today, through the process of stewardship accounting, whereby the managers of a business account or report to the owners of the business, financial statements are produced. Financial statements can take many forms. The best known are the profit and loss accounts and the balance sheets of businesses.

In the specific case of limited liability companies, financial statements are produced annually and take the form of an 'Annual Report and Accounts' which include: a profit and loss account and balance sheet, as well as other statements including the director's report and a cash flow statement.

Summarily, the components of financial statements are as follows:

- (i) Balance sheet – shows assets and liabilities of a business;
- (ii) Profit and loss accounts – shows whether the business is making profit or loss;
- (iii) Statement of sources and application of funds – shows the financing activities represented as inflows of funds or sources of funds, and investing activities as outflows of funds or uses of funds;
- (iv) Notes to the accounts – shows explanatory notes to figures in the financial statements;
- (v) Value-added statement – represents additional wealth created and its allocation between employees, government and re-investment for the future;
- (vi) Historical financial summary – summarises major financial figures on the audited accounts.

4.0 CONCLUSION

Auditing is systematic. It has techniques that you need to be conversant with in order to function effectively as an auditor. Professional independence, competence and confidentiality are ethical values of an auditor. The overview of auditing, as you have seen in this unit, will serve as a springboard for the study of the entire course.

5.0 SUMMARY

In this unit, you have been able to have an overview of auditing. You are now conversant with the meaning, nature and origin of auditing. You have learnt the types, purpose and advantages of audit. Also, you can now distinguish between accounting and auditing – while accountants balance the books and prepare financial statements, auditors express opinion as to the truth and fairness of financial statements.

In addition, you are now familiar with the development and growth of auditing in Nigeria, where it was seen that the formation of professional accounting bodies had contributed so much to the growth and development of auditing.

Finally, you can now identify the qualities a good auditor should possess, and the components of financial statements.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

1. According to Messier, Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users (See 3.1.1).
2. The primary function of an auditor is to express his opinion on the truth and fairness of the accounts.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

Areas of differences between accounting and auditing are as follows:

- i) Governance
- ii) Tasks
- iii) Obligations
- iv) Reporting (See 3.3)

6.0 TUTOR-MARKED ASSIGNMENT

Identify and discuss the qualities of a good auditor relative to the professional ethics.

7.0 REFERENCES/FURTHER READING

CAMA (1990). *Companies and Allied Matters Act*. Lagos: Government Press.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Kell, W.G.; Boynton, W.C. & Ziegler, R.E. (1986). *Modern Auditing* (3rd Ed.). New York: John Wiley and Sons.

Messier, W.F. (2000). *Auditing and Assurance Services: A Systematic Approach* (2nd Ed.). USA: McGraw-Hill Company Inc.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Scott, D.L. (2003). *An A to Z Guide to Investment Terms for Today's Investor*. Wall Street: Houghton Mifflin Company.

The American Accounting Association (AAA, 1973) in a study entitled, "*A Statement of Basic Auditing Concepts*".

Wikipedia (2006). This page was last modified 18:32, 12 March, 2006. All text is available under the terms of the GNU Free Documentation License Wikipedia® is a registered trademark of the Wikimedia Foundation, Inc.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockley, Essex, Great Britain: 4 Edge Limited.

UNIT 2 CLASSIFICATION OF AUDIT

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Classification of Audit by Nature
 - 3.1.1 Private Audit
 - 3.1.2 Statutory Audit
 - 3.1.3 Internal Audit
 - 3.2 Classification of Audit by Method of Approach
 - 3.2.1 Final or Completed Audit
 - 3.2.2 Interim Audit
 - 3.2.3 Continuous Audit
 - 3.2.4 Balance Sheet Audit
 - 3.3 Companies and Allied Matters Act (1990) and the Auditors
 - 3.3.1 Rights of the Auditors
 - 3.3.2 Qualifications as Auditors
 - 3.4 Generally Accepted Auditing Standards
 - 3.4.1 The General Standards
 - 3.4.2 The Standards of Fieldwork
 - 3.4.3 The Standards of Reporting
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

In this unit, you shall be exposed to the classification of audit in a greater detail – classification by nature as well as by method of approach.

Also, you will learn how the provisions of the Companies and Allied Matters Act (1990) affect the auditor.

Finally the Generally Accepted Auditing Standards will be explained to you. These standards relate to the measuring of the quality of performance.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- classify audit by nature
- classify audit by method of approach
- explain the provisions of CAMA (1990) as they affect the auditor
- distinguish auditing standards from auditing procedures.

3.0 MAIN CONTENT

3.1 Classification of Audit by Nature

This will be discussed under the following sub-heads:

3.1.1 Private Audit

This form of audit is undertaken at the request of the interested party even though there is no legal obligation that an audit should be carried out. The scope of the private audit may be determined as normally or broadly as the client wishes, according to his requirements.

3.1.2 Statutory Audit

Statutory audit arises under CAMA (1990). It is a statutory obligation for the accounts of every limited liability company to be audited annually by a professionally qualified auditor.

The scope of statutory audit is largely determined by legislation which the directors, shareholders or even the auditors have no authority to vary or alter in any way.

3.1.3 Internal Audit

Both private and statutory audits are undertaken by independent (external) auditors. The internal auditor is an employee of the organisation engaged in such a work on behalf of the organisation.

According to the Institute of Chartered Accountants in England and Wales (ICAEW), Internal Audit is defined as:

...a review of operations and records, sometimes continuous, undertaken within a business, by specially assigned staff.

The American Institute of Internal Auditors gave a similar definition as follows:

... internal auditing is an independent appraisal activity within an organisation for the review of accounting, financial and other controls, as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls.

The nature of the internal auditor's job/work requires that he should be given a degree of independence, but as an employee of the organisation, he takes directives from the management and reports to the management. Therefore, his independence may be impaired.

SELF-ASSESSMENT EXERCISE 1

1. Mention and explain the three classes of audit by nature.
2. How far can the external auditor rely on the work of the internal audit team?

3.2 Classification of Audit by Method of Approach

3.2.1 Final or Completed Audit

This is undertaken by the external auditors at the completion of preparation of final accounts of the business.

3.2.2 Interim Audit

By this method of approach, auditors have a predetermined period, say, monthly, quarterly, etc. to audit the account being prepared so far. It has some advantages over the final audit in the sense that errors, omissions or frauds are detected early.

Secondly, the audit work is completed soon after the final accounts have been drawn. Thirdly, the presence of auditors acts as a check on the accountants who may have fraudulent motive to manipulate the company's accounts.

However, the method has a little disadvantage in the sense that it interrupts a continuous accounting work.

3.2.3 Continuous Audit

This occurs in a situation where the auditing firm, concerned with auditing the accounts of a particular company, sends its own staff to that

company to audit the accounts daily and work is completed at the same time as the final accounts are drawn.

Time is saved, errors are minimised, and the possibility of fraud by the staff of the company may be ruled out. However, its flaw is that the audit staff may constitute a complete nuisance to the company.

3.2.4 Balance Sheet Audit

A balance sheet audit is slightly different from the conventional audit in the sense that it begins by verifying all items appearing in the balance sheet by tracing each item at a time to confirm that the items actually exist.

SELF-ASSESSMENT EXERCISE 2

How would you classify audit by method of approach?

3.3 Companies and Allied Matters Act (1990) and the Auditors

The provisions of CAMA (1990) in Section 357 made it clear that auditors should be appointed to protect the shareholders and members of the public by reporting in fair manner on the financial statements of every limited liability company.

The general duties of auditors are laid down in both the CAMA and engagement letter given to the auditors by the board of directors of the company.

The duties and ethical behaviours of auditors are also monitored by the relevant professional accounting bodies, namely, ICAN and ANAN.

Specifically, CAMA (1990) provided for the following in relation to the auditors.

- (i) Appointment
- (ii) Remuneration
- (iii) Resolutions as to appointment and removal of auditors
- (iv) Rights
- (v) Qualifications.

3.3.1 Rights of the Auditors

The rights of the auditors, as spelt out in CAMA (1990) are as follows.

- (a) Every auditor of a company should have a right of access at all times to the books and vouchers of the company.
- (b) He shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of his (their) duties.
- (c) The 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 any member of the company is entitled to receive.
- (d) A right to be heard at any general meeting, which he attends, on any part of the business of the meeting which concerns him as auditor.

3.3.2 Qualifications as Auditors

CAMA (1990), as well as the Institute of Chartered Accountants of Nigeria (ICAN), stipulate the qualifications of auditors to practise in Nigeria. Basically, auditors must possess technical competence to perform audit engagement. Auditors of a company must be members of recognised professional accountancy bodies.

SELF-ASSESSMENT EXERCISE 3

Explain the rights of auditors as provided for by CAMA (1990).

3.4 Generally Accepted Auditing Standards

The Companies and Allied Matters Act of 1990 made it mandatory for audited financial statements to state that they are true and fair, and that the profit and loss account and the balance sheet comply with the provisions of the Act.

The auditing standards apply to all reports in which the auditor expresses an opinion on the entire financial statement which is aimed at presenting a true and fair view of the state of financial affairs.

Auditing standards have universal acceptance among international accountancy bodies. These standards deal with the general standards expected from every auditor, the standards of fieldwork, and the standards of reporting.

Auditing standards and auditing procedures have been distinguished clearly by the accounting profession. While auditing standards relate to measures of the quality of performance, auditing procedures relate to the act to be performed. The standards measure the quality of job done based on the acts and the objectives to be attained by the use of the procedures undertaken.

Therefore, auditing standards deal with auditors' professional qualities and also with the professional judgement to be exercised during the audit engagement.

According to the American Institute of Certified Public Accountants in the Codification of Statement on Auditing, the Generally Accepted Auditing Standards are broken down into three sections as below.

- B-1 The General Standards
- B-2 The Standards of Fieldwork
- B-3 The Standards of Reporting

3.4.1 The General Standards

The general standards are as follows.

- (i) The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor or auditors;
- (ii) In all matters relating to the assignments, independence in mental attitude, is to be maintained by the auditor or auditors;
- (iii) Due professional care is to be exercised in the performance of the examination and the preparation of the report.

3.4.2 The Standards of Fieldwork

The standards of fieldwork are as follows:

- (i) The work is to be adequately planned and assistance, if any, is to be properly supervised.
- (ii) There is to be proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
- (iii) Sufficient competent evidential matters are to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

3.4.3 The Standards of Reporting

The standards of reporting are as follows:

- (i) The report shall state whether the financial statements are presented in accordance with the Generally Accepted Accounting Principles.
- (ii) The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
- (iii) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- (iv) The report shall either contain an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that the opinion cannot be expressed. The reason, therefore, should be stated. In all cases, where the auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

SELF-ASSESSMENT EXERCISE 4

Distinguish between 'auditing standards' and 'auditing procedures'.

4.0 CONCLUSION

In this unit, you have learnt about the relevance of the Generally Accepted Auditing Standards (GAAS). You are now aware of how the quality of job being done is measured and how quality is assured.

5.0 SUMMARY

In this unit, you have learnt the classification of audit by nature and by method of approach. Private, statutory and internal audits fall under the classification by nature, while final, interim, continuous and balance sheet come under the classification by method of approach. The provisions of CAMA (199) as they affect auditors were highlighted. Finally, you looked at the Generally Accepted Auditing Standards (GAAS) and how it relates to the measuring of the quality of job done.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

The classes of audit by nature are:

- i) Private audit

- ii) Statutory audit
- iii) Internal audit (See 3.1)

ANSWER TO SELF-ASSESSMENT EXERCISE 3

Right of auditors under the Act (See 3.3.1)

ANSWER TO SELF-ASSESSMENT EXERCISE 4

Auditing standards relate to measures of the quality of performance while auditing procedures relate to the act to be performed. The standards measure the quality of job done based on the acts and the objectives to be attained by the use of the procedures undertaken.

6.0 TUTOR-MARKED ASSIGNMENT

1. Mention and explain the different classes of audit.
2. Why must an auditor be independent?

7.0 REFERENCES/FURTHER READING

- CAMA (1990). *Companies and Allied Matters Act*. Lagos: Government Press.
- Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.
- Kell, W.G.; Boynton, W.C. & Ziegler, R.E. (1986). *Modern Auditing* (3rd Ed.). New York: John Wiley and Sons.
- Wittington, O.R. & Pany, K. (2004). *Principles of Auditing and Other Assurance Services* (14th Ed.). New York: McGraw-Hill and Irwin.
- Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

UNIT 3 INTERNAL CONTROL AND INTERNAL CHECK

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Internal Control
 - 3.1.1 Objectives of Internal Control
 - 3.1.2 Essential Features of Internal Control
 - 3.1.3 Components of Internal Control
 - 3.2 Internal Check
 - 3.3 Internal Audit
 - 3.3.1 Relationship between the Internal and External Auditors
 - 3.3.2 Differences between the Internal and External Auditors
 - 3.3.3 Cooperation between the Internal and External Auditors
 - 3.4 Internal Control in Specific Areas of a Business
 - 3.4.1 Internal Control Generally
 - 3.4.2 Cash and Cheques Received by Post
 - 3.4.3 Cash Sales and Collections
 - 3.4.4 Payments into Bank
 - 3.4.5 Cash Balances
 - 3.4.6 Bank Balances
 - 3.4.7 Cheque Payments
 - 3.4.8 Wages and Salaries
 - 3.4.9 Purchases and Trade Creditors
 - 3.4.10 Sales and Debtors
 - 3.4.11 Stock and Work-in-Progress
 - 3.4.12 Fixed Assets
 - 3.5 Limitations of Internal Control
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

In this unit, you shall learn the relevance of internal control and internal control system in an organisation. The objectives, essential features and components of internal control will be considered.

You shall also be able to distinguish between internal control and internal check, and explain the relationship, differences and areas of cooperation between the internal and external auditors.

Before the end of the unit, you shall also be able to highlight internal control in specific areas of a business and its limitations.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define internal control and internal control system
- list the objectives and describe the essential features of internal control
- identify the components of internal control
- distinguish between internal control and internal check
- describe internal control in specific areas of business
- state the limitations of internal control.

3.0 MAIN CONTENT

3.1 Internal Control

Internal control system means the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure, as far as possible, the completeness and accuracy of the records.

Also, the American Institute of Certified Public Accountants defines internal control thus.

Internal control comprises the plan of an organisation and all of the coordinated methods and measures adopted within a business to safeguard assets, check accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to the prescribed managerial policies.

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

3.1.1 Objectives of Internal Control

The objectives of internal control are as follows.

- (a) To ensure adherence to management policies.
- (b) To safeguard the company's assets.
- (c) To ensure accurate and reliable records.

At an early stage of his work, the external auditor will have to decide the extent to which he wishes to rely on the internal controls of the enterprise.

As the audit proceeds, that decision will be subject to review, and depending on the result of his examination, he may decide whether or not to place reliance (less or much) on these controls.

3.1.2 Essential Features of Internal Control

There are three features, namely:

- (a) authorisation (the initiation of a contractual obligations).
- (b) custody (the handling of assets involved in the transactions).
- (c) recording (the creation of documentary evidence of the transactions and its entry in the accounting records).

The essence of internal control lies in the separation of the three functions mentioned above, which represent the objectives of control in any departmental context.

SELF-ASSESSMENT EXERCISE 1

Define internal control.

3.1.3 Components of Internal Control

The basic components of internal controls are:

- (a) internal check (segregation).
- (b) internal audit.
- (c) physical control.

3.2 Internal Check

This aspect of internal control is exclusively concerned with the prevention and early detection of omissions, errors and fraud. It

involves the arrangement of bookkeeping and other clerical duties in such a way to ensure that:

- (a) no single task is executed from the beginning to the end by one person only.
- (b) the work of each clerk engaged upon a task is subjected to an independent check in the course of another's duties. For example, in a construction firm that employs staff members who are paid by cash (based on the number of hours worked for), the wages section may use a system which involves the following segregation of duties:
 - (i) Collection and sorting of time cards;
 - (ii) Calculation and listing of standard hours and overtime hours worked for by reference to the time cards;
 - (iii) Calculation of gross pay by reference to records supplied by the personnel department;
 - (iv) Production of payroll on accounting machine, that is, entry of gross pay, deductions, calculation of net pay, cumulative cast and cross-cast of payroll;
 - (v) Double check of cast and cross-cast of payroll;
 - (vi) Submission of payroll to a signatory in order to obtain wages cheque;
 - (vii) Visit to bank to obtain cash for wages;
 - (viii) Insertion of cash into envelopes by reference to duplicate pay list;
 - (ix) Payment of wages against signed receipt from each employee;
 - (x) Returning signed payroll and unclaimed wages to the cash department for special action.

SELF-ASSESSMENT EXERCISE 2

Distinguish between internal control and internal check.

3.3 Internal Audit

In the previous unit (Unit 2 of Module 1), you learnt the definition of internal audit as an independent appraisal activity within an organisation for the review of accounting, financial and other controls as a basis of service to management. And that it is the managerial control which functions by measuring the effectiveness of other controls. It was also pointed out that the internal auditor is an employee of the organisation and is responsible to its management. You are also aware that the internal auditor requires a degree of independence to function, but because he is an employee of the organisation and, invariably, takes directions from the management, his independence may be impaired.

The duties and responsibilities imposed upon the internal audit deserve special attention. The effective operation of a business depends on the effectiveness of the internal audit. Internal audit is one of the features of management control, and therefore, aids management to achieve efficient and effective operation of the business.

Internal audit unit is responsible for designing internal controls and procedures, and providing accurate information to the management for the day-to-day operations of the business.

3.3.1 Relationship between the Internal and External Auditors

The relationship subsisting between the internal and external auditors is based on the fact that on accounting matters, they operate largely in the same field and have a common interest in satisfying themselves that:

- (a) there is an effective system of internal check to prevent or detect errors and frauds, and that the system is operating correctly;
- (b) there is an adequate accounting system to provide the information necessary to prepare a true and fair financial statement.

3.3.2 Differences between the Internal and External Auditors

We can look at the differences from the domain of scope, approach and responsibility.

S/N	AREAS	INTERNAL AUDITOR	EXTERNAL AUDITOR
1.	Scope	Extent of work undertaken is largely determined by its management.	Extent of work undertaken is largely determined by law.
2.	Approach	Ensures that the accounting system is efficient to guarantee accurate information to be made available to management, and that the information discloses material facts.	His approach is governed by his duty to satisfy himself that the accounts presented to the stakeholders show a true and fair view of the profit and loss for the period and the balance sheet at the end of the period.
3.	Responsibility	Responsible to the management – he is a servant of the	Directly responsible to the shareholders.

		organisation and may have his independence constrained or reduced.	
--	--	--	--

The above differences, notwithstanding, the work of both on accounting matters is carried out largely by similar means such as:

- (a) the examination of the system of internal check for both soundness in principles and effectiveness in operation;
- (b) examination and internal checking of accounting records and statements;
- (c) verification of assets and liabilities;
- (d) observation, enquiry, the making of statistical comparisons, and other measures adjudged to be necessary.

SELF-ASSESSMENT EXERCISE 3

What are the basic differences between the internal and external auditors?

3.3.3 Cooperation between the Internal and External Auditors

Without cooperation, the work of both the internal and external auditors could be duplicated largely because their procedures are the same. Because of the wider experience gained in the public practice, the external auditor may be of assistance in an advisory capacity in connection with the installation and subsequent operation of internal audit in the company.

He (external auditor) may also derive some benefits from the internal auditor's intimate knowledge of the business, particularly, in connection with stock-in-trade, the physical existence of fixed assets, depreciation charges, the ascertainment of liabilities and the risk of fraud or misappropriation.

Specific areas of cooperation may be as follows.

- (a) The independent auditor may be able to rely, to a larger extent, on the internal auditor in determining whether the system of the internal check is operating satisfactorily and in assessing the general reliability of the accounting records.
- (b) The audit programmes of the internal auditor may include, by agreement, the work which has the effect of giving direct assistance to the external auditor by participating during the accounting period in matters such as cash counts and visits to

branches made either by the internal auditor alone or jointly with the external auditor.

- (c) The internal auditor may arrange his audit programmes at the end of the accounting period so that assistance is given to the independent auditor in connection with matters such as the confirmation of customer's account, verification of assets such as stock-in-trade and the preparation of audit working schedules required by the independent auditor for his records.

3.4 Internal Control in Specific areas of a Business

This section is divided up into the areas of activity usually found in a business. At the beginning of each area are the stated the objectives of internal control in the area and then some measures through which the objectives will be achieved.

3.4.1 Internal Control Generally

Objective

To carry on the business in an orderly and efficient manner, to ensure adherence to management policies, safeguard its assets, and secure the accuracy and reliability of records.

