1. **WHAT IS AN AUDIT?**Audit is an independent examination of financial statements of an entity that enables an auditor to express an opinion whether the financial statements are prepared (in all material respects) in accordance with an identified and acceptable financial reporting framework (e.g. international or local accounting standards and national legislations)

This view of audit is presented by ISA 200 *Objective and General Principles Governing an Audit of Financial Statements*.

The phrases used; “to express the auditor’s opinion” means that the financial statements give a true and fair view or have been presented fairly in all material respects.

True and fair presentation means that the financial statement are prepared and presented in accordance with the requirements of the applicable International Financial Reporting Standards (IFRS) and local pronouncements/legislations.   
What we can understand as the essential features of an audit from the above definition and explanation are   
as under:   
• An auditor involves in examination of financial statements, the auditor is not responsible for the preparation of the financial statements.   
• The end result of an audit is an opinion to assist the user of the financial statements. Auditing therefore relies heavily on professional judgment, not merely on the facts.   
• The auditor’s opinion makes reference to “true and fair” or “fair presentations” but “true and fair” is again a matter of judgment. It is not precisely defined for the auditor.   
• In order to make the user of the auditor’s report able to feel confident in relying on such report, the auditor should be independent of the entity. Independent essentially means that the auditor has no significant personal interest in the entity. This allows an objective, professional view to be taken.

You will note that this is a wide concept of an audit which can be applied to any entity, not just to limited companies. However, in this course, we are concerned primarily with audits of limited companies (often known as statutory or external audits). Any other audit applications will be clearly indicated for you.

**Why is there a need for an audit?**The problem that has always existed at the time when the manager reports to the owners is that: whether   
the owners will believe the report or not? This is because the reports may:   
a. Contain errors   
b. Not disclose fraud   
c. Be inadvertently misleading   
d. Be deliberately misleading   
e. Fail to disclose relevant information   
f. Fail to conform to regulations   
The solution to this problem of credibility in reports and accounts lies in appointing an independent person called an auditor to examine the financial statements and report on his findings. A further point is that modern companies can be very large with multi-national activities. The preparation of the accounts of such groups is a very complex operation involving the bringing together and summarizing of accounts of subsidiaries with differing conventions, legal systems and accounting and control systems. The examination of such accounts by independent experts who are trained in the assessment of financial information is of benefit to those who control and operate such organizations as well as to owners and outsiders.

Many financial statements must conform to statutory or other requirements. The most notable is that all company accounts have to conform to the requirements of the Companies act but many other bodies (like: Charities, Building Societies, Financial Services business etc) have detailed accounting requirements as required by the relevant legislations. In addition all accounts should conform to the requirements of International Financial Reporting Standards (IFRSs). It is essential that an audit of financial statements should be carried out to ensure that they conform to these requirements.   
**2. What is the distinction between auditing and accounting?  *Relationship between auditing and accounting***Auditing and accounting are closely connected but both are separate activities. The directors of a company are responsible for establishing books of accounts that will accurately record financial information and that are used for preparing the annual financial statements. It is similarly the responsibility of the directors to adopt consistent and appropriate accounting policies in order to prepare and present the financial statements. The financial statements have to comply with national legislative requirements and International   
**Financial Reporting Standards (IFRSs).**Accounting is the process of recording, classifying, summarizing and reporting financial information in a logical/systematic manner for the purpose of decision making. To provide relevant & reliable information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the financial statements.

In auditing the financial statements, the concern is with determining whether the presented financial statements properly (true and fair) reflect the financial information that occurred during the accounting period. Since auditors are primarily concerned with the end result of this work i.e. do the financial statements show a true and fair view? In order to arrive at their conclusion the auditors must have a deep knowledge and understanding of accounting (including applicable accounting standards) and in practice, the directors will consult with the auditors as to appropriate accounting policies to follow.

Many financial statement users and members of the general public confuse auditing with accounting. The confusion results because most auditing is concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title “Chartered Accountant” or “Certified Public Accountant” to individuals performing a major portion of the audit function.

Who can be an auditor?   
For appointment as auditor of:   
a) a Public Company or   
b) a Private Company which is a subsidiary of a Public Company.   
  
The person must be a CPA, ACCA or CFA holder within Kenya.