Measures

- (i) An appropriate and integrated system of accounts and records;
- (ii) Internal controls over those accounts and records;
- (iii) Financial supervision and control by management, including budgetary control, management accounting reports, and interim accounts;
- (iv) Safeguarding and if necessary, duplicating records;
- (v) Engaging, training, allocating to specific duty staff members who are capable of fulfilling their responsibilities. Rotation of duties and cover for absences.

3.4.2 Cash and Cheques Received by Post

Objectives

- To ensure that all cash and cheques received by post are accounted for and accurately recorded in the books;
- To ensure such receipts are promptly and intactly deposited in the bank.

Measures

- (i) Prevent interception of mail between receipt and opening;
- (ii) Appointment of an official to be responsible for the opening of the post;
- (iii) Two persons to be present at the opening of the post;
- (iv) All cheques and other negotiable instruments to be immediately given a restrictive crossing e.g. account payee only, not negotiable;
- (v) Immediate entry of the details of the receipts (date, payer, amount, cash, cheque, or other) in a 'rough cash book' or post-list of money received. The list should be signed by both parties present;
- (vi) Regular independent comparison of the post list with banking records. The tests should be of total, detail and dating to detect teeming and lading at a later stage in the processing.

3.4.3 Cash Sales and Collections**Objectives**

- To ensure that all cash, to which the enterprise is entitled, is received;
- To ensure that all such cash is properly accounted for and entered in the records;
- To ensure that all such cash is promptly and intactly deposited.

Measures

- (i) Prescribing and limiting the number of persons who are authorised to receive cash e.g. sales assistants, cashiers, etc;
- (ii) Establishing a means of evidencing cash receipts e.g. pre-numbered duplicate receipt forms, cash registers with sealed till rolls. The duplicate receipt form books should be securely held and issue controlled;
- (iii) Ensuring that customers are aware that they must receive a receipt form or ensuring that the amount stated in the cash register is clearly visible to the customer;
- (iv) Appointment of officers with responsibility for emptying cash registers at prescribed intervals, and agreeing the amount present with till roll totals or internal registers. Such collections should be evidenced in writing and be initialed by the assistant and the supervisor;
- (v) Immediate and intact banking. Payments out should be from funds drawn from the bank on an imprest system;
- (vi) Investigation of shorts and overs;

- (vii) Independent comparison of agreed till roll totals with subsequent banking records;
- (viii) Persons handling cash should not have access to other cash funds or to bought or sales ledger records;
- (ix) Rotation of duties and cover for holidays (which should be compulsory) and sickness;
- (x) Collections by roundsmen and travellers should be banked intact daily. There should be independent comparison of the amounts banked with records (e.g. duplicate receipt books) of the roundsmen and salesmen;
- (xi) Wherever possible, roundsmen should have a controlled issue of merchandise with a check, on their return, that they have cash or goods to the value of the controlled issue on the lines of an imprest system.

3.4.4 Payments into Bank

Objectives

- To ensure that all cash and cheques received are banked intact;
- To ensure that all cash and cheques received are banked without delay at prescribed intervals, preferably daily;
- To ensure that all cash and cheques received are accounted for and recorded accurately.

Measures

- (i) Cash and cheques should be banked intact;
- (ii) Cash and cheques should be banked without delay preferably daily;
- (iii) The bank paying-in slip should be prepared by an official with no access to cash collection points, bought or sales ledgers;
- (iv) Bankings should be made with security in mind, for example, for large cash sums, security guards should be used;
- (v) There should be independent comparison of paying-in slips with collection records, post lists and sales ledger records.

3.4.5 Cash Balances

Objectives

- To prevent misappropriation of cash balances;
- To prevent unauthorised cash payments.

Measures

- (i) Establishment of cash floats of specified amounts and locations;
- (ii) Appointment of officials responsible for each cash balance;
- (iii) Arrangement of security measures including use of safes and restriction of access;
- (iv) Use of imprest system with rules on reimbursement only against authorised vouchers;
- (v) Strict rules on the authorisation of cash payments;
- (vi) Independent cash counts on a regular and a surprise basis;
- (vii) Insurance arrangements e.g. for cash balances;
- (viii) Special rules for I.O.U.s. Preferably these should not be permitted.

3.4.6 Bank Balances**Objectives**

- To prevent misappropriation of bank balances;
- To prevent teeming and lading.

Measures

- (i) Reconciliation should be prepared at prescribed frequency;
- (ii) They should be performed by independent personnel;
- (iii) Arrangements should be made for bank statements to be sent direct to the person responsible for the reconciliation;
- (iv) Work on reconciliations should include the following:
 - A comparison of each debit and credit in the cash book with the corresponding entries in the bank statements;
 - A comparison of returned cheques with the cash book entries noting dates, payees and amounts;
 - A test of the detailed paying-in slips with the cash book;
 - The dates of credits in the bank statements should be traced through to the next period and their validity verified;
 - Any unusual items, for example, dishonoured cheques should be investigated.
- (v) The balances at the bank should be independently verified with the bank at intervals.

3.4.7 Cheque Payments

Objective

To prevent unauthorised payments being made from bank accounts.

Measures

- (i) Control over custody and issue of unused cheque books. A register should be kept if necessary;
- (ii) Appointment of an official to be responsible for the preparation of cheques;
- (iii) Rules should be established for the presentation of supporting documents before cheques can be made out. Such supporting documents may include orders, invoices, etc;
- (iv) All such documents should be stamped 'paid by cheque no. ...' with date;
- (v) Establishment of who can sign cheques. All cheques should be signed by at least two persons, with no person being permitted to sign if he is a payee;
- (vi) No cheques should be made out to bearer except for the collection of wages or reimbursement of cash funds;
- (vii) All cheques should be restrictively crossed;
- (viii) The signing of blank cheque must be prohibited;
- (ix) Special safeguards where cheques are signed mechanically or have pre-printed signatures. Such signings are often made for dividend payments, salary cheques and other reasons;
- (x) Rules to ensure prompt despatch and to prevent interception or misappropriation;
- (xi) Measures to ensure cash discounts are obtained;
- (xii) Special rules for authorising and checking direct debits and standing orders;
- (xiii) Separation of duties: custody, recording and initiation of cheque payments: cash records and other areas e.g. debtors and creditors.

3.4.8 Wages and Salaries

Objectives

- To ensure that wages and salaries are paid only to actual employees at authorised rates of pay;
- To ensure that all wages and salaries are computed in accordance with records of work performed whether in respect of time, output, sales made or other criteria;
- To ensure that payrolls are correctly calculated;
- To ensure that payments are made only to the correct employees;

- To ensure that payroll deductions are correctly accounted for and paid over to the appropriate third parties;
- To ensure that all transactions are correctly recorded in the books of account.

Measures

- (i) There should be separate records kept for each employee. The records should contain such matters as date of engagement, age, next of kin, agreed deductions, skills, department, and specimen signature. Ideally, these records should be maintained by a separate personnel department;
- (ii) Procedures for and specified officials responsible for, engagements, retirements, dismissals, fixing and changing rates of pay. Procedures should be laid down for notification of these matters to the personnel and wage roll preparation departments;
- (iii) Time records should be kept, preferably by means of supervised clock card recording. These should be approved and approval acknowledged. All overtime should be authorised;
- (iv) Output or piecework records should be properly controlled and authorised. Procedures should exist for reconciling output or piecework records with production records;
- (v) The payroll should be prepared by personnel unconnected with other wage duties. Special procedures should exist for dealing with advances, leave grant, layoff pay, luncheon vouchers, new employees, employees leaving, sickness and other absences and bonuses;
- (vi) The payroll should be checked by separate personnel. All work on the preparation and checking of payroll should be initialled. All such work should be supervised and the payroll scrutinized and approved by a senior official;
- (vii) The net amount due to be paid out in cash should be drawn after a coin analysis. Tight security should be imposed on the security of cash, both on collection from the bank and at all times up to the receipt of pay envelopes by the workforce. Ideally, collection of cash from the bank should be by a security organisation;
- (viii) Wage envelopes should be made up by personnel independent of the wage roll preparation team;
- (ix) Specified times should be laid down for distribution of wage packets. These should either be acknowledged by the recipients or distribution should be made in the presence of (but not by) foremen or others capable of identifying employees;
- (x) Surprise attendance at payouts should be made at intervals by internal audit or by a senior official;
- (xi) Unclaimed wages should be subject to special procedures. These should include a record to be maintained of unclaimed wages,

- safe custody of such pay packets, a requirement for investigation, subsequent payout only after proof of entitlement, breaking down and rebanking after a specified period of time;
- (xii) Payments by cheque and credit transfer should be subject to special procedures. These could include maintenance of a separate bank account with regular reconciliation;
 - (xiii) Deductions such as PAYE, national health insurance, pension contributions, save as you earn, and union dues should be subject to prompt payment over to the institutions concerned. Control totals subject to frequent review should be kept. Independent comparisons of such totals with records such as tax deduction cards should be performed regularly;
 - (xiv) Regular independent comparisons should be made between personnel records and wages records;
 - (xv) Regular independent comparisons of payrolls at different dates;
 - (xvi) Regular independent comparisons of wages paid with budgets and investigation of variances;
 - (xvii) Surprise investigation of wage records and procedures by internal audit or senior officials;
 - (xviii) An independent official should be appointed to be responsible for settling queries;
 - (xix) Wage records should conform to the requirements of Statutory Sick Pay.

Note that most firms now credit employees' bank accounts through the banking system – e-payment system.

3.4.9 Purchases and Trade Creditors

Objectives

- To ensure that goods and services are only ordered in the quantity, of the quality, and at the best terms available after appropriate requisition and approval;
- To ensure that goods and services received are inspected and only acceptable items are accepted;
- To ensure that all invoices are checked against authorised orders and receipt of the subject matter in good condition;
- To ensure that all goods and services invoiced are properly recorded in the books.

Measures

- (i) There should be procedures for the requisitioning of goods and services only by specified personnel on specified forms with space for acknowledgement of performance;

- (ii) Order forms should be pre-numbered and kept in safe custody. Issue of bank order form books should be controlled and recorded;
- (iii) Order procedures should include requirements for obtaining tenders, estimates or competitive bids;
- (iv) Sequence checks of order forms should be performed regularly by a senior official and missing items investigated;
- (v) All goods received should be recorded on goods received notes (preferably pre-numbered) or in a special book;
- (vi) All goods should be inspected for condition and agreement with order and counted on receipt. The inspection should be acknowledged. Procedures for dealing with rejected goods or services should include the creation of debit notes (pre-numbered) with subsequent sequence checks and follow up of receipt of suppliers' credit notes;
- (vii) At intervals, a listing of unfulfilled orders should be made and investigated;
- (viii) Invoices should be checked for arithmetical accuracy, pricing, correct treatment of VAT and trade discount, and agreement with order and goods-in records. These checks should be acknowledged by the performer preferably on spaces marked by a rubber stamp on the invoices;
- (ix) Invoices should have consecutive numbers put on them and batches should be pre-listed;
- (x) Totals of entries in the invoice register or daybook should be regularly checked with the pre-lists;
- (xi) Responsibility for purchase ledger entries should be vested in personnel separate from personnel responsible for ordering, receipt of goods and the invoice register;
- (xii) The purchase ledger should be subject to frequent reconciliations in total by or be checked by an independent senior official;
- (xiii) Ledger account balances should be regularly compared with suppliers' statements of account;
- (xiv) All goods and service procurement should be controlled by budgetary techniques. Orders should only be placed that are within budget limits. There should be frequent comparisons of actual purchases with budgets and investigation into variances;
- (xv) Cut off procedures at the year end are essential;
- (xvi) A proper coding system is required for purchase of goods and services so that the correct nominal accounts are debited.

3.4.10 Sales and Debtors

Objectives

- To ensure that all customers orders are promptly executed;
- To ensure that sales on credit are made only to bona fide good credit risks;
- To ensure that all sales on credit are invoiced, that authorised prices are charged and that before issue all invoices are completed and checked as regards price, trade discounts and VAT;
- To ensure that all invoices raised are entered in the books;
- To ensure that all customers' claims are fully investigated before credit notes are issued;
- To ensure that every effort is made to collect all debts;
- To ensure that no unauthorised credits are made to debtors accounts.

Measures

- (i) Incoming orders should be recorded, and if necessary, acknowledged, on pre-numbered forms. Orders should be matched with invoices and lists prepared at intervals of outstanding orders for management action. Sequence checks should be made regularly by a senior official;
- (ii) Credit control. There should be procedures laid down for verifying the credit worthiness of all persons or institutions requesting goods on credit. For existing customers, credit worthiness data should be kept up-to-date and checks made that outstanding balances and a new sale do not cause the pre-set credit limit to be exceeded. For new customers, investigative techniques should be applied including enquiry of trade protection organisations, credit rating agencies, referees, the company's file with the registrar of companies, etc. A credit limit should be established. This may be fixed at two levels- a higher one such that further sales are not made and a lower one such that management are informed- and a judgement made on granting credit;
- (iii) Selling prices should be prescribed. Policies should be laid down on credit terms, trade and cash discounts, and special prices;
- (iv) Despatch of goods should only be on properly evidenced authority. Goods out should be recorded either in a register or using pre-numbered despatch notes. Unissued blocks of despatch notes should be safeguarded and issue recorded. Sequence checks of dispatch notes should be made regularly by a senior official.

- Where appropriate, acknowledgement of receipt of goods should be made by customers on copy despatch notes;
- (v) Invoicing should be carried out by a separate department or by sales staff. Invoices should be pre-numbered and the custody and issue of unused invoice blocks controlled and recorded. Sequence checks should be regularly made by a senior official and missing or spoiled invoices investigated;
 - (vi) All invoices should be independently checked for agreement with customer's order, with goods despatched record, for pricing, discounts, VAT and other details. All actions should be acknowledged by signature or initials;
 - (vii) Accounting for sales and debtors should be segregated by employing separate staff for cash, invoice register, sales ledger entries and statement preparation;
 - (viii) Sales invoices should be pre-listed before entry into the invoice register or daybook and the pre-list total independently compared with the total of the register;
 - (ix) Customer claims should be recorded and investigated. Similar controls (e.g. pre-numbering) should be applied to credit notes. At the year end, uncleared claims should be carefully investigated and assessed. All credit notes should be subject to acknowledged approval by a senior official;
 - (x) A control account should be regularly and independently prepared;
 - (xi) Debtors' statements should be prepared by personnel separate from the sales ledger personnel. Posting should be subject to safeguards so that no statements are misappropriated before posting;
 - (xii) Procedures must exist for identifying and chasing slow payers. Overdue balances should be brought to the attention of senior management for legal or other action to be taken;
 - (xiii) All balances must be reviewed regularly by an independent official to identify and investigate overdue accounts, debtors paying by instalments or round sums, and accounts where payments do not match invoices;
 - (xiv) Bad debts should only be written off after due investigation and acknowledged authorisation by senior management;
 - (xv) At the year end, an aged analysis of debtors should be prepared to evaluate the need for a doubtful debt provision;
 - (xvi) Also at the year end, cut off procedure will be required. Particular attention will be paid to orders despatched but not invoiced.

3.4.11 Stock and Work-in-Progress

Objective

To ensure that stock is adequately protected against loss or misuse.

Measures

- (i) Separate arrangements for each type of stock e.g. raw materials, components, work-in-progress, finished goods, consumable stores;
- (ii) Control over the receipt of goods (see under purchases);
- (iii) Stock should be stored under conditions which deter deterioration due to physical causes e.g. heat, cold, damp, microbe action etc. Special arrangement should be made for stock which is dangerous or classified secret;
- (iv) Stock should be safeguarded against loss by theft by appropriate physical controls including restriction of access;
- (v) Where appropriate, stock records should be maintained. Entries should be made by personnel independent of staff responsible for purchasing and custody of goods;
- (vi) Documentation should be controlled by the use of controlled pre-numbered forms with regular sequence checks;
- (vii) Work-in-progress and finished goods stocks may be subject to recording by value including the charging of material, labour and overhead costs. Control over the latter items can be exercised by the use of control accounts and reconciliation with payroll or records of machine hours;
- (viii) Stock records should be continuously compared with actual stocks held by independent officials. All differences should be corrected and causes investigated;
- (ix) Ideally, all stock items should be subject to established maximum and minimum stock levels with re-order levels;
- (x) Special arrangements should be applied to returnable containers, other's stock on our premises, our stock on other's premises, scrap and waste;
- (xi) Whether or not a continuous inventory is maintained, there should at least be an annual stock take. Procedures should be prescribed for this with emphasis on identifying damaged, slow moving, and obsolete stock and on cut off procedures.

3.4.12 Fixed Assets

Objectives

- To ensure that fixed assets are only acquired with proper authority;
- To ensure that fixed assets are properly maintained and used only in the business;
- To ensure that fixed assets are properly accounted for and recorded;
- To ensure that disposals are properly authorised and that proceeds of disposals are accounted for and recorded.

Measures

- (i) Capital expenditure should be subject to authorisation procedures which in all cases should be evidenced. In appropriate cases (e.g. new products or production methods), capital investment appraisal techniques should be applied to acquisitions. It may be desirable in such cases for proposed expenditure to be reviewed by a special committee and for board authority to be required. Other capital expenditures (e.g. replacement of equipment) may be subject to requests on specified forms with board approval. In yet other cases (e.g. motor vehicles), the board may lay down overall policy and detailed approval may be given by a designated senior official (e.g. transport manager) subject to review by or reports to the board. In other cases (e.g. routine replacement or update of equipment) the expenditure may be subject to budget limits with actual expenditure approved by a senior official after review that the proposed expenditure is within the budget;
- (ii) All capital expenditures should be monitored by a senior official (e.g. chief accountant) with approvals; and any excess expenditure investigated and approval sought;
- (iii) Allocation of expenditure between capital and revenue should be approved;
- (iv) Adequate recording of fixed assets should be made with detailed breakdowns as necessary. In many cases (e.g. for plant, vehicles or buildings) detailed fixed assets registers should be maintained;
- (v) Where registers are maintained, frequent and regular review of the record with actual assets should be made by senior independent officials. Where necessary (e.g. land and buildings), this should include a check of documents of title. In all cases, condition and use should be checked;
- (vi) Disposals whether by scrapping, sale, or trade-in should be subject to authorisation procedures. Receipt of and assessment of

- reasonableness of proceeds should be monitored by a senior official (e.g. chief accountant);
- (vii) Arrangements to see that fixed assets are properly maintained by regular inspection and reporting of location, operation and condition. This can be combined with the physical verification of the asset registers;
- (viii) Depreciation policy should be laid down.

SELF-ASSESSMENT EXERCISE 4

1. State the objective of internal control relative to fixed assets.
2. Highlight the measures to achieve the set objectives.

3.5 Limitations of Internal Control

Internal controls are essential features of any organisation that is run efficiently. However, it is important to realise (especially for an auditor) that internal controls have inherent limitations which include:

- a requirement that the cost of an internal control is not disproportionate to the potential loss which may result from its absence;
- internal controls tend to be directed at routine transactions. The one-off or unusual transaction tends not to be the subject of internal control;
- potential human error caused by stress of workload, alcohol, carelessness, distraction, mistakes of judgment, annoyance, and the misunderstanding of instructions;
- the possibility of circumvention of controls either alone or through collusion with parties outside or inside the entity;
- abuse of responsibility;
- management override of controls;
- fraud;
- changes in environment making controls inadequate;
- human cleverness – however secure the computer code designed to prevent access, there is always some hacker who gets in.

Auditors must always perform some substantive tests of material items as well as relying on internal controls. The inherent limitations of internal control are the reason.

4.0 CONCLUSION

Having studied this unit you should be able draw a conclusion that, although internal controls are essential features of any organisation that is operated efficiently, they (internal controls) have inherent limitations.

5.0 SUMMARY

Internal control is aimed at:

- ensuring adherence to management policies;
- safeguarding the organisation's assets;
- ensuring accurate and reliable methods.
- internal check, internal audit and physical control are the basic components of internal control.
- There are relationships, differences and cooperation between the internal and external auditors.
- Internal control can be applied in specific areas of a business.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

Define 'Internal Control' (See 3.1).

ANSWER TO SELF-ASSESSMENT EXERCISE 3

Basic differences between the internal and external auditors can be seen from the following perspectives:

- i) scope
- ii) approach
- iii) responsibility (See 3.2)

ANSWER TO SELF-ASSESSMENT EXERCISE 4

(See 3.4.12)

- (a) The objectives of internal control relative to fixed assets are to ensure that fixed assets are:
 - (i) only acquired with proper authority;
 - (ii) properly maintained and used only in the business;
 - (iii) properly accounted for and recorded;
 - (iv) to ensure that disposals are properly authorised and that proceeds of disposals are accounted for and recorded.