1. **What are the different types of audit?**

Three types of audits are discussed in general, i.e.,   
1. Financial statement audits   
2. Operational audits   
3. Compliance audits

**Financial Statement Audits**   
An audit of financial statements is conducted to determine whether the overall financial statements (the quantifiable information being verified) are stated in accordance with specified criteria. Normally, the criteria are the requirements of the applicable International Financial Reporting Standards (IFRSs) and the Companies act. The financial statements most commonly comprises of the Balance Sheet, Income Statement, Statement of Changes in Equity, Cash Flow Statement, and Notes to the accounts. The assumption underlying an audit of financial statements is that these will be used by different groups for different purposes. Therefore, it is more efficient to have one auditor who will perform an audit and draw conclusions that can be relied upon by all users than to have each user perform his or her own audit. If a user believes that the general audit does not provide sufficient information for his or her purposes, the user has the option of obtaining more data. For example, a general audit of a business may provide sufficient financial information for a banker considering a loan to the company, but a corporation considering a merger with that business may also wish to know the replacement cost of fixed assets and other information relevant to the decision. The corporation may use its own auditors to get the additional information.

**Operational Audits**

An operational audit is a review of any part of an entity’s operating procedures and methods for the purpose of evaluating efficiency and effectiveness. At the completion of an operational audit, recommendations to management for improving operation are normally expected. An example of an operational audit is evaluating the efficiency and accuracy of processing payroll transactions in a newly installed computer system.

Because of the many different areas in which operational effectiveness can be evaluated, it is impossible to characterize the conduct of a typical operational audit. In one organization, the auditor might evaluate the relevancy and sufficiency of the information used by management in making decisions to acquire new fixed assets, while in a different organization the auditor might evaluate the efficiency of the paper flow in processing sales.

In operational auditing, the reviews are not limited to accounting. They can include the evaluation of organization structure, computer operations, production methods, marketing, and any other area in which the auditor is qualified.

The conduct of an operational audit and the reported results are less easily defined than for either of the other two types of audits. Efficiency and effectiveness of operations are far more difficult to evaluate objectively than compliance or the presentation of financial statements in accordance with accounting conventions and principles; and establishing criteria for evaluating the quantifiable information in an operational audit is an extremely subjective matter. In this sense, operational auditing is more like “management consulting” than what is generally regarded as “auditing”. Operational auditing has increased in importance in the past decade.

**Compliance Audits**

The purpose of a compliance audit is to determine whether the entity is following specific procedures, rules,   
or regulations set down by some higher authority. A compliance audit for a private business could include determining whether accounting personnel are following the procedures prescribed by the company controller, reviewing wage rates for compliance with minimum wage laws, or examining contractual agreements with bankers and other lenders to be sure the company is complying with legal requirements. In virtually every private and nonprofit organization, there are prescribed policies, contractual agreements, and legal requirements that may call for compliance auditing. Results of compliance audits are typically reported to someone within the entity being audited rather than to a broad spectrum of users.

1. **What are the advantages and disadvantages of auditing?**

**Advantages of an audit**

We have seen that the need for an external audit in the case of companies arises primarily from the existence of split-up of ownership from control. There are however, certain advantages in having financial statements audited even where no statutory requirement exists for such an audit in the case of a sole-trader ship, partnership, or non-profit organizations for example.   
These advantages can be summarized as follows:   
a) Disputes between management may be more easily settled. For instance, a partnership which has complicated profit sharing arrangements may require an independent examination of those accounts to ensure, as far as possible, an accurate assessment and distribution of the profits.   
b) Major changes in ownership may be facilitated if past accounts contain an independent audit report, for instance, where two sole traders merge their business to form a new partnership.   
c) Application to lenders/financial institutions for finance may be strengthened by the submission of audited accounts. However do remember that a bank, for instance, is likely to be far more concerned about the future of the business and available security, than by the past historical accounts, audited or otherwise.   
d) The audit is likely to involve an in depth examination of the business and so may enable the auditor to give more constrictive advice to management on improving the efficiency of the business.

**Disadvantages of an audit**

Like most thing in life, audits are not entirely without their disadvantages. There are two main points to make here:   
a) The audit fee! Clearly the services of an auditor must be paid for. It is for this reason that few partnerships and even fewer sole traders are likely to have their accounts audited.   
b) The audit involves the client’s staff and management in giving time to providing information to the auditor. Professional auditors should therefore plan their audit carefully to minimize the disruption which their work will cause.