6.0 TUTOR-MARKED ASSIGNMENT

Highlight and explain the inherent limitations of internal controls.

7.0 REFERENCES/FURTHER READING

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Labaran, S.A. (2006). *Auditing, Investigation and Assurance Services*. Jos: Seye Prints.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Wittington, O.R. & Pany, K. (2004). *Principles of Auditing and Other Assurance Services* (14th Ed.). New York: McGraw-Hill and Irwin.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

UNIT 4 FRAUD AND ERRORS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Meaning of Fraud
 - 3.2 Categories of Fraud
 - 3.2.1 Management Fraud
 - 3.2.2 Non-Management Fraud
 - 3.3 Fraud Detection and Prevention in Selected Accounts
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

The incidence of fraud and fraudulent practices in our society and business organisations, in particular, has become a source of worry. In this unit, you shall learn the concept of fraud, and distinguish between fraud and errors.

The categories of fraud, fraud detection and prevention in selected accounts will also be taught.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define fraud
- distinguish fraud from errors
- describe the categories of fraud
- explain fraudulent acts in selected accounts.

3.0 MAIN CONTENT

3.1 Meaning of Fraud

The term “fraud” can be used for several sins and offences including:

- (a) fraud, which involves the use of deception to obtain an unjust or illegal financial advantage.

- (b) intentional misstatements in, or omissions of amounts or disclosures from an entry's accounting records or financial statements.
- (c) theft, whether or not accompanied by misstatements of accounting records or financial statements.

Fraud can be defined as 'misrepresentation by a person of a material fact known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured'.

3.2 Categories of Fraud

Frauds can be classified under two categories, namely:

- (a) management fraud
- (b) non-management fraud

3.2.1 Management Fraud

This type of fraud occurs when the top management of an organisation deceives shareholders, creditors and external auditors for the purpose of issuing misleading financial statements. The situations which give room for management frauds to occur are as follows.

- (i) Affairs of the business are dominated by one man;
- (ii) Lack of sufficient competent staff to run the accounts department;
- (iii) Weakness in the internal control system;
- (iv) Related party transactions, this is, transactions between the firm's management and its officers;
- (v) When the board of directors do not get effectively involved in the supervision of the affairs of the organisation.

3.2.2 Non-Management Frauds

These types of fraud are rampant in the day-to-day affairs of the business, and they include the following:

- (a) defalcations
- (b) embezzlement
- (c) erasures
- (d) alterations
- (e) errors
 - original errors
 - errors of omission
 - errors of principle
 - errors of commission

Non-management fraud may occur either in the form of misappropriation of cash or goods or manipulation of accounts without direct misappropriation.

Please note the following explanations on the items identified under non-management frauds.

(a) Defalcation

This is defined as the act or instance of embezzling, and is caused by non-segregation of duties. Areas in which defalcation could occur include:

- (i) if the chief cashier cashes a debtor's cheque and fails to record the receipt;
- (ii) assets and goods may be intercepted and may not be on record;
- (iii) assets may also be taken out after they have been properly recorded.

These circumstances will lead to either temporary or permanent concealment.

(b) Embezzlement

This speaks of the act of appropriating money fraudulently to one's own use.

(c) Erasures

This refers to the act of instant erasing from the books of records.

(d) Alterations

This means the act or process of alteration or modification to defraud the employer.

(e) Errors

Errors are defined as the act of ignorance or imprudent deviation from a code or usual practice. Errors are sub-divided into four categories as listed earlier:

- (i) **Original errors** – errors emanating from the original or source document. They are made in copying the source document into the books of original entry.

- (ii) **Errors of omission** – errors made when the whole documents or transactions are completely omitted or overlooked from the record.
- (iii) **Errors of principle** – these can occur when the recording clerk fails to abide by the rules of double entry system or where item of expense is treated as revenue or where revenue is treated as capital.
- (iv) **Errors of commission** – these occur when one fails to perform his or her duty. These errors are common in everyday activities of the business.

SELF-ASSESSMENT EXERCISE 1

1. Distinguish fraud from errors.
2. Name and explain the different types of errors.

3.3 Fraud Detection and Prevention in Selected Accounts

Here, we shall highlight the different accounts and the most frequent frauds associated with them. The list is not exhaustive.

(a) Salaries and wages

- Ghost/dummy/fictitious names
- Overstatement of gross pay
- Time card fraud
- Understatement of deductions

(b) Sales

- Teeming and lading
- Understatement of sales invoices
- Misappropriation of cash as a result of delays in banking

(c) Purchases

- Submission of false invoices
- False charges from suppliers
- Unauthorised purchases and payment

(d) Petty cash

- Overloading of receipts
- Fake invoices
- Corroboration with the cashier

(e) Fixed assets

- Theft
- Misappropriation
- Manipulation of records
- Private use of company assets

These fraudulent acts can be prevented where:

- (i) adequate precautionary measures are adopted by the internal auditor to strengthen the internal control of the organisation;
- (ii) there are adequate checks on the system;
- (iii) there are separation of duties.

SELF-ASSESSMENT EXERCISE 2

Name three accounts of a business organisation and identify the kinds of fraudulent acts associated with them.

4.0 CONCLUSION

In this unit, you have learnt that the prevalence of fraud in organisations is very disturbing. Emphasis should be placed on having strong internal control system on ground in order to quickly detect and prevent fraudulent acts. The internal auditors should be alive to their responsibilities.

5.0 SUMMARY

In this unit, you have learnt the following:

- Definition of fraud as misrepresentation by a person of a material fact known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured;
- Categorising fraud (with explanations) into management and non-management fraud. Non-management fraud include: defalcations, embezzlement, erasures, alterations and errors;
- Describing the different accounts (selected) and the most frequent fraud associated with them.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

1. Fraud refers to misrepresentation by a person of a material fact known by that person to be untrue or made with reckless

indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured.

On the other hand, error is the act of ignorance or imprudent deviation from a code or usual practice.

2. Fraud is a crime while errors are mistakes.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

Different types of errors (See 3.2.2(e)).

- i) Original errors
- ii) Errors of omission
- iii) Errors of principle
- iv) Errors of commission

6.0 TUTOR-MARKED ASSIGNMENT

1. Define fraud.
2. Discuss appropriate measures that should be taken to prevent fraud in a business organisation.

7.0 REFERENCES/FURTHER READING

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Labaran, S.A. (2006). *Auditing, Investigation and Assurance Services*. Jos: Seye Prints.

Messier, W.F. Jr. (2000). *Auditing and Assurance Services. A Systematic Approach*, (2nd Ed.). USA: McGraw Hill Co. Inc.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Wittington, O.R. & Pany, K. (2004). *Principles of Auditing and Other Assurance Services* (14th Ed.). New York: MacGraw-Hill and Irwin.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

MODULE 2

Unit 1	Audit Cycle and Procedures
Unit 2	Audit Planning
Unit 3	Audit Evidence and Procedures
Unit 4	Audit Risk

UNIT 1 AUDIT CYCLE AND PROCEDURES

CONTENTS

1.0	Introduction
2.0	Objectives
3.0	Main Content
3.1	Audit Cycle and Procedures
3.1.1	Background Research
3.1.2	The Audit Plan
3.1.3	Accounting System Review
3.1.4	Internal Control System Review
3.1.5	Substantive Testing
3.1.6	Analytical Review Techniques
3.1.7	Analytical Review of Financial Statements
3.1.8	Preparation and Signing of Report
4.0	Conclusion
5.0	Summary
6.0	Tutor-Marked Assignment
7.0	References/Further Reading

1.0 INTRODUCTION

An audit can be carried out on organisations, both large and small, and both new and well-established.

This unit focuses on the cycle or stages in the modern audit of an established company which is big enough to have a comprehensive system of accounting and record keeping and a system of controls over those records.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain audit cycle
- outline the stages in the audit cycle
- describe the stages in the audit.

3.0 MAIN CONTENT

3.1 Audit Cycle and Procedures

Audit cycle refers to the stages in the conduct of an audit from the beginning to the end. The stages in the modern audit can be summarised as follows.

- (i) Background research;
- (ii) Preparation of the audit plan;
- (iii) Accounting system review;
- (iv) Internal control system review;
- (iv) Substantive testing;
- (v) Analytical review techniques;
- (vi) Analytical review of financial statements;
- (vii) Preparation and signing of report.

These stages will be explained below.

3.1.1 Background Research

Before commencing the audit proper, the auditor must discover as much as possible:

- (a) the present condition and future prospects of the industry of which his client is a part;
- (b) the past history and the present condition and future prospects of his client;
- (c) the management and key personnel of his client and recent changes;
- (d) the products and manufacturing and trading processes of the client and recent changes;
- (e) the locations of all his client's operations;
- (f) difficulties encountered by the client in manufacturing, trading, expanding, contracting, labour relations or financing;
- (g) problems in accounting or in internal control systems;
- (h) problems in accounting measurement like in stock valuation and income recognition;
- (i) problems likely to lead to audit risk like the difficulty of assessing the value of long-term contracts in a civil engineering business;
- (j) problems likely to be met in carrying out the audit, for example, distant locations, tight timing problems, or large staff requirements on stocktaking attendance;
- (k) changes in law or accounting practice which may affect the client.

This background research will be done by reading or interviewing the following.

- (i) Previous years' audit files;
- (ii) Members of staff of audit who have been previously engaged on the audit;
- (iii) Published material concerning the client's company and industry;
- (iv) The company's interim, internal and management accounts;
- (viii) The management of the enterprise.

The auditor must focus his audit, particularly on areas of special difficulty and risk in order to carry out a comprehensive and effective audit which is nevertheless efficient in terms of time spent. In addition, the evaluation of many areas in the financial statements must entail a consideration of the whole circumstances of the client.

3.1.2 The Audit Plan

The auditor must plan his audit in some detail and the plan will involve preparation of an overall audit plan showing:

- (a) an outline of the audit work to be done on each area of the client's systems and financial statements;
- (b) the staff who will do the work;
- (c) the location of the audit;
- (d) the timing of the work to be done;
- (e) a budget of time and costs.

The plan must be made to fit in with the client's timing requirement and with the client's ability to produce necessary analyses and summaries.

3.1.3 Accounting System Review

The auditor must:

- (a) ascertain by asking questions;
- (b) record on paper;
- (c) corroborate his record (confirm that the record is correct);
- (d) review for adequacy and for planning of tests;
- (e) test to determine that it always works as it is supposed to;
- (f) evaluate and
- (g) form a conclusion on the adequacy of the client's system for documenting and recording the transactions, assets and liabilities of the client in the books of account and other records. This is because:

- (i) the Companies Act requires the auditor to investigate and report on the company keeping of “proper” accounting records;
- (ii) the books of account and other records form the basis for the preparation of the financial statements.

3.1.4 Internal Control System Review

Be reminded that internal controls are procedures which ensure that all transactions, assets and liabilities are recorded correctly.

The auditor should:

- (a) ascertain;
- (b) record;
- (c) corroborate the record;
- (d) review;
- (e) test;
- (f) evaluate and
- (g) form a conclusion on the adequacy of the client’s system of internal control.

The objectives of the accounting systems and internal control systems investigations are to enable the auditor to have evidence that:

- (i) the client maintains adequate books and records;
- (ii) the client has a system of internal controls over the processing and recording of transactions such that all transactions are recorded correctly both numerically and in principle;
- (iii) the books of account can be relied on to form a reliable basis for the preparation of the accounts.

Thus, it is not necessary for the auditor to vouch for every transaction recorded in the books. He will rely upon the system. If the system is satisfactory, then he can substitute an investigation and test of the system for a detailed examination of every entry. This is both more economical and is more effective because it is only by examining the system that he can have evidence that all the transactions are recorded.

However, in practice, some areas of the firm’s internal controls may not exist or may be weak. In such cases, the auditor cannot rely on the controls and other evidence need to be sought for, for the completeness and accuracy of the record.

SELF-ASSESSMENT EXERCISE 2

1. Explain audit cycle.
2. In the audit cycle, what does the preparation of the audit plan entail?

3.1.5 Substantive Testing

Substantive testing is defined as:

...those tests of transactions and balances, and other procedures such as analytical review, which seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or in the financial statements.

You have seen that the reliability of the records is established by the auditor, by his investigating the system. However, not all data can be verified in this indirect way. Thus, some transactions, balances and items in the financial statements must be verified by direct evidence.

In particular, substantive tests are applied to the followings.

- (a) Transaction records where internal controls are weak or non-existent and where the system cannot be relied on.
- (b) Unusual, extraordinary or one-off transactions and transactions which are not covered by a system. For example, if the client sold a part of its premises, this transaction is clearly rare and the client will not have a system for dealing with it, and thus, the auditor must seek evidence that the transaction was fully and accurately recorded and was carried out with proper authority.
- (c) All assets and liabilities at the balance sheet date. For some assets (e.g. debtors and creditors) the system will provide good audit evidence, but additional audit evidence is always sought.

In practice, an auditor has to consider on grounds of effectiveness and cost, whether to rely on systems controls or whether to carry out substantive tests in each area of audit. In some areas, sufficient evidence can be obtained by analytical review. In many areas, a combination of internal control reliance, substantive testing and analytical review provide the necessary audit evidence.

3.1.6 Analytical Review Techniques

This is defined as:

...the study of relationships between elements of financial information expected to conform to a predictable pattern based on the organisation's experience and between financial and non-financial information. Information is compared with compatible information for a prior period or periods, with anticipated results and with information relating to similar organisations.

In general, audit evidence is gained from internal control, from substantive tests and increasingly from analytical review.

3.1.7 Analytical Review of Financial Statements

At the conclusion of the detailed work of the audit, when all the systems testing and substantive testing has been done, the auditor will have audit evidence that:

- (a) proper books of account have been kept which form a reliable basis for the preparation of accounts;
- (b) the accounts have been properly drawn up from those books;
- (c) all assets, liabilities and transactions, balances and items in the account have been confirmed indirectly by systems investigation and /or directly by substantive testing.

Nonetheless, the auditor will then subject the financial statements to an overall final analytical review to determine whether:

- (i) acceptable, consistent and appropriate accounting policies have been applied. For example, the accounts would not show a true and fair view if the depreciation policy had been changed from straight line to reducing balance without this being disclosed.
- (ii) all the information in the financial statements is compatible with all other information. For example, an industrial firm using straight line depreciation may have items of plant which have been fully depreciated. However, in determining product cost for valuing work in progress and finished goods, notional depreciation on fully depreciated plant may have been taken.
- (iii) all items in the accounts are compatible with the auditor's knowledge of the enterprise and its circumstances. For example, the auditor may have read in the press that new processes have been invented in a client's industry which makes some of the client's plant obsolete.

- (iv) there is adequate disclosure of all items requesting disclosure. Numerous disclosure requirements are in the Companies Act and also some items may require special disclosure for proper understanding of the accounts.
- (v) the accounting requirements of the Companies Act and other regulations have been complied with.
- (vi) overall, the auditor has sufficient evidence to enable him to give an opinion on the truth and fairness of the accounts.

3.1.8 Preparation and Signing of Report

The ultimate aim of an audit is the report by the auditor to his client. This is a formal statement giving:

- (a) a title identifying the persons to whom the report is addressed (e.g. Auditors' report to the members of the ABC Plc.).
- (b) an introductory paragraph identifying the financial statements audited (e.g., Profit and Loss Account, Balance Sheet, etc.).
- (c) separate sections, appropriately headed, dealing with:
 - (i) respective responsibilities of directors and auditors;
 - (ii) the basis of the auditors' opinion (We conducted our audit in accordance with Auditing Standards);
 - (iii) the auditors' opinion (e.g., the financial statements give a true and fair view).
- (d) the manuscript or printed signature of the auditors.
- (e) the date of the report.

SELF-ASSESSMENT EXERCISE 3

Outline the areas where substantive tests are applied relative to the audit cycle.

4.0 CONCLUSION

You must have learnt from the study of this unit that:

- a. although the stages in conducting the modern audit have been described, the audit is not done all at one time, but it is spread out over a period of time.
- b. the modern audit is concerned largely with a search for evidence. Evidence can be of several kinds including;
- c. internal control reliance:
 - i. substantive testing;
 - ii. analytical review.

5.0 SUMMARY

In this unit, you have learnt that modern audit has the following stages:

- Background research into the client's place in the economy generally and its industry in particular, the clients' constitution, history, operations and personnel;
- Preparation of an audit plan;
- Accounting system review;
- Internal control system review;
- Substantive testing including analytical review techniques;
- Analytical review of financial statements;
- Preparation and signing of the auditor's report.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

Audit cycle refers to the stages in the conduct of an audit from the beginning to the end.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

What the preparation of audit plan entails (See 3.1.2).

ANSWER TO SELF-ASSESSMENT EXERCISE 3

Substantive tests are applied to the following areas:

- (i) Transaction records where internal controls are weak or non-existent and where the system cannot be relied on.
- (ii) Unusual, extraordinary or one-off transactions which are not covered by a system.
- (iii) All assets and liabilities at the balance sheet date (See 3.1.5).

6.0 TUTOR-MARKED ASSIGNMENT

"The auditor must plan his audit in some detail".

- i. Explain this in detail.
- ii. Why is this plan necessary?

7.0 REFERENCES/FURTHER READING

CAMA (1990). *Companies and Allied Matters Act*. Lagos: Government Press.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

UNIT 2 AUDIT PLANNING

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Audit Planning: Matters to Take into Account
 - 3.2 Overall Audit Plan
 - 3.3 The Audit Programme
 - 3.4 Knowledge of the Client's Industry, Business and Organisation
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

In management, planning is defined as the process of deciding what objectives to pursue during a future time period and what to do, so as to achieve those objectives, and how the current decisions may limit the scope of future actions.

You may recall, that the first standard of fieldwork, requires that the work must be adequately planned. Planning is a technical area in auditing because it demands competence and technical knowledge.

It is of great importance that an audit is planned in advance because:

- (a) the intended means of achieving the audit objectives must be established;
- (b) the audit can be controlled and directed;
- (c) attention can be focused on the critical and high risk areas;
- (d) the work can then be completed economically and to time scale requirements.

In this unit, you will be dealing with some matters to be taken into account, and the preparation of an audit plan.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- specify some matters to be taken into account in planning audits

- list matters which are relevant to the preparation of an overall audit plan
- define an audit programme and state what must be taken into account in developing it
- describe ways in which knowledge of the business may be gained.

3.0 MAIN CONTENT

3.1 Audit Planning: Matters to Take into Account

Matters to be taken into consideration in audit planning are as follows:

- (a) The work to be performed in addition to the audit;
- (b) Reviewing previous years' working papers;
- (c) Changes in legislation or auditing or accounting practice;
- (d) Analytical review of management accounts, consulting with management;
- (e) Changes in the business or its management or ownership;
- (f) Changes in systems or accounting procedures;
- (g) Timing requirements;
- (h) Extent of preparation by the client of analyses and summaries;
- (i) Use of internal audit;
- (j) Degree of reliance on internal controls;
- (k) Joint auditors, if any;
- (l) Rotational testing;
- (m) Liaison with the audit committee.

3.2 Overall Audit Plan

The general strategy, in the preparation of overall audit plan, will be directed towards the following matters:

- (a) Terms of engagement – work to be done (audit), precise accounting work to be done for client, tax, etc., letters to be sent (letter of weakness, etc.), reports to third parties (regulatory authorities);
- (b) The clients and their backgrounds – history, products, locations, especially noting factors like a new managing director, a new product;
- (c) Important figures and ratios – from previous years and if available, from management and draft accounts;
- (d) Audit risk areas – these might include stock, work-in-progress, or dealings with a company under common ownership;
- (e) The effect of information technology on the audit;
- (f) Extent of involvement of internal audit;

- (g) Requirement for involvement of specialists;
- (h) Setting of materiality levels;
- (i) Clients assistance – may be required in providing documents and analyses, arranging visits to branches;
- (j) The audit approach – the extent of reliance on internal control, the use of substantive tests and analytical review procedures;
- (k) Time-table – dates of interim, year end and final audits, and of deadlines to meet;
- (l) Staffing requirements – in terms of experience and special skills needed, and of availability;
- (m) Budget and fee;
- (n) The operating style and control consciousness of directors and management;
- (o) Possibilities of error or fraud;
- (p) Involvement with subsidiaries and their auditors, branches, divisions and other component of the audit assignment;
- (q) Regulatory requirements;
- (r) Going concern issues.

SELF-ASSESSMENT EXERCISE 1

1. Why is it important that an audit is planned in advance?
2. What matters must be taken into account in planning an audit?

3.3 The Audit Programme

The audit programme develops and documents the nature, timing and extent of planned audit procedures required to implement the overall audit plan. Essentially, the audit programme will consist of a very detailed list of things to be done and will show all assets, liabilities, revenues and expenses and such things as sample sizes, bases of selection of samples and when and where the programme is to be carried out. It is a set of instructions to staff.

The audit programme needs to take the following into account:

- (a) Risks of error;
- (b) Amount of audit evidence required in each area;
- (c) Coordination of auditing with accounts preparation (if accounts are prepared by the audit team);
- (d) The coordination of any assistance from client staff, for example, on schedule preparation, availability of records, internal audit;
- (e) Involvement of other auditors (especially with groups) and experts, if required.

3.4 Knowledge of the Client's Industry, Business and Organisation

It is essential that all members of the audit team fully understand the client's industry, business and organisation. This is so because:

- (a) only in that way can they judge the risks associated with the engagement;
- (b) an economical and effective audit can only be carried out with a full knowledge of significant environmental, operational and organisational factors;
- (c) knowledge of the factors helps in communication with client's staff, in assessing the reliability of management representations and in judging the appropriateness of accounting policies and disclosures.

This knowledge can be gained from:

- (i) the client's annual report and accounts;
- (ii) analytical review of the client's interim accounts, financial reports, variance analyses, etc.
- (iii) internal audit reports;
- (iv) visits to the client's premises and discussions with management and staff;
- (v) perusal of minutes of shareholders, directors, audit committee, budget committee, etc;
- (v) previous year's audit files including the permanent file;
- (vi) consideration of the state of the economy;
- (vii) reports from within the audit firm which may be relevant to the client, for example, management consultancy and appropriate tax authorities;
- (viii) perusal of relevant literature from credit rating agencies, stockbrokers, investment analysts;
- (ix) perusal of relevant trade magazines and journals.

SELF-ASSESSMENT EXERCISE 2

For the purpose of audit planning, list ways in which knowledge of the business may be gained.

4.0 CONCLUSION

You have learnt from this unit that the most effective and efficient audit can only be performed if it is well planned. Planning includes getting

the right mix of evidence gathering, in terms of analytical review, systems testing and substantive testing.

However, much as audit is planned, it is impossible to take into account every factor which will actually affect the audit. To this end, identifying the probable factors will at least enable the audit firm to take them into account in formulating the plan and the staffing requirements.

5.0 SUMMARY

- In this unit, you have been able to acquaint yourself with the followings.
- Importance of planning an audit in advance;
- Matters to take into account in audit planning;
- Overall audit plan;
- Knowledge of the client's industry, business and organisation.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

It is important that an audit is planned in advance for the following reasons.

- i) The intended means of achieving the audit objectives must be established.
- ii) Attention can be focused on to critical and high risk areas.
- iii) The audit can be controlled and directed.
- iv) The work can then be completed economically and to time scale requirements.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

Knowledge of the business may be gained for the purpose of audit planning through different means (See 3.4, paragraph 2 above).

6.0 TUTOR-MARKED ASSIGNMENT

1. What is an audit programme and what must be taken into account in developing it?
2. Why is it essential that all members of the audit team fully understand the client's industry, business and organisation?

7.0 REFERENCES/FURTHER READING

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Kell, Walter G.; et.al. (1986). *Modern Auditing* (3rd Ed.). New York: John Wiley and Sons.

UNIT 3 AUDIT EVIDENCE AND PROCEDURES

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Financial Statements Assertions
 - 3.2 Audit Evidence
 - 3.2.1 Limitations
 - 3.2.2 Varieties of Evidence
 - 3.2.3 Basic Techniques for Collecting Evidence
 - 3.2.4 Test Checking
 - 3.2.5 Sources of Audit Evidence
 - 3.2.6 Reliability of Audit Evidence
 - 3.2.7 Sufficiency of Audit Evidence
 - 3.2.8 Procedures for Collecting Evidence
 - 3.3 Consideration of Relevant Concepts
 - 3.3.1 Audit Trail
 - 3.3.2 Circularisation of Debtors
 - 3.3.3 Audit Working Papers
 - 3.3.4 Auditing Procedures
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

Auditing is concerned with the verification of accounting data and with determining the accuracy and reliability of accounting statements and reports.

Verification does not mean seeking proof or absolute certainty in connection with the data and reports being audited. It means looking for sufficient evidence to satisfy oneself as auditor that the accounts show a true and fair view. What is sufficient evidence depends on what professional experience and knowledge tell one to be satisfactory.

In this unit, you shall be considering the different aspects of audit evidence after making financial statements and assertions as the point of entry. Also, you shall be exposed to the relevant concepts – audit trail, circularisation of debtors, audit working papers and auditing procedures – that will help you in grasping some important elements in auditing.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- verify the various assertions that are made in accounting statements
- enumerate the varieties of evidence
- describe the basic techniques for collecting evidence
- explain audit trail and circularisation of debtors
- demonstrate the activities involved in auditing procedures.

3.0 MAIN CONTENT

3.1 Financial Statements and Assertions

Directors produce or cause financial statements to be produced. In doing so, they are asserting as follows:

- (a) The individual items are:
 - (i) correctly described;
 - (ii) show figures which are mathematically correct or fairly estimated;
- (b) The accounts as a whole show a true and fair view.

The idea to grasp is that the producer of a set of accounts is making assertions about items in the accounts when he puts them in the accounts.

The assertions he is making are as follows:

- (a) **Existence:** an asset or liability exists at the Balance Sheet date. This is an obvious assertion with such items as land and buildings, stocks and others.
- (b) **Rights and obligations:** an asset or liability pertains to the entity at the Balance Sheet date. This means that the enterprise has, for example, ownership of an asset. Ownership as an idea is not simple and there may be all sorts of rights and obligations connected with a given asset or liability.
- (c) **Occurrence:** a transaction or event took place which pertains to the enterprise during the relevant period. It may be possible for false transactions (e.g. sales or purchases) to be recorded. The assertion is that all recorded transactions actually took place.

- (d) **Completeness:** there are no unrecorded assets, liabilities, transactions or events or undisclosed items. This is important for all accounts items but is especially important for liabilities.
- (e) **Valuation:** an asset or liability is recorded at an appropriate carrying value. Appropriate may mean in accordance with generally accepted accounting principles such as the Companies Act Rules and Accounting Standards requirements and also consistent with statements of accounting policies consistently applied.
- (f) **Measurement:** a transaction or event is recorded at the proper amount and revenue or expense allocated to the proper period.
- (g) **Presentation and disclosures:** an item is disclosed, classified and described in accordance with applicable reporting framework.

As an example, let us look at an item in a balance sheet 'bank overdraft ₦102, 500. 00'. In including this item in the balance sheet, the directors are making the following assertions.

- (a) That there is a liability to the company's bankers.
- (b) That at the balance sheet date, this liability was N102,500.00
- (c) That this amount is agreed by the bank.
- (d) That the overdraft was repayable on demand. If this were not so, it would not appear amongst the current liabilities and terms would be stated;
- (e) That the overdraft was not secured. If it were secured, this fact would need to be stated.
- (f) That the company has the authority to borrow from its memorandum and articles.
- (g) That a bank reconciliation statement can be prepared.
- (h) That the bank is willing to let the overdraft continue.

If no item 'bank overdraft' appeared in the balance sheet, it would represent an assertion by the directors that no overdraft liability existed at the balance sheet date.

The assertion will either be corroborated or refuted and any information that does this is referred to as evidential matter.

3.2 Audit Evidence

The auditor's attitude to each item in the accounts will be as follows.

- (a) Identify the express and implied assertions made by the directors in including (or excluding) the item in the accounts;

- (b) Evaluate each assertion for relative importance to assess the quality and quantity of evidence required;
- (c) Collect information and evidence;
- (d) Assess the evidence for:
 - (i) appropriateness: appropriateness subsumes the ideas of quality and reliability of a particular piece of audit evidence and its relevance to a particular assertion;
 - (ii) sufficiency.

Note that audit evidence tends to be persuasive rather than absolute and that auditors tend to seek evidence from different sources or of a different nature to support the same assertion. Note also that auditors seek to provide reasonable but not absolute assurance that the financial statements are free from misstatement. Auditors do not normally examine all the information available but reach their conclusions about financial statement assertions using a variety of means including sampling.

Having formulated judgement on each individual item in (or omitted from) the accounts, the auditor must formulate a judgement on the truth and fairness of the accounts as a whole. To do this, he will need other evidence in addition to the judgements he has made on the individual items. As an example, he may need evidence of the directors' implied assertion that the accounts should be drawn up on the going concern principle.

3.2.1 Limitations

The quality and quantity of evidence are constrained by the following.

- (a) Absolute proof is impossible;
- (b) Some assertions are not material;
- (c) Time is limited. Accounts must be produced within a time scale and the auditor may have to cope with less than perfection to comply with the time scale;
- (d) Money is limited. The ideal evidence may be too expensive to obtain;
- (e) Sensitivity. Some items are of greater importance than others (valuation of property in property companies, for example) or capable of greater variations (stock and work-in-progress).

3.2.2 Varieties of Evidence

The evidence an auditor collects can be divided into the following categories:

- (a) Observation:
 - (i) Examination of physical assets;
 - (ii) Witnessing the internal control and book-keeping procedures;
 - (iii) Observation of the records to ensure that book-keeping and internal control procedures have been carried out.
- (b) Testimony from independent third parties. e.g. bank letters, debtors circularisation.
- (c) Authoritative documents prepared outside the firm e.g. title deeds, share and loan certificates, leases, contracts, franchises, invoices.
- (d) Authoritative documents prepared inside the firm, e.g. minutes, copy invoices.
- (e) Testimony from directors and officers of the company. This may be formal, for example, the letter of representation, or informal, for example, in replies to Internal Control Questionnaire (ICQ) questions.
- (f) Satisfactory internal control. For many items, this is the most useful evidence.
- (g) Calculations performed by the auditors. Evidence of the correctness of many figures can be obtained this way.
- (h) Subsequent events. The audit is usually performed well after the year end and many assertions can be verified by reference to subsequent events.
- (i) Relationship evidence. Evidence confirming the truth about one item may tend to confirm the truth about another. For example, evidence confirming the correctness of investment income also confirms some aspects of the item of 'investments'.
- (j) Agreement with expectations. Verification can be assisted by the computation and comparison of ratios and absolute magnitudes with those achieved (a) in the past; (b) by other companies; and (c) budgeted. Conversely, inconsistencies and unusual or unexpected items will alert the auditor.
- (k) External events. The client is not isolated from the world, and the auditor should use his knowledge of current events in his assessment.

3.2.3 Basic Techniques for Collecting Evidence

The basic techniques for collecting evidence are nine in number and they are as follows:

- (a) Physical examination and count.
- (b) Confirmation. This should be in writing, external sources being preferable to internal sources.
- (c) Examination of original documents. Original documents should be compared with the entries in the books. The usual wording is vouching.
- (d) Re-computation. Additions, calculations, balance extractions, etc.
- (e) Retracing book-keeping procedures. Checking postings.
- (f) Scanning. This is somewhat indefinite but is widely used, especially in seeking the unusual or the unlikely.
- (g) Inquiry. Asking questions. This is a necessary and valid technique. However, auditors acquire a habit of always seeking confirmation of oral answers.
- (h) Correlation. Seeking internal consistency in records and accounts.
- (i) Observation. Seeing for oneself is the best possible confirmation especially in connection with internal control systems.

3.2.4 Test Checking

It is not always necessary to obtain evidence about each individual transaction. The modern approach is to obtain evidence about each type of transaction by examining a representative sample of each type. This is called test checking and is applied as much to assets and liabilities as to routine transactions. The size of the sample to be tested depends on:

- (a) the strength of the internal control system;
- (b) the materiality of the items;
- (c) the number of items involved;
- (d) the nature of the item;
- (e) the audit risk attached.

3.2.5 Sources of Audit Evidence

Sources of audit evidence include from within (systems, books, documents, assets, management and staff) and from without (customers, suppliers, lenders, professional advisers etc.).

The sources and amount of evidence required will depend on, materiality, relevance, and reliability of the evidence available from a source, and the cost and time involved.

Relevance of audit evidence depends on whether it assists the auditor in forming an opinion on some aspects of the financial statements. For example, evidence that indicates that a recorded asset exists is relevant to audit objectives.

3.2.6 Reliability of Audit Evidence

The reliability of audit evidence can be assessed to some extent on the following presumptions.

- (a) Documentary evidence is more reliable than oral evidence;
- (b) Evidence from outside the enterprise (e.g. bank letter) is more reliable than that secured solely from within the enterprise;
- (c) Evidence originated by the auditor by such means as analysis and physical inspection is more reliable than evidence obtained from others (auditors always say 'show me' not 'tell me').
- (d) Evidence for a figure in the accounts is usually obtained from several sources (e.g. for debtors – a good system with internal controls, debtors circularisation, ratio analysis, payment after date, etc). The cumulative effect of several evidential sources which give a consistent view is greater than that from a single source (i.e. $2 + 2 = 5$);
- (e) Original documents are more reliable than photocopies or facsimiles.

3.2.7 Sufficiency of Audit Evidence

Sufficiency is a great problem in auditing. The auditor's judgement will be influenced as follows.

- (a) His knowledge of the business and its industry;
- (b) The degree of audit risk. Assessment of this is helped by considering the following points.
 - (i) Nature and materiality of items of account (e.g. stock is material and difficult to measure);
 - (ii) The auditor's experience of the reliability of the management and staff and the records;
 - (iii) The financial position of the enterprise (in a failing enterprise, directors may wish to bolster profits by over- valuing assets or suppressing liabilities);
 - (iv) Possible management bias (as in (iii)), but also the management may wish to 'even out' profits for stock market image or taxation reasons;
- (c) The persuasiveness of the evidence;
- (d) The nature of the accounting and internal control systems and the control environment.

3.2.8 Procedures for Collecting Evidence

The procedures for collecting evidence include:

- (a) substantive testing;
- (b) analytical review.

These have been considered at some point in this course.

SELF-ASSESSMENT EXERCISE 1

1. Highlight the various assertions that are made in financial statements.
2. Enumerate and explain the varieties of audit evidence.

3.3 Consideration of Relevant Concepts

3.3.1 Audit Trail

Audit trail is a trail of evidence linking individual transactions of the summary totals in the financial statements. The flow of data starts from recording of source documents such as invoices, cheques, and summarising them in the journals at the end of the month and posting to the ledgers. At the year end, the balances in the ledger are transferred to the balance sheet and the profit and loss account (final accounts).

3.3.2 Circularisation of Debtors

This is one of the auditor's uses of third parties or external confirmation. Circularisation of debtors is a practice whereby the auditor obtains permission from the client to contact debtors, requesting them to confirm the amounts outstanding against them.

Two forms of debtors' circularisation are as follows:

- (i) The negative approach – the debtor is to reply only if he disputes the balance shown against him;
- (ii) The positive approach – the debtor is required to confirm details of sums of money as outstanding in the records of the clients company.

3.3.3 Audit Working Papers

According to Parry and Whittington, working papers are the connecting link between the client's records and the auditor's report. The main object of the audit working papers is to record and demonstrate the steps

which have been followed or adopted by the auditors to enable them form an opinion on the accounts upon which they are required to report. Thus, permanent records of evidence gathered during an audit engagement are established.

They should be prepared in such a manner that if properly indexed, any auditor can readily locate data relative to any part of the audit. Working papers are sometimes used as an aid in giving testimonial years after completion of the audit. Working papers enhance the efficiency with which the audit is conducted, and should provide the following:

- (i) A means of controlling the current year's audit work and the basis on which to plan the following year's work;
- (ii) Evidence of work carried out by the auditors;
- (iii) Schedules in support of the accounts additional to or summarising the details in the client's work;
- (iv) Information about the business which accounts have been audited including its recent history.

Working papers are divided into two, thus:

- the current file and
- the permanent file.

(a) The Current File

This relates primarily to the set of accounts or statements being audited and should normally contain the following:

- (i) A copy of the accounts or statements on which the auditors are reporting signed by the directors;
- (ii) An internal control questionnaire or other records including flow charts if appropriately designed to ascertain the adequacy of the system of internal control;
- (iii) An audit programme (details of steps of work performed by auditors supplemented by particulars and dates of work carried out and precise details of audit tests performed and their results);
- (iv) A schedule for each item in the balance sheet including comparative figures showing its make-up and how existence, ownership, valuation and liability have been verified. These schedules should be cross-referenced to documents arising from external verifications such as bank tellers, results of circularisation of debtors, and attendance at physical stocktaking;

- (v) Schedules supporting each item in statutory profit and loss account including comparative figures and such other items in trading or subsidiary account as may be necessary;
- (vi) A checklist concerning compliance with statutory disclosure provision;
- (vii) A record showing queries which are raised during the audit and their disposals. Queries which are not cleared must be entered on a further schedule for the attention of the senior audit partner. Material queries which cannot be settled in a satisfactory way require the qualification of the audit report. All these must be documented and supported by a note of all discussions with the client relating to that query;
- (viii) A schedule of important statistics or working ratios like:
 - gross profit per cent
 - current assets to current liabilities
 - stock turnover
 - trade debtors and trade creditors
 - profit to capital employed ratios

The purpose of keeping these ratios is that any significant variation in any one year may need explanations.

- (ix) By extracts from directors' and shareholders' minutes of meetings;
- (x) Copies of letters to the client stating any material weaknesses or matters which the auditors are not satisfied with in respect of accounting or control procedures;
- (xi) Letters of representation, that is, written confirmation by the client of information and opinions expressed in respect of matters such as stock values and amount of current and contingent liabilities.

(b) The Permanent File

This contains matters of continuing importance affecting the company on the audit. Such matters are as follows:

- i. Memorandum and Articles of Association and other appropriate statutory or legal provisions/regulations;
- ii. Copies of other documents and minutes of continuing importance;
- iii. A short description of the type of business carried out and the place of the business;
- iv. List of accounting records and officials responsible for them as well as the organisational plan;

- v. Statements showing a note of accounting matters of importance such as the history of the results and the bases of accounting adopted;
- vi. The client's internal accounting and internal audit instructions plus stocktaking instructions, where applicable.

SELF-ASSESSMENT EXERCISE 2

What purpose do working papers serve?

3.3.4 Auditing Procedures

Let us look at the two major activities involved in the final audit, namely, vouching and verification.

(a) Vouching

This is the process of examining documentary evidence necessary to support the recorded transactions which are purported to have taken place, during the period under review. Such an examination will establish the following:

- i. The correctness of the monetary amounts at which the transaction is recorded; costs, in the case of purchases; and proceeds, in the case of sales;
- ii. That the transactions were duly authorised in the first place;
- iii. That the transactions took place within the period under review;
- iv. That the goods and services acquired appeared to be compatible with the company's normal trading activities;
- v. That the calculation of costs, proceeds, extensions, discounts, etc., are arithmetically correct;
- vi. That the expenditure or income, as the case may be, has been correctly allocated so that effects have been given to the distinction between capital, revenue, deferred revenue, etc;
- vii. That there is evidence (of rubber stamping and signature or initials) that the document in question has been authorised and checked initially as part of the company's own control procedures.

(b) Verification

This relates to assets and liabilities and other items in the balance sheet at the year end. Verification ensures the correctness or otherwise of the following:

- (i) The stated cost must be related to what is paid for, and evidenced by a receipt;
- (ii) The purchase/acquisition must be duly authorised as evidenced by a signature, board meetings' decisions, memorandum and article of association, etc;
- (iii) The assets and liabilities appear in the balance sheet at a fair valuation;
- (iv) The assets exist. Here, the auditor relies on physical verification wherever practicable and appropriate. This is especially relevant where the physical assets may be directly compared with the company's own records;
- (v) The company really owns the assets – ownership. Let us understand here that existence is one thing, ownership is quite another. An asset may just be physically present in the company's premises to support entries in the books of the company. Ownership may be verified by reference to a document of title in relation to that property like a receipt of purchase. Also, it may be verified by reference to corroborative evidence or the representation of outside parties.

SELF-ASSESSMENT EXERCISE 3

Highlight the objects of vouching.

4.0 CONCLUSION

In this unit, you have learnt that the evidence obtained from outside the organisation (from an independent source) provides greater degree of assurance of reliability for the purpose of an audit. The amount of evidence that will be sufficient to support auditor's opinion is a matter of professional judgement after studying the circumstances around the organisation.

5.0 SUMMARY

In this unit, you have learnt the following:

- When accounts are prepared, assertions are made about the items in the accounts, items omitted and the accounts as a whole;
- The auditor conducts an audit by:
 - i. identifying the assertions made;
 - ii. considering the information and evidence he needs;
 - iii. collecting the evidence and information;
 - iv. evaluating the evidence;
 - v. formulating a judgement.