1. **What are the different stages of audit?**

Auditing is essentially a practical task. The auditor always needs to reflect the nature of the circumstances of   
the entity under audit. It is unlikely that any two audit assignments will ever identical. It is however possible   
to identify a number of standard stages in a typical external audit. These are as follows:   
- Audit appointment   
- Engagement letter   
- Initial planning   
􀂃 Knowledge of the business   
􀂃 Risk Assessment   
􀂃 Internal control review (procedures)   
􀂃 Control procedures (authorities/approvals/segregation of duties)   
- Preparation of the audit plan   
- Accounting system review   
- Analytical review techniques (Compliance procedures-Application of control test procedures e.g. if purchases are according to the controls established.   
- Considering the ways in which audit evidence can be sought   
- Substantive testing (transaction level procedures)   
- Reasonable assurance   
- Review of the financial statements (compliance with the standards/material misstatement etc.)   
- Preparation and signing of report   
At the stage of considering the ways of seeking audit evidence the auditor will make a preliminary evaluation   
of the entity’s control system:

1. **Knowing the audit profession and other services?**

Auditing firms do not describe themselves as auditors. They describe themselves as Certified Public Accountants, or as Chartered Accountants. Auditing firms are composed of accountants who perform audits for their clients. They also perform other services. The small chartered accountant firms especially may spend more time on other services than on auditing. The other services may include:   
a. Writing up books of accounts (Book keeping)   
b. Balancing books of accounts (Extracting trial balance)   
c. Preparing final accounts   
d. Tax management   
e. Statutory form filling   
f. Financial consultancy   
g. Management and system consultancy   
h. Liquidation and receivership work   
i. Investigations (Fraud audit)

1. **Objective of an Audit:**

Objective of an audit of financial statements is to enable an auditor to express an opinion whether the   
financial statements are prepared, in all material respects, in accordance with an identified financial reporting   
framework (e.g. International or Local Accounting Standards).   
The terms used to express the opinion are “give a true and fair view” or “present fairly in all material   
respects”.

**Benefit of opinion**   
It improves credibility of financial statements.

**What an opinion does not achieve?**   
It does not provide any assurance about   
i) Future viability of the entity; and   
ii) Efficiency or effectiveness of management.

1. **General Principles of an Audit:**

**Professional Ethics**

There are a number of ethical matters that are extremely important for auditors to consider when performing their work. It is vital to the public image and credibility of the profession that the auditor is seen to be behaving in an acceptable manner in addition to actually complying with the ethical requirements.

It is important to recognize that many groups in society rely on accountant’s work, not just the shareholders on whose behalf the accountant is working. The accountant therefore has a public accountability. In the light of this, ICAP’s ethical guidelines emphasis the following key points about the characteristics of accountants:   
  
a) **Independence:**

Auditor is independent of management i.e. he is not under the control or influence of management.

b)  **Integrity:**

Auditor is honest and is not corrupt. He is straight forward in performing his professional work.

c) **Objectivity:**

He obtains the evidence needed to form an opinion and his opinion is based on that evidence alone. He is not subjective in forming his opinion.

d)  **Professional Competence and Due Care:**

Auditor has attained certain professional qualification, has acquired the requisite skill and has attained the experience necessary for the audit and performs his work with planning and due diligence.

e)  **Confidentiality:**

Auditor neither discloses the information obtained during the course of his audit without permission of his client (except when required in a court of law) nor uses that information himself.

f) **Professional Behavior:**

He should not only act in a professional manner but should also appear to be a professional. He should maintain his professional knowledge and skill at a level required to ensure that a client or employer receives the benefit of competent professional service based on up-to-date developments in auditing practice and relevant legislation.

g)  **Technical Standards:**

Audit should be performed by following certain standards, international or national.   
  
**International Standards on Auditing (ISAs)**

The auditor should follow basic principles and essential procedures together with related guidance as contained in ISAs. International Standards on Auditing (ISAs) are issued by the International Auditing Practices Committee (IAPC). The IAPC is a standing committee of the Council of the International Federation of Accountants (IFAC), which was formed in 1977 and is based in New York. IFAC has more than 150 member bodies, representing over 2 million accountants in more than 100 countries, and membership of IFAC automatically confers.

The IAPC issued standards and statements on auditing and related services in order to improve the   
degree of uniformity of auditing practice and related services throughout the world. The IAPC works closely with its members and national standard setters in order to gain acceptance of international Standards of Auditing (ISAs). Member bodies have increasingly sought to align the national position with the international positions IFAC and the IASC have gained influence and recognition. Standard setters increasingly refer to the international position in their consultative documents as authoritative support for a particular view.