- There are some limitations to the ideal approach to the collection of evidence;
- There are many different varieties of evidence as well as techniques for evidence collection;
- Circularisation of debt can be depended upon for its reliability;
- Working papers serve as useful aids to the auditors.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

The various assertions made in the financial statements are as follows:

- i) Existence
- ii) Rights and obligations
- iii) Occurrence
- iv) Completeness
- v) Valuation
- vi) Measurement
- vii) Presentation and disclosure

ANSWER TO SELF-ASSESSMENT EXERCISE 2

Varieties of audit evidence (See 3.2.2)

ANSWER TO SELF-ASSESSMENT EXERCISE 3

The purpose of working papers is to record and demonstrate the steps which have been followed or adopted by the auditors to enable them form an opinion on the account on which they are required to report.

6.0 TUTOR-MARKED ASSIGNMENT

1. Appraise the limitations to the ideal approach to the collection of audit evidence.
2. Highlight the contents of the permanent file.

7.0 REFERENCES/FURTHER READING

Damagun, Y.M. (2005). *Auditing Theory and Practice*, (2nd Ed.). Zaria, Nigeria: Ahmadu Bello University Press Limited.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Messier, W.F. Jr. (2000). *Auditing and Assurance Services: A Systematic Approach* (2nd Ed.). USA: McGraw-Hill Co. Inc.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Pany, Kurt & Whittington, O. (1994). *Auditing*. Boston: Richard D. Irwin, Inc.

Saliers, Earl A. (Ed.) (1923). *Accountants' Handbook*. New York: The Ronald Press Company.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

UNIT 4 AUDIT RISKS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Audit Risks - Types
 - 3.1.1 Normal Audit Risk
 - 3.1.2 Higher than Normal Risk
 - 3.1.3 Audit Work Risk
 - 3.2 Audit Firm Organisation and Audit Risk
 - 3.3 Particular Audits and Audit Risk
 - 3.4 Risk-based Audit Methodology
 - 3.4.1 Using the Risk-Based Audit Strategy
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

The term 'audit risk' refers to the possibility that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are not well stated. It can also be stated that audit risk means the chance of damage to the audit firm as a result of giving an audit opinion that is wrong in some particular. Damage to the audit firm may be in the form of monetary damages paid to a client or third party as compensation for loss caused by the conduct (for example, negligence) of the audit firm or simply loss of reputation with the client (and perhaps also the audit) or the business community.

Audit risk is reduced by gathering evidence – the more the evidence gathered, the less the audit risk assumed.

In this unit, you will be considering the following topics.

- Types of audit risks;
- Audit firm organisation and audit risk;
- Particular audits and audit risk;
- Risk-based audit methodology.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define audit risk
- explain the types of audit risk
- describe the features of audit firm organisation which may minimise risk
- explain the risk-based audit methodology.

3.0 MAIN CONTENT

3.1 Audit Risks – Types

There are three types of audit risks, namely:

- (a) normal audit risk
- (b) higher than normal audit risk and
- (c) audit work risk

3.1.1 Normal Audit Risk

All audits involve risk. However strong the audit evidence and however careful the auditor, there is always a possibility of an error or fraud being undetected.

In general, if there are indications that audit risk is normal and there are no indications of higher than normal risk, then the auditor could be regarded as one that:

- (a) organises his office and staff in a competent manner;
- (b) follows the auditing standards and guidelines; he is unlikely to be found negligent and to have to pay damages as a consequence of fraud or error not discovered by him.

Indications that risk is normal may include the following:

- (a) Past experience indicates risk is normal;
- (b) The management and staff of the client are competent and have integrity;
- (c) The accounting system is well designed, it works and it is subject to strong internal controls;
- (d) The client is old established and is not subject to rapid change;
- (e) The board of directors is actively engaged in the company and control and its leadership is of good quality;
- (f) The board of directors has competent non-executive directors and better still, an audit committee.

Where audit risk is normal, then the auditor may approach his audit by relying on:

- (a) key controls;
- (b) substantive tests;
- (c) analytical review.

3.1.2 Higher than Normal Risk

Some audit assignments involve high audit risk. Some audits contain at least one area of high risk.

Indications of higher than normal audit risk are as follows:

- (a) Previous experience;
- (b) Future plans of the enterprise which include sale or flotation on the Stock Exchange of the company;
- (c) High gearing;
- (d) Liquidity problems;
- (e) Poor management;
- (f) Lack of controls and/or poor book-keeping;
- (g) Recent changes of ownership/control;
- (h) Dominance by a single person;
- (i) Rapid staff turnover;
- (j) In small companies, non-involvement of the proprietor or conversely over-reliance on management for control;
- (k) Changes of accounting procedures or policies;
- (l) Evidence from background research;
- (m) Over-reliance on one or a few products, customers, suppliers;
- (n) Recent high investment in new ventures or products;
- (o) Problems inherent in the nature of the business e.g. stock counting or valuing difficulties, difficulty in determining the extent of liabilities, warranty claims, cut-off;
- (p) The existence of 'put upon enquiry' situation.

The audit approach in high risk situations must be:

- (a) sceptical;
- (b) to use high caliber audit staff;
- (c) collection of a wide range of audit evidence in each area;
- (d) meticulous preparation of audit working papers;
- (e) probing of all high risk areas to the bottom;
- (f) extreme care in drafting the audit report.

3.1.3 Audit Work Risk

All audit work involves normal risk and some audit works involve higher than normal risk. This is because there is always a possibility of the accounts containing a misstatement due to error or fraud.

In addition to the audit risk arising from client activity, there is also a risk that the audit work may be of an inadequate standard.

The risk arising from audit work may include the following:

- (a) Failure to recognise 'put upon enquiry' situations;
- (b) Failure to draw the correct inferences from audit evidence and the analytical review;
- (c) Use of the wrong procedures in a particular situation;
- (d) Failure to perform necessary audit work because of time or cost considerations;
- (e) Failure to detect error or fraud because of poor sampling method or inadequate sample sizes.

SELF-ASSESSMENT EXERCISE 1

1. What is audit risk?
2. What factors might indicate that risk is normal?

3.2 Audit Firm Organisation and Audit Risk

It is essential that an audit firm should organise its affairs in such a way as to minimise the risk of paying damages to clients or others arising out of negligent work.

Features of organisation, which may minimise risk are as follows:

- (a) Proper recruitment and training of all personnel;
- (b) Allocation of staff with appropriate ability to particular audits;
- (c) Planning of the work of the firm in such a way that each audit can be approached in a relaxed but disciplined way and timing problems can be accommodated;
- (d) Two-way communication with staff on matters of general concern and in connection with specific audits;
- (e) Use of audit manuals which conform to the audit standards and guidelines;
- (f) Use of audit documentation which is comprehensive and yet which allows for special situations;

- (g) Use of budgeting and other techniques to ensure that audits are remunerative and yet risk- minimising;
- (h) Use of precise and frequently updated letters of engagement;
- (i) Use of review techniques for all audits;
- (j) Existence of technical section so that all new developments (accounting, law, audit procedures) are rapidly incorporated into the firm's actions.

3.3 Particular Audits and Audit Risk

Risks arising from a particular audit can be minimised by:

- (a) techniques for recognising the existence of audit risk;
- (b) segregating normal risk areas from high risk areas;
- (c) allocating staff who are competent to do the work especially in high risk areas;
- (d) extensive background research into the client and its industry;
- (e) careful planning with emphasis on high risk areas;
- (f) comprehensive documentation;
- (g) good briefing of audit staff;
- (h) emphasis to staff on the need for recognition of high risk situations and good communication when high risk or put upon enquiry situations are discovered;
- (i) particular attention to the conclusions reached from audit evidence;
- (j) special emphasis on the analytical review;
- (k) review of the audit work by a senior auditor unconnected with the particular audit;
- (l) emphasis on materiality considerations and sample sizes.

3.4 Risk- based Audit Methodology

Audit costs have been rising steadily in the last few years. At the same time, audit fee resistance has risen due to competition, low growth in the market and the growth of competitive tendering for audits. Consequently, audit firms are continually trying to reduce audit costs while at the same time reducing audit risk. This has led to the idea of risk-based auditing being in some sense a distinct approach to auditing. Historically, auditing has progressed from being a largely substantive testing process, through a largely systems based process into a risk based method which uses a range of audit techniques including: substantive testing, internal control compliance, analytical review and the use of inherent factors.

Inherent factors include background knowledge of the client and past audit record indicating no special difficulties. According to Mautz and

Sharaf, it is a valid auditing postulate that 'in the absence of evidence to the contrary, what has held true for the client in the past will hold true in the future'.

Essentially, auditing is the gathering of evidence about each part of the accounts; but as absolute assurance is impossible, there are always some elements of residual risks which have to be accepted. The extent of acceptable risk is a matter of judgement. It can be seen as the product of the separate risks accepted in each type of evidence gathering. Thus:

Overall risk = Inherent risk x Control risk x Analytical review x Substantive risk.

Thus if, for example, an audit situation was examined, found to be material and the risk factors assessed, the following set of figures might be assembled:

(the may be debtors)

Overall acceptable risk 5% (= 5 chances in 100 of giving a wrong opinion).

Inherent risk (client is old established, well-managed and no problems have been encountered in the area previously) 50%.

Control risk (internal control is strong, unchanged from last year, little possibility of management override) 20%.

Analytical control risk (figures tie up with credit sales, with previous years and with budgets subject to small changes stemming from different external conditions) 50%.

Thus, substantive risk = $OR/IR \times CR \times AR = 0.05/0.5 \times 0.2 \times 0.5 = 1$

This means the audit assurance required from substantive testing is 100% – 100% i.e. no assurance is required. Assurances from the other sources of evidence are sufficient to support an audit opinion with 5% risk. Most auditors would find this a bit strong, but if you change the risk factor from control to 30% then the substantive risk becomes 67% and the level of assurance required from the evidence source substantive testing is only 100% – 67% = 33%. In effect, in designing statistical sampling tests for substantive testing, the level of confidence required is only 33%. The sample sizes corresponding to this are likely to be very small.

3.4.1 Using the Risk-based Audit Strategy

We would comment on this sub-heading as follows.

- (a) The risk based equation outlined above is one of several.. Others include:

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

$$AR = IR \times DR \times SR$$

AR stands for overall audit risk. This is the risk that the auditor will draw an invalid conclusion from and wrongly qualify or not qualify his/her audit report.

IR is inherent risk – risk which derives from the nature of the entity and of its environment prior to the establishment of internal controls. Some enterprises are inherently more risky than others e.g. new v. old established, high tech (computer manufacturer) v. low tech (hand-made up-market furniture).

DR is detection risk – the risk that the auditor's substantive procedures and his review of the financial statements will not detect material errors.

SR is sampling risk – detection risk arising out of sample based substantive tests.

Some of these are sub-sets of others (e.g. sampling risk of detection risk).

- (b) Care must be taken to weigh the risk from each source of evidence as it is gathered and then to avoid over-auditing in the remaining evidence gathering. For example, if adequate weight is given to inherent factors and analytical review, it may be that minimal internal control evaluation and/or substantive testing will be required.
- (c) It may be undesirable to carry out detailed Internal Control Evaluation (ICE) and compliance testing techniques if:
- (i) a high level of assurance can be gained from inherent factors and analytical review;
 - (ii) a preliminary review indicates that controls appear to be very strong;
 - (iii) a high level of assurance was obtained in the previous year and the system has not changed;
 - (iv) the area is not material;

- (x) a preliminary review indicates that controls are not strong and a high level of assurance will have to come from substantive testing.
- (d) Use computer aided auditing techniques wherever possible.
- (e) Use the same sample, as far as possible, for several tests both compliance and substantive. However, care must be taken to think through each sample and clearly record what evidence is being obtained whether it is compliant (if so, on what controls) or substantive.
- (f) In using sampling, always look for rational sampling methods including stratification.
- (g) Increase the role of internal audit. Smaller and smaller firms are turning to internal audit and audit firms should make maximum use of this resource.
- (h) Increase the use of accounting technicians for the actual sampling and employ high level staff for the thought behind the audit work. As a matter of comment, the use of clever recent graduates for audit work seems to be expensive (high salaries, low output as learners and with time off for study) and a turn off from auditing.

SELF-ASSESSMENT EXERCISE 2

Define:

- i. overall audit risk, and
- ii. inherent risk.

4.0 CONCLUSION

In this unit, you have discovered that risk is a useful concept in planning all audit work. Modern audit firms are increasingly adopting a risk-based approach, which means that audits are divided into normal and high risk audits and individual audits are divided into normal risk areas and high risk areas.

The normal risk areas are covered with emphasis on key controls and analytical review and the larger part of the audit effort is placed on the high risk areas.

5.0 SUMMARY

What you have learnt in this unit can be summarised as follows:

- Audit risk is a term which has grown in importance in recent years;

- Audit risk may be defined in two stages.
 - (a) The possibility that the financial statements contain material misstatements which have escaped detection by any internal controls on which the auditor has relied and on the auditor's own substantive tests and other works;
 - (c) The possibility that the auditor may be required to pay damages to the client or other persons as a consequence of:
 - i. the financial statements containing a misstatement, and
 - ii. the complaining party suffering loss as a direct consequence of relying on the financial statements, and
 - iii. negligence by the auditor in not detecting and reporting on the misstatement can be demonstrated.
- Audit risk can be seen as normal or higher than normal;
- Normal audit risk exists in all auditing situations;
- Higher than normal audit risk can be associated with particular clients or with particular areas of a client's affairs;
- Audit risk can arise from a client which is high risk as a whole, for particular areas of a client's affairs, or, from inadequacies in audit work;
- Audit risk can be minimised by appropriate audit firm organisation and appropriate audit work on a particular client;
- Many modern writers consider the use of risk-based auditing as a new direction in auditing, contrasting with the older substantive testing and systems-based auditing. Risk-based auditing takes account of substantive test risk, internal control risk, detection risk, analytical control risk, sampling risk and inherent risk.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

Audit risk means the chance of damage to the audit firm as a result of giving an opinion that is wrong in some particular.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

The following factors might indicate that risk is normal.

- i) Past experience;
- ii) Management and staff of the client are competent and have integrity;
- iii) The accounting system is well designed, it works and is subject to strong internal controls, etc (See 3.1.1)

ANSWER TO SELF-ASSESSMENT EXERCISE 3**(a) Overall audit risk**

This is the risk that the auditor will draw an invalid conclusion and wrongly qualify or not qualify his report.

(b) Inherent risk

This means a risk which derives from the nature of the entity and of its environment prior to the establishment of internal controls.

6.0 TUTOR-MARKED ASSIGNMENT

What factors might indicate higher than normal risk?

7.0 REFERENCES/FURTHER READING

Kell, W.G.; Boynton, W.C. & Ziegler, R.E. (1986). *Modern Auditing* (3rd Ed.). New York: John Wiley and Sons.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Pany, K. & Whittington, O. R. (1994). *Auditing*. Boston: Richard D. Irwin, Inc.

MODULE 3

Unit 1	Procedures for Auditing Transactions I - Fixed Assets and Investments
Unit 2	Procedures for Auditing Transactions II - Current Assets (Cash, Debtors, Stock)
Unit 3	Procedures for Auditing Transactions III - Liability Verification
Unit 4	Audit Reports

UNIT 1 PROCEDURES FOR AUDITING TRANSACTIONS I - FIXED ASSETS AND INVESTMENTS

CONTENTS

1.0	Introduction
2.0	Objectives
3.0	Main Content
3.1	Fixed Assets Verification
3.1.1	Brief on Fixed Assets
3.1.2	Objectives of Validating Fixed Assets
3.1.3	Procedure for Fixed Assets Audit
3.2	Investments
3.2.1	Brief on Investments
3.2.2	Audit Objectives Relative to Investments
3.2.3	Audit Programme for Investments
3.2.4	Special Points to Note on Verification of Investments
4.0	Conclusion
5.0	Summary
6.0	Tutor-Marked Assignment
7.0	References/Further Reading

1.0 INTRODUCTION

You may recall that in the last unit two major activities discussed in the final audit were vouching and verification. While vouching was seen as the process of examining documentary evidence necessary to support the recorded transactions which purportedly took place during the period under review, there is also the need for the verification of the assets and liabilities (and other items) appearing in the balance sheet at the end of the year. You are now very conversant with the objects of verification as highlighted in the last unit.

In this unit and even in the next two units, you will be exposed to the procedures for auditing transactions with emphasis on verification of fixed assets, investments and liabilities bearing in mind that there are well established techniques for auditing transactions.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define fixed assets
- state the objectives of verifying fixed assets
- state the procedures for fixed assets audit
- categorise investments
- outline the procedures for audit of investments.

3.0 MAIN CONTENT

3.1 Fixed Assets Verification

Fixed assets are the properties of the business that are permanent in nature. Examples include: land, buildings, machinery, plant, equipment, furniture and others. The significance of fixed assets of an organisation should be of interest to an auditor. For instance, in a wholesale organisation, fixed assets consist of a small part of the total assets while in a manufacturing firm; the amount of fixed assets is always very significant in the balance sheet reporting.

An auditor should be familiar with the major items of fixed assets as well as review addition of fixed assets during the year. Fixed assets are purchased for use in the day-to-day operations of the business and their lifespan will extend over a number of years. The cost of the assets is spread over the estimated useful life. Expenditure made in the purchase of assets or assets improvements are charged to capital expenditure.

Depreciation of assets is usually based on historical cost. Depreciation has been defined by Statement of Standard Accounting Practice (SSAP) as “the measure of the wearing out, consumption or other loss of value of a fixed asset whether arising from use, effluxion of time or obsolescence through technology and market changes”.

An auditor should compute or verify the computation on fixed assets. Depreciation should be allocated to accounting periods so as to charge a fair proportion to each accounting period during the expected life of the assets. In computing depreciation, the auditor should consider the following.

- (a) Cost of the asset;
- (ii) Use life;
- (iii) Residual/scrap/salvage value.

The auditor should be familiar with the various methods of computing depreciation, especially, with the popular ones like:

- (i) straight line method and
- (ii) reducing balance method

It is the auditor's responsibility to exercise professional judgement in assessing management's method of allocation of depreciation expense to accounting periods. Depreciation rate to be used should depend on the:

- (i) nature of the fixed assets;
- (ii) expected useful life;
- (iii) residual value; and
- (iv) technological development of new products.

3.1.2 Objectives of Validating Fixed Assets

The auditor's objectives in validating fixed assets are to determine:

- (i) the physical existence;
- (ii) what cost is recorded on historical basis;
- (iii) that all additions to fixed assets are genuine;
- (iv) that depreciation is properly computed;
- (v) that proper recording of residual value is maintained;
- (vi) that the total amount recorded in the balance sheet is fair.

3.1.3 Procedure for Fixed Assets Audit

The procedure can be highlighted as follows.

- (i) Review the internal control over fixed assets;
- (ii) Examine the general ledger for major additions and retirements so that they can be observed during the physical check;
- (iii) Verify legal ownership of assets;
- (iv) Verify major items added during the year and authorisation of invoices, work orders, etc.
- (v) Verify all retirements of each asset;
- (vi) Test the amount of depreciation for each new addition and ascertain if the computation is consistent with that of the past years;
- (vii) Analyse repairs and maintenance accounts;

- (viii) Review the organisational policies on capitalisation;
- (ix) Review minutes of meetings of the board of directors, management, etc. for authorisation to acquire new assets;
- (x) Determine whether the amount recorded in the balance sheet is fair.

SELF-ASSESSMENT EXERCISE 1

1. What are the determinants of depreciation rate of fixed assets?
2. State the objectives of verifying fixed assets that appear in the balance sheet.

3.2 Investments

3.2.1 Brief on Investments

Firms invest in other companies by acquiring debt and equity securities. The investments may be for short-term or long-term holdings, and can be in the form of securities, certificate of deposit, commercial paper, treasury bills, etc. It is important to distinguish the categories into which investments can be divided. They are as follows.

(a) Variability

- (i) Fixed sum deposits
- (ii) Investments by varying value.

(b) Quotation

- (i) Quoted investments
- (ii) Unquoted investments.

(c) Ownership proportion

- (i) Investment giving minority interests (less than 20%)
- (ii) Investment in associated companies (20% – 50%)
- (iii) Investments in subsidiary companies (Not greater than 50%).

(d) Period of ownership

- (i) Short-term investments
- (ii) Long-term investments.

(e) Treatment in balance sheet

- (i) Investments which are current assets
- (ii) Investments which are not current assets.

The auditor should ensure that investments are recorded at their fair market value or at the fair market value of those given up at the time of exchange, whichever is clearly determinable. The auditor should evaluate or check the method of accounting for investments in the financial statements and with related disclosure requirements.