International auditing and accounting standards do not at present override local regulations. Neither IFAC nor the IASC can currently compel any organization to comply with international standards; nor are there specific sanctions where organizations claim to have complied with international standards, but have not done so.

*The preface to International Standards on Auditing and Related Services (ISA 100) states that IAPC guidance   
falls into two categories:*

**International Standards on Auditing (ISAs)**  
ISAs contain basic principles and essential procedures, together with related guidance in the form of explanatory and other material.  
   
The basic principles and essential procedures are to be understood and applied in the context of explanatory and other material that provides guidance for their application. The text of a whole standard is considered in order to understand and apply the basic principles and essential procedures.

**International Auditing Practice Statements (IAPSs).**

In conducting an audit in accordance with ISAs, the auditor is also aware of and considers International Auditing Practice Statements (IAPSs) applicable to the audit engagement. IAPSs provide practical assistance to auditors in implementing standards and promote good practice. They are not intended to have the authority of standards.  *The auditor may also conduct the audit in accordance with both ISAs and auditing standards of a specific jurisdiction or country.*

**Professional Skepticism**

The audit should be planned and performed with an attitude of professional skepticism i.e. forming an opinion only after obtaining sufficient and appropriate audit evidence instead of blindly accepting any information or explanation given by the management. An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that   
contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance.

**SCOPE OF AN AUDIT   
What does it mean?**

The term “scope of an audit” refers to the audit procedures that, in the auditor’s judgment and based on the ISAs, are deemed appropriate in the circumstances to achieve the objective of the audit.   
  
􀂃 Audit opinion   
􀂃 Reasonable assurance   
􀂃 Sufficient appropriate audit evidence   
􀂃 Audit procedures (based on ISAs) ll

**Audit-Evidence:**

It is obtained by applying necessary audit procedures. Audit procedures should be based on requirements of   
ISAs, relevant professional bodies, legislation, regulations, and the terms of the audit engagement and reporting requirements. Auditing is concerned with the verification of accounting date 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 depends on what experience and knowledge of contemporary auditing standards tells one is satisfactory.

An auditor obtains audit evidence regarding management’s assertions for the following areas:

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 not 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, the companies Act rules, Accounting Standards requirements and 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 disclosure:**

An item is disclosed, classified and described in accordance with applicable reporting framework. For example fixed assets are subject to the Companies act and IAS 16.

**An example:**

We will look at an item in a balance sheet, bank overdraft Ksh. 10,250. In reporting this item in the balance   
sheet, the directors are making these assertions:

a. That there is a liability to the company’s bankers.   
b. That at the balance sheet date this liability was Ksh. 10,250.   
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.

**REASONABLE ASSURANCE   
What is reasonable assurance?**

It is a conclusion that the financial statements are not materially misstated. An auditor cannot obtain absolute assurance because of limitations described in Paragraph below.

**How reasonable assurance is achieved?**

It is achieved by obtaining audit evidence.

**Factors affecting reasonable assurance**   
i) Inherent limitation of an audit, i.e. failure of audit procedures to detect material misstatements in financial statements because of:   
a) The use of testing (application of procedures on samples).   
b) The inherent limitations of accounting and internal control system.   
c) Persuasive nature of audit evidence rather than conclusive (Persuasive: one leading   
to an opinion; one which causes to believe; Conclusive: final, convincing).   
ii) Exercise of judgment by the auditor in gathering of evidence and drawing of conclusion.   
iii) Existence of other limitations like related parties etc.

**Audit Risk and Materiality**

Guidance provided by ISA 200 in this matter is discussed in later chapters which specifically and exclusively   
discuss it.

**Responsibility for the Financial Statements:**

Responsibilities for preparing and presenting the financial statements are that of management. Auditor’s responsibility is to express an opinion thereon.

**AUDIT RISK AND MATERIALITY**

Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and   
industry, the regulatory environment in which they operate, and their size and complexity, they face a   
variety of business risk. Management is responsible for identifying such risks and responding to them.   
However, not all risks relate to the preparation of the financial statements. The auditor is ultimately   
concerned only with risks that may affect the financial statements. The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. The concept to reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as “audit risk”.

**Audit Risk**

The risk that the auditor expresses inappropriate audit opinion when the financial statements are materially misstated. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is in   
appropriate.