3.2.2 Audit objectives relative to Investments

The audit objectives relative to investments are to determine:

- (i) that adequate internal control exists over the investments;
- (ii) that the investments actually exist, and are the properties of the client;
- (iii) that the investments are properly valued, and classified on the balance sheet;
- (iv) that all revenues arising from the investments have been promptly collected and recorded.

3.2.3 Audit Programme for Investments

Note that the verification of investments is considered to include:

- (a) analysis of related accounts such as dividend revenue, interest earned, accrued interest, dividends receivable, gain or loss on sale of securities;
- (b) for income tax purposes – there is need to know the dates of transactions and the tax bases.

Therefore, the audit programme is as follows.

- (i) Prepare a description of internal control for investments, and obtain a detailed schedule of all the company's investment;
- (ii) Trace transactions for purchase and sales of securities through the system;
- (iii) Review reports by the internal auditors on their periodic inspection of securities;
- (iv) Review monthly reports by officer of client's company on securities;
- (iv) Obtain/prepare analyses of investments accounts and all related revenue accounts;
- (v) Inspect securities on hand and compare serial numbers with those shown on previous examination;
- (vi) Obtain confirmation of securities in the custody of others;
- (vii) Verify purchases and sales of securities during the year;
- (viii) Verify gain or loss of security transactions and obtain information for income tax returns;

- (ix) Make independent computation of revenue from securities by reference to dividend record books;
- (x) Investigate the methods of accounting for investments in subsidiary companies;
- (xi) Determine the market value of securities at the date of balance sheet;
- (xii) Determine financial statements presentation.

3.2.4 Special Points to Note on Verification of Investments

- (i) Internal control is very important. Note particularly the separation of duties of authorisation, custody and recording;
- (ii) Physical inspection is very desirable; all the certificates should be examined together.

SELF-ASSESSMENT EXERCISE 2

The auditor should be concerned with the verification of investments. What does this aspect of his audit work hope to achieve?

4.0 CONCLUSION

In this unit, you have learnt that review of internal control over fixed assets and investments relative to the audit procedure should be taken seriously as other verification activities, more or less, derive strength from that. Also, physical verification (check/inspection) of fixed assets and investments is more important than their being sighted on the balance sheet.

5.0 SUMMARY

In this unit, you have learnt the following:

- Fixed assets are the properties of the business that are permanent in nature;
- An auditor should be conversant with the various methods and rates of computing depreciation;
- An auditor should be aware of the objectives of validating/verifying fixed assets and investments as they appear on the balance sheet;
- Review of the internal control as well as physical verification are very important in the audit procedures for fixed assets and investments.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

1. Determinants of depreciation rate of fixed assets are:
 - i) nature of the fixed asset
 - ii) expected useful life
 - iii) residual value
 - iv) technological

6.0 TUTOR-MARKED ASSIGNMENT

1. Why is physical check of fixed assets more important than sighting them on the balance sheet?
2. Highlight the procedures for fixed assets audit.

7.0 REFERENCES/FURTHER READING

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

UNIT 2 PROCEDURES FOR AUDITING TRANSACTIONS II – CURRENT ASSETS (CASH, DEBTORS AND STOCK)

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Cash
 - 3.1.1 Objectives of Cash Audit
 - 3.1.2 Audit Programme for Cash
 - 3.2 Debtors
 - 3.3 Stock
 - 3.3.1 Auditor's Responsibility
 - 3.3.2 Auditor and Inventory
 - 3.3.3 Audit Programme for Inventory
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

In this unit, you will be considering the auditing procedures for the following current asset items:

- cash
- debtors
- inventory

Emphasis will be placed on how to go about verifying these items as they appear in the balance sheet.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- state the objectives of cash audit
- outline the audit programme for cash
- enumerate the general method of verifying debtors
- state group inventory relative to financial reporting
- list audit programmes for inventory.

3.0 MAIN CONTENT

3.1 Cash

Cash is one of the most liquid assets and as such, it is susceptible to defalcation. This is why the audit procedures applied to cash should be more extensive.

3.1.1 Objectives of Cash Audit

The auditor's objectives in an audit of cash are as follows:

- (i) to determine that the amount shown in the final accounts constitutes cash in hand, cash at banks, and cash in transit;
- (ii) to determine the reasonableness of the cash reported;
- (iii) to determine that any restricted cash is properly classified and disclosed.

In auditing cash, the auditor must study and evaluate internal control to determine if cash is presented in a fair and logical manner. Also, he conducts both compliance and substantive tests to see if the controls are adequate, and confirms the amounts on deposit directly with the banks, counts cash, prepares bank reconciliation statements and so on. If the result of the auditor's study and evaluation shows weak internal control, he will extend the scope of his audit work. The auditor discovers the company through verification.

3.1.2 Audit Programme for Cash

Audit programme for cash takes the following procedures.

- (i) List each location where cash is held, showing for each, the date and time of the comment and the name of staff responsible first;
- (ii) Take a surprise possession of the cash book/safe for cash count in the presence of the cashier. Possession and counting should be done simultaneously;
- (iii) Cash count result should be entered into the worksheet and the cash returned to the cashier;
- (iv) All documents relating to cash can be retained by the auditor until verifications are made;
- (v) Note the number of the last cheque leaf used, and test to determine that all unused cheques are accounted for and under adequate control;

- (vi) Perform verification of cash transactions in some expense accounts;
- (vii) Send out confirmation requests to verify amounts in deposit at the audit date;
- (viii) Trace recorded cash receipts to the bank statement;
- (ix) Test cash receipt and cash disbursement cut-off;
- (x) Reconcile bank accounts as of audit date. Reconciliation statements prepared by the client should be examined to determine if there are any unusual items. Note that all uncleared cheques have been cleared after date. Also note lodgements credited after date, but actually paid in before date;
- (xi) Investigate all non-sufficient fund cheques and all outstanding cheques
- (xii) Compare cancelled cheques with cash disbursement journal;
- (xiii) Prove footings of cash disbursement and cash receipts journals and trace the posting to the ledger;
- (xiv) Investigate and trace all bank transfers;
- (xv) Prepare worksheet for deposits for the period;
- (xvi) Determine the corrections of cash balance as per the balance sheet date.

3.2 Debtors

Debtors form a large item among the assets of most firms and their verification is essential. The general method of verifying debtors include the following.

- (a) Determine the system of internal control over sales and debtors. The system for debtors should ensure that:
 - (i) only bona fide sales bring debtors into being;
 - (ii) all such sales are made to approved customers, and are recorded;
 - (iii) once recorded, the debts are only eliminated by receipt of cash;
 - (iv) debts are collected promptly;
 - (v) balances are regularly reviewed and aged, a proper system for follow up exists, and, if necessary, adequate provision for bad and doubtful debts is made;
- (b) Test the effectiveness of the system;
- (c) Obtain a schedule of debtors;
- (d) Test balances on ledger accounts to the schedule and vice versa;
- (e) Test casts of the schedule;
- (f) Examine make-up of balances. They should be composed of specific items;
- (g) Ensure each account is settled from time to time;
- (h) Examine and check control accounts;

- (i) Enquire into credit balances;
- (j) Consider the valuation of debtors. This is really a consideration of adequacy of the provision for bad and doubtful debts.

It should be noted that:

- (i) debts which are considered irrecoverable should be written-off to the profit and loss account;
- (ii) provisions for doubtful debts should be set up against debts which are considered doubtful;
- (iii) the practice of debtors circularisation should be employed (Ref. 3.3.2 of Module 2, Unit 3 for explanation).

3.3 Stock

Another name for stock (of goods) is inventory, and it is often composed of a large amount of a company's assets. According to the Statement of Accounting Standards (SAS) published by the Nigerian Accounting Standards Board (NASB), stocks can be defined as "items of value held for use or sale by an enterprise and usually compose of raw materials and supplies used in production, work-in-progress and finished goods".

In financial reporting, inventory can be grouped into the following.

- (i) Retail inventory – this is usually small in quantity of a substantial number of different items which can be found in pharmacy stores, supermarkets/department stores, etc;
- (ii) Wholesale inventory – usually very large with different items;
- (iii) Manufacturer's inventory – consists of:
 - raw materials
 - work-in-progress
 - finished goods.

3.3.1 Auditor's Responsibility

The auditor's responsibilities regarding inventory are as follows.

- (i) Ensure that the amount presented in the balance sheet is not overstated. In doing this, the auditor must be present at the time of stocktaking (inventory count), to observe and check the accuracy of the counting;
- (ii) Ensure that all inventories to be included are added and those to be excluded are removed;

- (iii) Ensure that there is proper validation of physical existence and the valuation of inventory. Failure to get assurance may lead to false balance sheet presentation of the inventory amount;
- (iv) Make appropriate classification and accurate determination of quantity and cost of stocks that are necessary for proper determination of the results of the operation of an enterprise and for the presentation of current assets in its balance sheet.

3.3.2 Auditor and Inventory

From the foregoing, you can deduce that an auditor should be present when inventory count is conducted. His observations, tests and inquiries would enable him to form an opinion as to inventory quantities and conditions prevailing on that date.

An auditor should perform tests of the accounting records, and should be able to use statistical sampling method to satisfy himself that the amount presented in the financial statements is fairly recorded.

SAS No. 4 requires every auditor to state different methods of valuation – First In First Out (FIFO), Last In First Out (LIFO), moving average, etc. – that have been adopted for different types of stocks, the amount included in the financial statements, and the methods used in respect of each type. Any departure from one method of valuation used in the previous period should be disclosed in accordance with SAS No. 1.

3.3.3 Audit Programme for Inventory

The audit programmes for inventory are as follows.

- (i) Review and test internal control over inventory. Test of compliance is used to perform this test;
- (ii) Review physical inventory plans;
- (iii) Examine some purchase orders;
- (iv) Perform test on cost accounting system;
- (v) Make inquiry on goods held on consignment;
- (vi) Conduct inventory observations and physical count of all goods in the store;
- (vii) Test clerical accuracy of inventory sheets and other cost records;
- (viii) Apply lower cost or market;
- (ix) Review standard cost variances;
- (x) Test the gross profit;
- (xi) Review the analysis of cost of goods;
- (xii) Review balance sheet disclosures;
- (xiii) Determine the reasonableness of amount of inventory in the balance sheet.

SELF-ASSESSMENT EXERCISE

1. What are the objectives of cash audit?
2. Highlight the audit programme for inventory.

4.0 CONCLUSION

You are now aware of the auditor's responsibility in respect of verification of current assets. Review of internal controls for cash, debtors and stock helps in their verification as presented in the balance sheet. Auditors should be conversant with the general and specific procedures for auditing current assets.

5.0 SUMMARY

In this unit, you have learnt the following:

- that cash, being susceptible to defalcation because of its high liquidity, deserves the application of a more extensive audit procedures;
- that there are auditor's objectives in the audit of cash;
- the audit programme for cash, debtors and stock;
- that, in financial reporting, inventory could be grouped into retail, wholesale and manufacturer's;
- that auditors have responsibility with regard to inventory;
- that, it is very important for the auditor to be present when inventory count is conducted.

ANSWER TO SELF-ASSESSMENT EXERCISE

1. Objectives of cash audit are as follows:
 - i) to determine that the amount shown in the final accounts constitutes cash in hand, cash at banks, and cash in transit.
 - ii) to determine the reasonableness of the cash reported.
 - iii) to determine that any restricted cash is properly classified and disclosed.
2. Audit programme for inventory (See 3.3.3).

6.0 TUTOR-MARKED ASSIGNMENT

Outline the general methods of verifying debtors.

7.0 REFERENCES/FURTHER READING

Damagun, Y.M. (2005). *Auditing Theory and Practice* (2nd Ed.). Zaria, Nigeria: Ahmadu Bello University Press Limited.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockey, Essex, Great Britain: 4 Edge Limited.

UNIT 3 PROCEDURES FOR AUDITING TRANSACTIONS III – LIABILITY VERIFICATION

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Balance Sheet Grouping of Liabilities
 - 3.2 Objectives of Liability Verification
 - 3.3 Verification of Assets versus Verification of Liabilities
 - 3.4 Verification Procedures
 - 3.5 Audit Programme for Liabilities
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

In general terms, liabilities refer to obligations that result from past transactions to pay for assets or rendering of services. Liabilities can be classified into two major groups as follows:

- (i) **Current liabilities** – liabilities or debts that are payable within a short period of time, usually, within one year;
- (ii) **Long-term liabilities** – liabilities that are payable within a long period of time, usually, more than one year.

Auditing procedures relative to liability verification require attention. This unit will, therefore, consider the following topics:

- (i) Balance sheet grouping of liabilities;
- (ii) Objectives of liability verification;
- (iii) Comparing what the auditor looks for in the verification of assets and liabilities;
- (iv) Audit programme for liabilities.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- outline the classification of liabilities in the balance sheet
- state the objectives of liability verification

- differentiate the concern of the auditor in liability verification from what he looks for in the audit of assets
- enumerate the audit programme for liabilities.

3.0 MAIN CONTENT

3.1 Balance Sheet Grouping of Liabilities

A balance sheet will contain many liabilities grouped under various headings. The headings are as follows.

- (a) Share Capital;
- (b) Reserves;
- (c) Creditors (long-term): amounts falling due after more than one year. Examples are the followings:
 - (i) Debenture loans
 - (ii) Bank loans and overdrafts;
 - (iii) Payments received on account;
 - (iv) Trade creditors;
 - (v) Bills of exchange payable;
 - (vi) Amounts owed to group companies;
 - (vii) Amounts owed to related companies;
 - Other credits including taxation
 - Accruals and deferred income
- (d) Provision for liabilities and charges such as:
 - (i) pension and similar obligations;
 - (ii) taxation, including deferred taxation;
 - (iii) other provisions;
- (e) Creditors (current liabilities): amounts falling due within one year
- (f) Contingent liabilities: liabilities which may happen as a result of some event which may or may not occur. For example, litigation.

Thus, the auditor has the duty to verify the following.

- (a) The existence of liabilities shown in the balance sheet;
- (b) The correctness of the amount of money of such liabilities;
- (c) The appropriateness of the description given in the accounts and the adequacy of disclosure;
- (d) All existing liabilities are actually included in the accounts.

3.2 Objectives of Liability Verification

The audit objectives of liabilities are as follows:

- (a) to determine the adequacy of internal control for the processing and payment of suppliers' invoices;
- (b) to prove that the amount shown on the balance sheet is supported by accounting records;
- (c) to determine that all liabilities existing at the balance sheet date have been recorded;
- (d) to ensure that adequate provision has been made for any known and unknown (contingent) liabilities.

3.3 Verification of Assets versus Verification of Liabilities

In the verification of assets, the auditor is guarding against over-statement of asset values, while in the audit of liabilities; the auditor wants to make sure that liabilities are not understated.

Let us note the following:

- (a) liability is a matter of fact whereas valuation of assets is a matter of opinion;
- (b) understatement of liabilities is usually accompanied by understatement of expenses and over-statement of net profit;
- (c) over-statement of asset values results partly from improper entry in the accounting records, that is, by recording fictitious transactions.

SELF-ASSESSMENT EXERCISE 1

1. Identify the classes of liabilities in the balance sheet.
2. What is the auditor's concern in the verification of liabilities?

3.4 Verification Procedures

It is not possible to detail the procedures for verifying all possible liabilities. However, some general principles can be discerned, and these should be applied according to the particular set of circumstances met with in practice. These are as follows.

- (a) **Schedule:** request or make a schedule for each liability or class of liabilities. This should show the make up of the liability with the opening balance, if any, all charges, and the closing balance.
- (b) **Cut-off:** verify cut-off. For example, a trade creditor should not be included unless the goods were acquired before the year end.

- (c) **Reasonableness:** consider the reasonableness of the liability. Are there circumstances which ought to elicit suspicion?
- (d) **Internal control:** determine, evaluate and test internal control procedures. This is particularly important for trade debtors.
- (e) **Provisions date clearance:** consider the liabilities at the previous accounting date. Have they all been cleared?
- (f) **Terms and conditions:** this applies principally to loans. The auditor should determine that all terms and conditions agreed when accepting a loan have been complied with.
- (g) **Authority:** the authority for all liabilities should be sought. This will be found in the company minutes or directors' minutes and for some items the authority of the memorandum and articles may be needed.
- (h) **Description:** the auditor must see that the description in the accounts of each liability is adequate.
- (i) **Documents:** the auditor must examine all relevant documents. These will include invoices, correspondence, debenture deeds, etc, according to the type of liability.
- (j) **Security:** some liabilities are secured in various ways, usually by fixed or floating charges. The auditor must enquire into these and ensure that they have been registered.
- (k) **Vouching:** the creation of each liability should be vouched, for example, the receipt of a loan.
- (l) **Accounting policies:** the auditor must satisfy himself that appropriate accounting policies have been adopted and applied consistently.
- (m) **Letter of representation:** obtain from debtors a letter of representation covering debts.
- (n) **Interest and other ancillary evidence:** the evidence of loans tends to be evidenced by interest payments and other activities which stem from the existence of the loans.
- (o) **Disclosure:** all matters which need to be known to receive a true and fair view from the accounts must be disclosed. The Companies Acts provisions must be complied with.
- (p) **External verification:** with many liabilities, it is possible to verify the liability directly with the creditor. This action will be taken with short-term loan creditors, bank overdrafts and by a similar technique to that used with debtors, the trade creditors.
- (q) **Materiality:** materiality comes into all accounting and auditing decisions.
- (r) **Post-balance sheet events:** these are probably more important in this area than in any other.
- (s) **Accounting standards:** liabilities must be accounted for in accordance with the accounting standards.
- (t) **Risk:** assess the risk of misstatement.

3.5 Audit Programme for Liabilities

From the foregoing, audit programme for liabilities can be summarised as follows.

- (a) Perform a review of credibility;
- (b) Review and evaluate internal control;
- (c) Perform cut-off procedures;
- (d) Obtain or prepare trial balance of account payables (liabilities) as of the balance sheet date and reconcile with the ledger;
- (e) Select and confirm creditors;
- (f) Search for unrecorded account payables;
- (g) Determine proper balance sheet presentation of liabilities;
- (h) Obtain from client, a letter of representation, covering liabilities.

SELF-ASSESSMENT EXERCISE 2

Design an audit programme for liabilities.

4.0 CONCLUSION

In this unit, you are now aware of the audit programme for liabilities. The auditor is concerned with material misstatement of liabilities, whether it is over-stated or under-stated.

5.0 SUMMARY

In this unit, you have learnt the following:

- that liabilities can be classified into two – current liabilities and long-term liabilities;
- the grouping of liabilities in the balance sheet;
- the objectives of liability verification;
- that in the audit of assets, the auditor guards against over-statement of asset values;
- that in the verification of liabilities, the auditor ensures, particularly, that liabilities are not understated;
- the verification procedures and programmes for liabilities.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

1. Classes of liabilities in the balance sheet are:
 - a. share capital
 - b. reserves
 - c. long-term creditors

- d. provision for liabilities and charges
 - e. current liabilities
 - f. contingent liabilities
2. The auditor's concern in the verification of liabilities is to ensure that liabilities are not understated.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

Audit programme for liabilities (See 3.5)

6.0 TUTOR-MARKED ASSIGNMENT

Highlight the verification procedures relative to liabilities.

7.0 REFERENCES/FURTHER READING

Damagun, Y.M. (2005). *Auditing Theory and Practice* (2nd Ed.). Zaria, Nigeria: Ahmadu Bello University Press Limited.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Pany, Kurt & Whittington, O. Ray. (1994). *Auditing*. Boston: Richard D. Irwin Inc.

UNIT 4 AUDIT REPORTS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Overview of Auditor's Report
 - 3.2 Types of Auditor's Opinions and Reports
 - 3.2.1 Unqualified Opinion/Report
 - 3.2.2 Qualified Opinion
 - 3.2.3 Adverse Opinion
 - 3.2.4 Disclaimer Opinion
 - 3.3 Qualification in Audit Reports
 - 3.4 Reasons for Qualification in Audit Reports
 - 3.5 Assertions in a Standard Auditor's Report
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

The Companies and Allied Matters Act (CAMA) of 1990 and the Fourth Standard of reporting provide that an auditor should report on the financial statements under examination to show if those statements present a true and fair view of the financial position of the firm. If the firm's financial statements do not present a true and fair view, the auditor should qualify his reports.

The Companies and Allied Matters Act of 1990 requires auditors to issue an opinion covering the following areas.