**Materiality**

Risk of material misstatement levels:   
• Overall Financial Statement level   
• Often relates to entity’s control environment   
• Also relates to declining economic conditions   
• Transactions, account balances, & disclosures level   
Auditor is not responsible for detection of misstatements that are not material. The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is   
consistent with the objective of an audit

**Responsibility for the Financial Statements:**

Responsibilities for preparing and presenting the financial statements are that of management. Auditor’s   
responsibility is to express an opinion thereon.

This responsibility (by the management) includes:   
• Designing, implementing and maintaining internal control relevant to the preparation and   
presentation of financial statements that are free from material misstatement, whether due to fraud or error;   
• Selecting and applying appropriate accounting policies; and   
• Making accounting estimates.

**RIGHTS, DUTIES AND LIABILITIES OF AUDITOR   
Powers/Rights of an Auditor**  
i) Right of access to books of account and vouchers.   
ii) Right to receive information and explanations.   
iii) Right of access to books and papers of branch.   
iv) Right to receive notices of general meetings and to attend those meetings.   
v) Right to make representation where another person is being appointed as auditor.

**Duties of an Auditor**   
a) Duties of auditor are:   
i) To give a report to the members on the accounts, books of account, balance sheet and profit and loss account examined by him.   
ii) Where any matter reported upon is answered in the negative or with a qualification the report shall include reasons for such qualification with factual position.   
iii) To include in the report of the company such matters as directed by the Government.   
iv) To attend those general meetings of a listed company, either himself or through authorized person, in which the balance sheet, profit and loss account and the auditors' report are to be considered.   
a) To make report for inclusion in prospectus.   
b) To certify receipts and payments account in the statutory report.   
c) To make report on declaration of solvency in case of voluntary winding up.   
d) To exercise reasonable care and skill in carrying out his duties and make such inquiries as considered necessary.

**Appointment:**

**First Auditors**

a) The first auditors of a company shall be appointed by the directors within 60 days of incorporation of the company.

b) The first auditors will hold office till the first annual general meeting.

c) If the directors fail to appoint the first auditors, the members shall appoint the first auditors, provided further that the auditors such appointed shall not be removed during the tenure expect through a special resolution.

d) Where the first auditors are not appointed either by the directors or by the members within 120 days of incorporation of the company, the Registrar of companies will appoint the auditor.

**Subsequent Auditors**

(a) At each annual general meeting the company (members) shall appoint the auditors.

(b) The auditors shall hold office from the conclusion of that meeting till the conclusion of next annual general meeting.

(c) If no auditors are appointed at annual general meeting Registrar of companies shall appoint an auditor.

**Casual Vacancy**

a) Any casual vacancy shall be filled by directors.

b) Auditors so appointed shall hold office till next annual general meeting.

c) If directors do not appoint auditors to fill casual vacancy within 30 days, The Registar may appoint an auditor.

**Disqualification of Auditors**

**Disqualifications**

Following persons are not qualified to become auditors of a company:

i) Present directors, other officer or employees of the company or who held these offices during the last three years.

ii) A partner or employee of a director, other officer or employee of the company.

iii) A spouse of a director.

iv) A person who is indebted to the company.

v) A body corporate.

vi) A person or his spouse or minor children or in case of firm all partners of such firm who holds any shares of an audit client or any of its associated companies.

**LIABILITIES OF AN AUDITOR**

**Auditors’ Liabilities**

• Civil Liabilities (arising from law suits/Liability for negligence)

• Under law of contract.

• Under law of tort.

• Criminal Liabilities

– Against charges of forgery (evidence created / documents forged etc.)

– Against false statement (regarding opinion in report)

**Civil Liabilities**

Civil liabilities arise in the situation when there is absence of reasonable care and skill that can be expected of a person in a set of circumstances. When negligence of an auditor is being evaluated, it is in terms of what other competent auditors would have done in the same situation

**Duty of care under contract Law**

The company has a contract with the auditor and hence can sue the auditor for breach of contract if the auditor is negligent in carrying out the terms of the contract. Note that only the company can sue the auditor in contract as other people, such as banks, creditors and shareholders are not in a contractual relationship with the company.

• When carrying out their duties the auditors must exercise reasonable care and skill. This is required by the accountant’s rule of professional conduct.

• Members should carry out their professional work with due skill, care diligence and expedition and with proper regard for the technical and professional standards expected of them as members.