- (a) The balance sheet of the company;
- (b) The profit and loss account;
- (c) The statement of sources and application of funds;
- (d) The holding companies (in the case of group accounts);
- (e) Other accounts as required by the Act such as: the disclosure of certain information relating to loans to directors and officers, directors' emoluments, pensions, and compensation for loss of office.

The American Institute of Certified Public Accountants, in the codification of auditing statements under the standard of report, states the fourth standard of reporting, thus:

- The report shall state the expression of opinion regarding the
- financial statements, taken as a whole. When an overall
- opinion cannot be expressed, the reasons, therefore, should be
- stated and the report shall contain a clear-cut indication of
- the auditor's examination and the responsibility he is taking.

In this unit, therefore, we shall consider the following:

- overview of auditors' reports relative to the relevant legislation and auditing standards;
- types of auditor's opinions and reports;
- qualifications in audit reports;
- reasons for qualification in audit reports.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- outline an overview of auditor's reports
- explain the types of auditor's opinions and reports
- highlight the statement of accounting standards on qualifications in audit reports
- explain reasons for qualifying audit reports
- describe the assertions in a standard auditor's report.

3.0 MAIN CONTENT

3.1 Overview of Auditor's Report

Let us make an overview of auditor's reports, bearing in mind the provisions of the relevant legislations as well as the Statement of Auditing Standards, as follows.

- (a) The auditing standard applies to all reports in which the auditor expresses an opinion on financial statements intended to give a true and fair view of the state of affairs, profit and loss, and where applicable, source and application of funds. The standard is not intended to override the statutory exemptions granted in respect of certain types of enterprises, but it is intended to apply to the audit reports relating to such enterprises in other respects;
- (b) The audit report should identify to whom it is addressed and the financial statements to which the report relates;
- (c) The auditor should refer expressly in his report to the following:

- (i) whether the financial statements have been audited in accordance with approved auditing standards;
- (ii) whether in the auditor's opinion, the financial statements give a true and fair view of the state of affairs, profit and loss, and where applicable, source and application of funds;
- (iii) any matter prescribed by the relevant legislations or other requirements;
- (d) When expressing an opinion that the financial statements give a true and fair view, the auditor should be satisfied among other things:
 - (i) that all relevant statements of standard accounting practices have been complied with except in situations in which for justifiable reasons, they are not strictly applicable, because they are impracticable or exceptional, having regard to the circumstances, would be inappropriate or give a misleading view; and
 - (ii) that any significant accounting policies which are not the subjects of statements of standard accounting practices are appropriate to the circumstances of the business;
- (e) The auditor should refer in his report to the particular accounting convention used in preparing the financial statements, such as historical cost convention, etc., in order to avoid misunderstanding;
- (f) Emphasis of matter. As a general principle, the auditor issuing an unqualified opinion should not make reference to specific aspects of the financial statements in the body of his reports as such reference may be misconstrued as being a qualification. In order to avoid giving the impression that a qualification is intended, references which are regarded as emphasis of matter should be contained in a separate paragraph and introduced with a phrase such as:
 - i. we draw attention to ...
 - ii. and should not be referred to in the opinion paragraph. Emphasis of matter should not be used to rectify a lack of appropriate disclosure in the financial statements nor should it be regarded as a substitute for a qualification.
- (g) The auditor should comply with any reporting requirement imposed by legislation and any other reporting requirement relevant to the financial statement. Note that the auditor is only required to include reference to the accounting convention if he considers it necessary to avoid misunderstanding

3.2 Types of Auditor's Opinions and Reports

3.2.1 Unqualified Opinion/Report

This is also known as “clean” report. It is referred to as such because the auditor is able to report affirmatively (positively) on the statements prepared. It speaks to conformity with the Generally Accepted Accounting Principles (GAAP), consistent application of accounting principles and includes all informative disclosures.

Unqualified report cannot be issued when the internal control is very weak, and where there is restriction on the scope of the auditor's work.

Below is an example of unqualified report:

We have examined the financial statements set out on pages to and have obtained all necessary information and explanations which we considered necessary. Proper books have been kept and proper returns received from the branches, and the financial statements, which are in agreement therewith, comply with the requirements of the Companies and Allied Act of 1990.

To the best of our knowledge and belief, the Group complied with the guidelines of the Productivity, Prices and Incomes Board during the year ended, 20.....

In our opinion, the financial statements give a true and fair view of the state of the financial position of the Company and the Group as at, 20....., and of the Profit and Loss Accounts, the Balance Sheet and the Sources and Application of Funds of the Group for the year ended on that date.”

Note that the auditor's report has two sections, they are as follows.

- (a) The scope section/paragraph – explains the financial statements examined and the application of Generally Accepted Auditing Standards (GAAS) in performing the audit;
- (b) The opinion paragraph – deals with the auditor's professional view concerning the results of the audit work.

3.2.2 Qualified Opinion

This type of report lacks sufficient competent evidential matter to support an opinion. It has restrictions on the scope of the audit, and the auditor believes that:

- (a) there is material departure from GAAP;
- (b) there is lack of consistency;
- (c) there are significant uncertainties.

In this situation, the auditor must disclose the reasons and possible effects of his qualification. The auditor should use the words “except”, “exception” or “subject to” in the opinion paragraph.

3.2.3 Adverse Opinion

Adverse opinion is issued by an auditor when exception is so material to warrant justification. The financial statements, as a whole, do not present fairly the true financial position of the company. Thus, adverse opinion is issued when qualified opinion cannot be justified, and the auditor must disclose substantive reasons and the principal effects on the overall financial statements.

3.2.4 Disclaimer Opinion

If an auditor does not have enough evidence to form an opinion, he must state so in his report and disclaims an opinion. A disclaimer can result either because the scope of the auditor’s examination was seriously limited or due to some unpredictable uncertainties.

Therefore, for an auditor to disclaim an opinion, there must be serious scope limitation or unusual uncertainties, and the financial statements revealed material departures from the GAAP.

SELF-ASSESSMENT EXERCISE 1

List and explain the types of auditor’s opinions and reports.

3.3 Qualification in Audit Reports

We shall consider this in relation to the stipulations in the Statement of Auditing Standards.

- (a) When the auditor is unable to report affirmatively on the relevant matters, he should qualify his report by referring to all material matters about which he has reservations. All reasons for the qualification should be given together with a qualification of its effect on the financial statements, if this is both relevant and practicable. Also, reference may need to be made to non-compliance with legislation and other requirements.

- (b) A qualified report should leave the reader in no doubt as to the meaning and implications for an understanding of the financial statements.
- (c) The nature of the circumstances giving rise to a qualification of opinion will generally fall into one of two main categories:
 - (i) where there is an uncertainty which prevents the auditor from forming an opinion on a matter, or
 - (ii) where the auditor is able to form an opinion on the matter giving rise to the qualification, but this conflicts with the view given by the financial statements (disagreement).
- (d) The forms of qualification which should be used in different circumstances are shown below (courtesy of Recommendation of Auditing Practices Committee on Qualification in Audit Reports):

Nature of Circumstances	Material but not fundamental	Fundamental
Uncertainty	“Subject to” opinion	Disclaimer of opinion
Disagreement	“Except” opinion	Adverse opinion

Note our discussion on the types of auditor’s opinion and reports (3.2 above). Each of the above categories gives rise to alternative forms of qualification, depending upon whether the subject of the uncertainty or disagreement is considered to be fundamental so as to undermine the view given by the financial statements taken as a whole.

- Disclaimer of opinion: the auditor states that he is unable to form an opinion as to whether the financial statements give a true and fair view.
- “Subject to” opinion: the auditor effectively disclaims an opinion on a particular matter which is not considered fundamental.
- Adverse opinion: the auditor states that in his own opinion, the financial statements do not give a true and fair view.
- “Except” opinion: the auditor expresses an adverse opinion on a particular matter which is not considered fundamental.

3.4 Reasons for Qualification in Audit Reports

The reasons for qualification can be obtained as follows:

- (a) **Uncertainties**
 - (i) **Limitation in the scope of the audit:** this arises if the auditor is unable to obtain all the information and explanations which he

considers necessary for the purpose of the audit, for example, absence of proper accounting records;

- (ii) **Inherent uncertainties:** this results from circumstances in which it is not possible to reach an objective conclusion as to the outcome of a situation due to the circumstances themselves rather than to any limitation of the scope of audit procedures, for example, major litigations.

(b) **Disagreements**

Circumstances that can give rise to disagreements are as follows:

- (i) Departures from acceptable accounting practices;
- (ii) Disagreement as to the facts or amounts included in the financial statements;
- (iii) Disagreement as to the manner or extent of disclosure of facts or amounts in the financial statements;
- (iv) Failure to comply with relevant legislations or other requirements.

3.5 Assertions in a Standard Auditor's Report

The standard auditor's report in this context is referred to as a clean or unqualified opinion. There are certain basic elements that should be pointed out for clear understanding and appreciation of the duties of auditors.

These basic assertions or elements are as follows.

- (i) We have examined;
- (ii) The financial statements;
- (iii) Of a particular company;
- (iv) Application of the GAAS;
- (v) Tests of the accounting records of client;
- (vi) Application of other audit procedures;
- (vii) In our opinion;
- (viii) Present fairly or present a true and fair view of the company's financial position;
- (ix) In accordance with the GAAP;
- (x) Consistent application of accounting principles.

SELF-ASSESSMENT EXERCISE 2

Outline the basic assertions in a standard auditor's report.

4.0 CONCLUSION

In this unit, you have learnt that the reason for the standard of reporting is to alert every auditor on the responsibilities he owes to the public and his client. The greatest legal requirement placed upon the statutory auditor is for the auditor to state if the accounts audited are true and fair.

Financial statements can be said to be true and fair if the assets are truly and fairly stated, all liabilities are taken into account, the results shown in the profit and loss accounts are truly and fairly reported, and all pieces of information are provided in accordance with the GAAP and the Companies and Allied Matters Act of 1990.

5.0 SUMMARY

In this unit, you have interacted with the following topics:

- An overview of the auditor's reports in relation to the relevant legislation and the auditing standards;
- Types of auditor's opinions and reports;
- Qualifications in audit reports;
- Reasons for qualification in auditor reports;
- Basic assertions in a standard auditor's reports.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the reasons for the qualification in audit reports.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

Types of auditor's opinions and reports:

- i) unqualified opinion
 - ii) qualified opinion
 - iii) adverse opinion
 - iv) disclaimer opinion
- (See 3.2)

ANSWER TO SELF-ASSESSMENT EXERCISE 2

Basic assertions in a standard auditor's report (See 3.5)

7.0 REFERENCES/FURTHER READING

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Labaran, S.A. (2006). *Auditing, Investigation and Assurance Services*. Jos: Seeye Prints.

Messier, W.F. Jr. (2000). *Auditing and Assurance Services: A Systemic Approach* (2nd Ed.) USA: McGraw-Hill Co. Inc.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockley, Essex, Great Britain: 4 Edge Limited.

MODULE 4

Unit 1	Auditor's Importance, Responsibility and Independence
Unit 2	Legal Position and Liability of Auditors
Unit 3	Introducing Cooperative Auditing

UNIT 1 AUDITORS' IMPORTANCE, RESPONSIBILITY AND INDEPENDENCE

CONTENTS

1.0	Introduction
2.0	Objectives
3.0	Main Content
3.1	Importance of the Auditor in a Business Organisation
3.2	Auditor's Responsibility in Relation to those of Management
3.3	Auditor's Independence
3.3.1	Concept of Auditor's Independence
3.3.2	Auditor's Relationships
3.3.2.1	Management
3.3.2.2	The Board of Directors
3.3.2.3	Internal Auditors
3.3.2.4	Shareholders
4.0	Conclusion
5.0	Summary
6.0	Tutor-Marked Assignment
7.0	References/Further Reading

1.0 INTRODUCTION

In Module 1, Unit 1, you learnt about the "Overview of Auditing" where, the following topics were discussed.

- Purpose and advantages of audit;
- Qualities of a good auditor.

In this unit, you are going to follow up the above topics by being exposed, to the topics listed below.

- Importance of the auditor in a business organisation;
- Responsibilities of the auditor in relation to those of management;
- Auditor's independence relative to his relationship with interested groups.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the importance of the auditor in a business organisation
- outline the responsibilities of the auditor
- explain the concept of auditor's independence
- describe important groups with which the auditor maintains professional relationships
- differentiate between the responsibilities of the auditor and those of management.

3.0 MAIN CONTENT

3.1 Importance of the Auditor in a Business Organisation

Business organisations, whether public or private, generate financial statements – balance sheet, profit and loss accounts, etc. periodically. Also, internal control comes into play to ensure adherence to management policies, safeguard the company's assets, and ensure accurate and reliable records. All of these have to be appraised and verified. The law even requires that this should be done for public liability companies.

Both the owners of the business and users of financial statements will be interested in the following, amongst others:

- (a) that the results of operations is authenticated;
- (b) that the business is doing well;
- (c) that the accounts are true and fair;
- (d) that the company complied with statutory stipulations.

Therefore, the importance of the auditor can be seen from the perspectives of the role/purpose and advantages of audit, as summarised below.

- (a) Appraises and helps to improve the system of internal control;
- (b) Enables the organisation to comply with statutory provisions on the audit of accounts;
- (c) Confirms the actual financial position of the organisation being audited;
- (d) Gives credibility to the financial statements;
- (e) Ensures that accounts are produced in line with the best practice.

3.2 Auditor's Responsibility in relation to those of Management

Fundamental to a financial statement audit is the division of responsibility between management and the external auditor. The critical distinction is as follows:

- Management is responsible for preparing the financial statements and the contents of the statements are the assertions of management.
- The auditor is responsible for examining (verifying) management's financial statements and produces report that contains an expression of opinion on their fairness. In the course of examination, the auditor detects errors and frauds.

In discharging its responsibility, management is expected to:

- (a) devise a system of internal control that will safeguard assets and help assure the production of reliable financial statements;
- (b) maintain an adequate and effective system of accounts;
- (c) adopt appropriate accounting policies.

Note that the criteria followed by:

- (a) Management in preparing financial statements ordinarily are Generally Accepted Accounting Principles (GAAP), and
- (b) The auditor in his examination, uses Generally Accepted Auditing Standards (GAAS).

In order to highlight the division of responsibilities between management and the auditor, many companies include "a report on management's responsibility" in their annual reports to the shareholders.

The auditor may assist in the preparation of financial statements. For example, he may counsel management as to the applicability of a new accounting principle, and, during the course of the audit, he may propose adjustments to the client's statements. However, acceptance of this advice and the inclusion of the suggested adjustments in the financial statements do not alter the basic separation of responsibility.

Ultimately, management is responsible for all decisions concerning the form and content of the statements.

SELF-ASSESSMENT EXERCISE 1

1. Highlight the importance of the auditor in a business organisation.
2. Distinguish between the responsibilities of the independent auditor with those of management.

3.3 Auditor's Independence

This will be discussed under the following sub-heads.

3.3.1 Concept of Auditor's Independence

In line with our earlier discussion in Module 1, Unit 1, professional independence is a concept fundamental to the accounting profession. It is essentially an attribute of mind, characterised by integrity and objective approach to professional work. An auditor is expected to examine the work of others and to express his opinion therein. Therefore, it is necessary that he is independent of those who appointed him.

In auditing, independence means the possession of integrity, ability to be self-reliant and honest, freedom from bias and the avoidance of relationships which, to a reasonable observer, would suggest a conflict of interest on the auditor's part. Also, it means the avoidance of any relationship which might impair the auditor's objectivity in expressing opinion. An auditor must have an independence of mind.

However, there are situations which have the effect of undermining the auditor's independence, most of which border on the temptation on his part not to incur the wrath of those who have the capacity to disengage him.

As a way out, Section 359 (6) of CAMA, 1990 has provided for the establishment of audit committees to ensure the auditor's independence. The committees include non-executive members of the company appointed to view the company's position in a detached and dispassionate manner, liaise between the auditors and the management board, and to reconcile disputes between the auditor and the management board.

3.3.2 Auditor's Relationships

The auditor is an intermediary in the communication of accounting data. In the discharge of his responsibilities, the auditor must be independent of both the preparers and the users of the financial statements that

represent summaries of such data. In an audit engagement, the auditor maintains professional relationships with four important groups as listed below.

- (a) Management
- (b) The board of directors
- (c) Internal auditors
- (d) Shareholders.

3.3.2.1 Management

During the course of an audit, there is extensive interaction between the auditor and management. To obtain the evidence needed in an audit, the auditor often requires confidential data about the entity. It is imperative, therefore, to have a relationship based on mutual trust and respect.

The auditor should have an interest in the well-being and future of his client. However, this concern should be tempered by a posture of professional scepticism about management's assertions. Moreover, the auditor must be prepared to evaluate critically the fairness of management's financial statement representations.

3.3.2.2 The Board of Directors

The board of directors of a company is responsible for seeing that the company is operated in the best interests of the shareholders. The auditor's relationship with the directors depends largely on the composition of the board. When the board consists primarily of company officers, the auditor's relationship with the board may be the same as with management.

However, when the board has a number of outside members, a different relationship is possible. Outside members are not officers or employees of the company. In such a case, the board, or a designated audit committee composed primarily of outside members of the board, can serve as an intermediary between the auditor and management.

3.3.2.3 Internal Auditors

An external auditor ordinarily has a close working relationship with the client's internal auditors. Management, for example, may ask the auditor to review the internal auditors planned activities for the year and report on the quality of their work. The auditor also has a direct interest in the work of internal auditors that pertains to the client's system of internal control.

The internal auditor's work cannot be used as a substitute for the external auditor's work. However, it can be an important complement. In determining the effect of such work on his examination, the auditor should:

- (i) consider the competence and objectivity of the internal auditor, and
- (ii) evaluate the quality of the internal auditors' work.

The competence of the internal auditor can be ascertained by inquiring into his technical training, experience and proficiency. His objectivity can be evaluated by considering the organisational level to which he reports and reviewing the substance of his reports. In evaluating the quality of the internal auditors' work, the auditor should examine, on a test basis, the audit programmes and working papers of the work performed.

3.3.2.4 Shareholders

Shareholders rely on audited financial statements for assurance that management has properly discharged its stewardship responsibility. The auditor, therefore, has an important responsibility to shareholders as the primary users of his report.

During the course of an engagement, the auditor is not likely to have direct personal contact with the shareholders who are not officers or key employees of the client.

SELF-ASSESSMENT EXERCISE 2

List and explain four important groups with which the auditor maintains professional relationship.

4.0 CONCLUSION

In this unit, you have discovered that it is permissible under GAAS for the internal auditor to provide direct assistance to the auditor in performing a financial statement audit. When this occurs, the auditor should supervise the internal auditor to the extent considered necessary. In addition, all judgment required in the examination must be made by the external auditor.

5.0 SUMMARY

In this unit, you have learnt the followings.

- The auditor is important in a business organisation;
- Management is responsible for preparing the financial statements and the contents of the statements are the assertions of management;
- The auditor is responsible for examining management's financial statements and expressing an opinion on their fairness;
- The auditor requires professional independence in order to perform;
- The auditor maintains professional relationships with four important groups – management, the board of directors, internal auditors and shareholders.

ANSWER TO SELF-ASSESSMENT EXERCISE 1

1. The importance of the auditor in a business organisation are as follows:
 - (a) Appraises and helps to improve the system of internal control;
 - (b) Enables the organisation to comply with statutory provisions on the audit of accounts;
 - (c) Confirms the actual financial position of the organisation being audited.
2. Responsibilities of the external auditor and management are as follows.

While the management is responsible for preparing the financial statements, the auditor's responsibility is to verify the financial statements prepared by management and state how true and fair they are.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

In an audit engagement, the auditor maintains professional relationships with four important groups, namely:

- (a) management
- (b) the board of directors
- (c) internal auditors
- (d) shareholders. (See 3.3.2)

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the concept of auditor's professional independence.

7.0 REFERENCES/FURTHER READING

CAMA (1990). Companies and Allied Matters Act. Lagos: Government Printer.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Kell, W.G; Boynton, W.C. & Ziegler, R.E. (1986). *Modern Auditing* (3rd Ed.). New York: John Wiley and Sons.

Labaran, S.A. (2006). *Auditing, Investigation and Assurance Services*. Jos: Seeeye Prints.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

Woolf, E. (1997). *Auditing Today* (6th Ed.). Hockley, Essex, Great Britain: 4 Edge Limited.

UNIT 2 LEGAL POSITION AND LIABILITY OF AUDITORS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Appointment of Auditors
 - 3.2 Remuneration of the Auditors
 - 3.3 Resolutions as to Appointment and Removal of Auditors
 - 3.4 Disqualification as Auditors
 - 3.5 Auditors' Reports
 - 3.6 Rights of Auditors
 - 3.7 Obligations of Auditors
 - 3.8 Auditors' Liabilities
 - 3.8.1 Minimising Liabilities
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

The law has relevance for auditors, especially, with regard to their rights, obligations and liabilities. In this unit, you shall be looking at the effects on auditors of the Companies and Allied Matters Act of 1990, the provisions in the Act establishing the relevant accountancy bodies (especially the Institute of Chartered Accountants of Nigeria), and the stipulations of other branches of the law by considering the following:

- appointment of auditors
- remuneration of the auditors
- resolutions as to appointment and removal of auditors
- disqualification as auditors
- auditors' reports
- rights of auditors
- obligations of auditors
- auditors' liabilities.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the provisions of CAMA, 1990 regarding the appointment and remuneration of auditors
- explain the procedure in respect of resolution to appoint and remove auditors
- mention categories of persons that cannot qualify as auditors
- enumerate the essential elements of the auditors' reports
- highlight the rights and obligations of auditors
- explain auditors' liabilities and enumerate ways they can be minimised.

3.0 MAIN CONTENT

3.1 Appointment of Auditors

CAMA (1990) provides that auditors should be appointed to protect the shareholders and members of the public by reporting the financial statements of every limited liability company in a fair manner.

Specifically, Section 357 of CAMA (1990) stipulates as follows.

- (1) Every company shall at each Annual General Meeting (AGM) appoint an auditor or auditors to hold office from the conclusion of that, till the conclusion of the next AGM;
- (2) At any AGM, a retired auditor, however appointed, shall be re-appointed without any resolution being passed unless:
 - (a) he is not qualified for re-appointment;
 - (b) a resolution has been passed at that meeting appointing another person instead of him or providing expressly that he shall not be re-appointed;
 - (c) he has given the company notice, in writing, of his intention to resign or unwillingness to be re-appointed.

Provided that where notice is given of an intended resolution to appoint someone in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of those 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.

- (3) Where at an AGM, no auditor or auditors are appointed or re-appointed, the commission may direct the registrar to appoint a person to fill the vacancy;
- (4) The company shall within one week of the power of the registrar under sub-section 3 of this section becoming exercisable, give notice as required by this section, the company and every officer of the company who are in default shall be liable to a fine of ten naira for every day during which the default continues;
- (5) Subject as hereafter provided, the first auditors of a company may be appointed by the directors at any time before the first AGM, and auditors so appointed shall hold office until the conclusion of that meeting provided that:
 - (a) the company may at a general meeting remove such auditors and appoint in their place other persons who have 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; and
 - (b) if the directors fail to exercise their powers under this sub-section, the company in a general meeting may appoint the first auditors, and thereupon the said powers of the directors shall cease.
- (6) The directors may fill any casual vacancy in the office of the auditors, but while any such vacancy continues, the surviving or continuing auditors, if any, may act.

It can be summarised by stating that the appointment of an auditor may be done by the audit committee made from the shareholders or directors at the AGM.

3.2 Remuneration of the Auditors

Section 361 of CAMA (1990) states that:

- The remuneration of the auditors of a company in the case of an auditor appointed
- by the directors or by the registrar, fees may be fixed by the directors or by the
- registrar as the case may be.....

You should note here that the auditors are paid by whoever appointed them. This is subject to negotiation between the auditors and those that appointed them.

3.3 Resolutions as to Appointment and Removal of Auditors

Section 362 of CAMA (1990), deals with this issue. It states as follows.

- (1) A special notice shall be required for a resolution at a company's AGM appointing as auditor a person other than a retiring auditor;
- (2) On the receipt of notice of such an intended resolution as aforesaid, the company shall forthwith send a copy thereof to the retiring auditor (if any);
- (3) Where notice is given for such an intended resolution as aforesaid and the retiring auditor makes representations in writing to the company (not exceeding a reasonable length) and requests their notification to members of the company with respect to the intended resolution, the company shall unless the representations are received by it too late for it to do so:
 - (a) in any notice of the resolution given to members of the company to state the fact of the representations;
 - (b) send a copy of the representations to every member of the board to whom notice of meeting is sent.

3.4 Disqualification as Auditors

The Institute of Chartered Accountants of Nigeria Act (1965) provides that none of the following persons shall be qualified for appointment as auditors:

- (a) an officer or servant of the company;
- (b) a person who is a partner of or in the employment of any officer or servant of the company;
- (c) a body corporate (limited liability company);
- (d) a non-member of the Institute.

In the application of the above, 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.

SELF-ASSESSMENT EXERCISE 1

1. Highlight the procedure relating to the resolution to appoint and remove auditors.
2. Who pays auditors' remuneration?

3.5 Auditors' Reports

Auditors are required to make a report to the members on the financial statements examined by them. The reports should be laid before the company at the AGM during their tenure of office, and the reports shall contain statements as to the true and fair view of the accounts.

The auditors' reports shall be read aloud before the company's board of directors in the general meeting and every member is entitled to be given a copy of the reports.

3.6 Rights of Auditors

Under CAMA (1990), every auditor of a company shall:

- (a) have a right of access, at all times, to the books and all relevant materials of the company;
- (b) be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of his duties;
- (c) have a right to report on the accounts;
- (d) be entitled to attend any AGM of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive;
- (e) have the right to be heard at any general meeting which he attends on any part of the business of the meeting which concerns him as auditor.

3.7 Obligations of Auditors

Auditors are obliged to:

- (a) conduct the audit in accordance with their letters of engagement;
- (b) do their work honestly and carefully, and with competence;
- (c) endeavour to access every information relevant to the conduct of audit;
- (d) report on the audit – unqualified or qualified or otherwise;
- (e) express opinion as to the truth and fairness of the financial statements.

3.8 Auditors' Liabilities

Auditors perform audits and sign audit reports. These reports are the auditors' opinions on the truth and fairness, etc. of the financial statements. Auditors are known to be competent and honest. So, if the auditors opine that the financial statements show a true and fair view,

readers of the financial statements will have faith in them because they have faith in the auditors.

Therefore, the auditor has a responsibility to do his work honestly and with reasonable care and skill as his work is relied upon by others.

At this point, we have to note that:

- (a) an auditor may fail to exercise sufficient skill and care;
- (b) consequently, some fraud or error may be undiscovered, or he may fail to discover that the accounts fail to show a true and fair view, or may contain a material misstatement;
- (c) as a result, somebody who relies on the work of the auditor may lose money;
- (d) this loss of money flows from the failure of the auditor to do his job properly;
- (e) the auditor may have to make good from his own resources the loss suffered by another person, that is, to pay damages which flow from his negligence.

3.8.1 Minimising Liabilities

Auditors can minimise their potential liability for professional negligence in several ways, which include the followings.

- (a) Not being negligent;
- (b) Following the precepts of the auditing standards;
- (c) Agreeing the duties and responsibilities in the engagement letter (Engagement letter should specify the specific tasks to be undertaken and exclude specifically, those that are not to be taken. It should also define the responsibilities to be undertaken by the client and specify any limitations on the work to be undertaken).
- (d) Defining in their report the precise work undertaken, the work not undertaken, and any limitations to the work. This is so that any third party will have knowledge of the responsibility accepted by the auditor for the work done;
- (e) Stating in the engagement letter the purpose for which the report has been prepared and that the client may not use it for any other purpose;
- (f) By stating in any report the purpose of the report and that it may not be relied on for any other purpose;
- (g) By identifying the authorised recipients of report in the engagement letter and in the report;

- (h) By defining the scope of professional competence to include only matters within the auditors' competence. Do not take on work you are not proficient in.

SELF-ASSESSMENT EXERCISE 2

Identify the rights of auditors.

4.0 CONCLUSION

In this unit, you have seen that the law has relevance for the auditors. As an auditor, you should be conversant with all the relevant laws guiding the professional conduct of audit work.

5.0 SUMMARY

In this unit, you learnt that the law has relevance for auditors with respect to the following:

- appointment;
- remuneration;
- resolution as to their appointment and removal;
- reports;
- rights, obligations and liabilities.

ANSWER TO SELF-ASSESSMENT EXERCISE 2

- 1(a) Section 362 of CAMA (1990) deals with the resolution to appoint and remove auditors. It states as follows.

A special notice shall be required for a resolution at a company's AGM appointing as auditor, a person other than a retiring auditor;

On the receipt of notice of such an intended resolution as aforesaid, the company shall forthwith send a copy thereof to the retiring auditor (if any);

Where notice is given for such an intended resolution as aforesaid and the retiring auditor makes representations in writing to the company (not exceeding a reasonable length) and requests their notification to members of the company with respect to the intended resolution, the company shall, unless the representations are received by it too late for it to do so:

- (i) send a copy of the representations to every member of the board to whom notice of meeting is sent.

- b. Auditors' remuneration is paid by whoever appointed them, which is subject to negotiation between the auditors and those that appointed them.

2. The rights of auditors

Under CAMA (1990), every auditor of a company shall:

- (a) have a right of access, at all times, to the books and all relevant materials of the company;
- (b) right to require from the officers of the company such information and explanation as he thinks necessary for the performance of his duties;
- (c) right to report on the accounts;
- (d) right to attend any AGM of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive;
- (e) right to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditor.

6.0 TUTOR-MARKED ASSIGNMENT

Outline the ways auditors can minimise their potential liability for professional negligence.

7.0 REFERENCES/FURTHER READING

CAMA (1990). Companies and Allied Matters Act. Lagos: Government Printer.

Damagun, Y.M. (2005). *Auditing Theory and Practice* (2nd Ed.). Zaria, Nigeria: Ahmadu Bello University Press Limited.

Ekwere, A.B. (1994). *Contemporary Auditing*. Jos: Fab Anieh (Nigeria) Limited.

Millichamp, A.H. (1996). *Auditing* (7th Ed.). London: Letts Educational.

UNIT 3 INTRODUCING COOPERATIVE AUDITING

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 The Concept of Cooperative
 - 3.1.1 Types of Cooperative Governances
 - 3.1.2 Types of Cooperatives
 - 3.2 Cooperative Audit
 - 3.2.1 Salient Features of Cooperative Audit
 - 3.2.2 Main Features of Cooperative Audit
 - 3.2.3 Need for Cooperative Audit
 - 3.2.4 Objects of Cooperative Audit
 - 3.2.5 Main Aspects of Cooperative Audit
 - 3.2.6 Duties of a Cooperative Auditor
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

Cooperatives today, play a prominent role in different economies, and although cooperation is a voluntary movement of the public at large, there has been considerable state participation in the development of cooperative movement in many countries.

Mahatma Gandhi had envisaged that the cooperative movement is a tool for eradication of poverty when he said that:

- i. cooperation is a gateway to economic freedom.
- ii. Cooperative audit focuses on cooperative societies. In this unit, therefore, we shall consider the following:
 - what cooperative means;
 - types of cooperative governances and cooperatives;
 - features of cooperative audit;
 - objects of cooperative audit;
 - need for cooperative audit;
 - duties of a cooperative auditor.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the concept of cooperative
- explain the types of cooperative governances and cooperatives
- highlight the features and objects of cooperative audit
- assess the need for cooperative audit
- identify the duties of a cooperative auditor.

3.0 MAIN CONTENT

3.1 The Concept of Cooperative

The international cooperative alliance's statement on the cooperative identity defines a cooperative as "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise". It is a business organisation owned and operated by a group of individuals for their mutual benefit.

A cooperative may also be defined as "a business owned and controlled equally by the people who use its services or who work at it".

A cooperative can be seen as a legal entity owned and democratically-controlled equally by its members. Members have a close association with the enterprise as producers or consumers of its products or services, or as its employees.

3.1.1 Types of Cooperative Governances

These are as follows.

(a) Retailers' Cooperative

This is an organisation which employs economies of scale on behalf of its members to get discounts from manufacturers and to pull marketing.

(b) Workers' Cooperative

This is a cooperative that is owned and democratically-controlled by its "worker-owners".

There are no outside owners in "pure" workers' cooperative; only the workers own shares of the business.

(c) Consumers' Cooperative

A consumers' cooperative is a business owned by its customers. Employees can also generally become members.

3.1.2 Types of Cooperatives

Cooperative types include the followings.

(a) Housing cooperative

A housing cooperative is a legal mechanism for ownership of housing where residents either own shares reflecting their equity in the cooperative's real estate, or have membership and occupancy rights in a not-for-profit cooperative, and they underwrite their housing through paying subscription or rent.

(b) Building cooperative

Members of the building cooperative pool resources to build houses, normally using a high proportion of their labour. When the building is finished, each member is the sole owner of a homestead, and the cooperative may be dissolved.

(c) Agricultural cooperative

Agricultural cooperatives are widespread in rural areas. They provide inputs into the agricultural process. Agricultural cooperatives are the most rational and convenient form of organising small and medium farmers. They are key components of strategy of development of rural and underdeveloped regions.

SELF-ASSESSMENT EXERCISE 1

Name and discuss three types of cooperatives.

3.2 Cooperative Audit

This will be discussed under the following.

3.2.1 Salient Features of Cooperative Audit

The audit of a cooperative society is different from that of a limited liability company (company) because the objects of a cooperative society are quite different from those of a company. While the main object of a company is to earn profits, that of a cooperative society is to

render service to its members. Service rather than profit is the motto of a cooperative society.

Regarding the nature, extent and scope of cooperative audit, a cooperative auditor should not confine his enquiry to the books of accounts, but should go beyond the books and make enquiries into the working and general functioning of the (cooperative) society. His enquiry should embrace all circumstances which determine the general position of the society and should aim at seeing that the society is working on sound lines.

Thus, cooperative audit is not merely a financial audit, it involves administrative audit also.

3.2.2 Main Features of Cooperative Audit

The main features of cooperative audit relate to the following.

- (a) Adherence to cooperative principles;
- (b) Observance of provisions of acts, rules and bylaws;
- (c) Valuation of assets and liabilities and verification of cash balance and securities;
- (d) Verification of balances of depositors and creditors;
- (e) Examination of overdue debts and classification of bad debts;
- (f) Personal verification of members and examination of their passbooks;
- (g) Discussion of draft audit report with the managing committee;
- (h) Audit classification of society;
- (i) Examination of the working and other prescribed particulars of the society.

Apart from the general processes of auditing like posting, vouching, verification of assets and liabilities and so on, the special features of cooperative audit are briefly mentioned below.

(i) Examination of overdue debts

Overdue debts affect the working of a credit society seriously. They affect the working capital position of the society. As such, it is necessary to make a detailed analysis of the overdue debts with a view to ascertaining the chances of their recovery and classifying them as good or bad. It is also necessary to compare the percentage of overdue debts to working capital and loans and advances with that of the previous year and ascertain whether the trend is decreasing or increasing, whether adequate action is being taken for recovery, and whether necessary provision is being made for doubtful debts.

(ii) Adherence to cooperative principles

It has to be ascertained in general whether, and, to what extent, the objects for which the society was set up have been fulfilled. The assessment need not be in terms of returns made but in terms of benefits given to members. The benefits could be in terms of sales made at lower prices to members, economy achieved in operations, avoidance of wastage of funds, avoidance of middlemen in purchases and so on.

(iii) Personal verification of members and examination of their passbooks

This is necessary in cooperative societies in order to ensure that books of accounts are free from manipulations, since in many rural and agricultural societies, a considerable number of members could be illiterate and as such, personal verification provides a safeguard against any manipulation.

3.2.3 Need for Cooperative Audit

Cooperative audit serves the following purposes.

- (a) Members of the society are to be satisfied that the affairs of the society are managed properly and are on sound business principles. This is rendered possible by the cooperative auditor undertaking a detailed check of the voluminous transactions taking place during the entire year and making a report of his findings as a result of this check, to the members.
- (b) A large number of societies borrow funds from outside. The creditors would be keen to satisfy themselves of the financial soundness and creditworthiness of the society. For this purpose, they would depend upon the cooperative auditor's report.
- (c) A large number of persons are employed by cooperatives for managing their affairs. In order to ensure that there is proper check on efficiency and integrity of employees, the management would require a systematic and thorough check of their accounts. This purpose is served by cooperative audit.
- (d) Non-members of the cooperatives, who deposit their funds with the cooperative, would like to satisfy themselves that their funds are safe with the society. This is made possible by the auditor's report on the working of the society.

3.2.4 Objects of Cooperative Audit

At this point, let us summarise the objects of cooperative audit as follows.

- (a) Verification of the accuracy of the books of accounts and ascertaining correctness of accounts;
- (b) Detection of clerical errors and errors of principles, and prevention of such errors;
- (c) Detection and prevention of frauds;
- (d) Examination of the affairs of the society in order to ascertain whether they have been carried on in accordance with the provisions of the cooperative law and the principles of cooperation, and on sound business principles;
- (e) Assessment of the extent to which the conditions of the members, particularly their economic conditions, have improved by the operations of the society;
- (f) Certification of the actual returns made or loss incurred.

3.2.5 Main Aspects of Cooperative Audit

In several countries (including the Asian countries), there are two main aspects.

- (a) Cooperative audit is an audit conducted under the statute, and therefore, it is statutory in character;
- (b) It is undertaken by government itself, and it is therefore, state-controlled audit.

You should note the experience in the Kingdom of Bangkok.

The Cooperative Auditing Department (CAD) is the only institution to audit the cooperatives and farmer groups. In an attempt to perform the duty efficiently, the CAD has set a vision to develop and promote transparency in cooperatives, move forward with information technology and introduce accounting to Thai farmers.

The CAD plays a significant role to strengthen the financial and accounting conditions of cooperatives and farmer groups and for the well-being of Thai farmers, the CAD has enhanced their accounting knowledge.

Thus, CAD's interim and annual auditing aims at:

- (i) checking the correctness of book-keeping and observe whether the internal control is as efficient as possible, and helps the cooperatives in updating and completing the accounts;
- (ii) giving a true and fair view of the financial condition of cooperatives and farmer associations.

Due to the increasing number of cooperatives, especially agricultural cooperatives, CAD has private auditors to relieve the auditing workload.

However, the auditing procedure must be standardised.

3.2.6 Duties of a Cooperative Auditor

From the foregoing, we can highlight the duties and responsibilities of a cooperative auditor to include the following.

- (a) To verify the cash balance and securities, examine the overdue debts, if any, value assets and liabilities of the society, verify balances at the credit of the depositors and creditors and the amount due by the society's debtors;
- (b) To satisfy himself that the cooperative society has kept all account books and registers in connection with the business of the society properly and up-to-date;
- (c) Verify whether necessary statutory provisions have been strictly observed;
- (d) Verify whether the business of the society has been concluded according to the cooperative principles and sound business practices;
- (e) Conduct personal verification of members' accounts and examination of their passbooks with a view to preventing manipulation of accounts by dishonest employees and office bearers;
- (f) Certify the financial statements – balance sheet, etc.

SELF-ASSESSMENT EXERCISE 2

1. What is the need for cooperative audit?
2. What is the difference between cooperative audit and other business organisations' audit?

4.0 CONCLUSION

In this unit, you have learnt that cooperative audit is not merely a financial audit, it involves administrative audit also. Countries establish Cooperative Audit Departments (CAD) to:

- audit the accounts of cooperatives;
- assist/advise on book-keeping;
- offer advisory services generally;
- strengthen accounting and internal control system.

CAD may engage private auditors to assist in reducing the workload.

5.0 SUMMARY

In this unit, you are conversant with the following topics.

- Cooperatives today, play a prominent role in different economies, and that service (rather than profit) is the focus of a cooperative society;
- There are types of cooperative governances and cooperatives;
- Cooperative audit has features, need and objects;
- A cooperative auditor has duties and responsibilities

ANSWER TO SELF -ASSESSMENT EXERCISE 3

Three types of Cooperatives are as follows.

(a) Housing Cooperative

A housing cooperative is a legal mechanism for ownership of housing where residents either own shares reflecting their equity in the cooperative's real estate, or have membership and occupancy rights in a not-for-profit cooperative, and they underwrite their housing through paying subscription or rent.

(b) Building Cooperative

Members of the building cooperative pool their resources to build housing, normally using a high proportion of their labour. When the building is finished, each member is the sole owner of a homestead, and the cooperative may be dissolved.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the concept of cooperative.
2. Assess the duties and responsibilities of a cooperative auditor.

7.0 REFERENCES/FURTHER READING

Cooperative Audit Department, Bangkok, Thailand.
<http://www.cad.go.th/ewtadmin/ewt> (Assessed: 12 October, 2009).

Statement on the Cooperative Identity.

Sullivan, Arthur & Sheffrin; Steven. M. (2003). *Economics: Principles in Action*. New Jersey: Pearson Prentice Hall.

Wikipedia, the free encyclopedia <http://en.wikipedia.org> (Last modified/assessed: 23 September, 2009).