• The degree of skill and care expected of an auditor in a particular situation depends on the circumstances. There is no general standard of skill and care; the auditor is respected to react to the situation and circumstances he is facing

**Breach of contract**

A contract breaches when failure of one or both parties in a contract to fulfill the requirements of the contract arises. An example is the failure of a CPA firm to deliver a tax return on the agreed upon date. Parties who have a relationship that is established by a contract are said to have privity of contract. Typically, CPA firms and clients sign an engagement letter to formalize their agreement about the services to be provided, fee, and timing. There can be privity of contract without a written agreement, but an engagement letter defines the contract more clearly

**Tort action of negligence**

Failure of auditors to meet their obligations, thereby causing injury to another party (other than audit client) A typical tort action against a CPA firm is a bank’s claim that an auditor had a duty to uncover material misstatements in financial statements that had been relied on in making a loan.

**Jeb Fasteners v Marks Bloom (1980)**

The plaintiff acquired the share capital of the company. The audited accounts, due to the negligence of the auditors, did not show a true and fair view of the state of affairs of the company. It was accepted that at the time of the audit the defendant auditors did know of the plaintiffs but did not know that they were contemplating a take over bid.

HELD: whilst recognizing that the auditors owed a duty of care in this situation. It was decided that the auditors were not liable because the plaintiff had not suffered any loss. It was proved that the plaintiffs would have bought the share capital of the company at the agreed price whatever the accounts had said. Therefore, whether or not a duty of care existed was not directly relevant to the decision.

**How to minimize the liabilities**

• Not being negligent

• Following the ISAs

• Agreeing the engagement letter

• Defining in report the work undertaken

• Defining the purpose for the report

• By limiting liabilities to third parties

• By defining the scope of professional competence

**OVERVIEW OF THE AUDIT PROCESS**

1. **APPOINTMENT**

(Refer to earlier discussion on auditor appointment, qualification and disqualification)

1. **ENGAGEMENT LETTER**

The company has a contract with the auditor and hence can sue the auditor for breach of contract if the auditor is negligent in carrying out the terms of the contract. Note that only the company can sue the auditor in contract as other people, such as banks, creditors and shareholders are not in a contractual relationship with the company.

• When carrying out their duties the auditors must exercise reasonable care and skill. This is required by the accountant’s rule of professional conduct.

• Members should carry out their professional work with due skill, care diligence and expedition and with proper regard for the technical and professional standards expected of them as members.

• The degree of skill and care expected of an auditor in a particular situation depends on the circumstances. There is no general standard of skill and care; the auditor is respected to react to the situation and circumstances he is facing

Audit Engagement Letter is written by the auditor to his client. The letter documents terms of engagement as agreed between the auditor and the client.

**Example of an Audit Engagement Letter**

The following letter is for use as a guide and will need to be varied according to individual requirements and circumstances.

To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the balance sheet of …………..as of …………., and the related statements of income and cash flows for the year then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

Our audit will be made with the objective of our expressing an opinion on the financial statements. We will conduct our audit in accordance with International Standards on Auditing (or relevant national standards or practices). Those ISAs require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered. In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems, which come to our notice.

We remind you that the responsibility for the preparation of financial statements including adequate disclosure is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets of the company. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit. Our fees, which will be billed as work progress, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future years unless it is terminated, amended or superseded. Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.

Acknowledged on behalf of

ABC Company by

(Signed)

Name and Title

Date \_\_\_\_\_\_\_\_

**Following are the components of Audit Engagement Letter**

**Principal Contents**

i) The objective of financial statements.

ii) Management’s responsibility for financial statements.

iii) The scope of the audit.

iv) The form of any reports or other communications.

v) The fact that due to certain unavoidable factors, the auditors may not be able to detect all material misstatements due to fraud or error.

vi) Requirement of unrestricted access to records etc.

**Optional Contents**

i) Arrangements regarding the planning of the audit.

ii) Expectation of receiving written representations.

iii) Request for confirmation of terms of engagement.

iv) Description of any other letters or reports the auditor expects to issue to the client.

v) Basis for computation of fees.

**Contents to be included under Special Circumstances**

i) Arrangements concerning the involvement of other auditors, experts, internal auditors and other client staff.

ii) Arrangements to be made with predecessor auditor, in case of initial audit only.

iii) Restriction on auditor’s liability, if any.

iv) Reference to any further agreements between the auditor and the client.

1. **INITIAL PLANNING**
   1. **Understanding the entity and its environment and assessing the risks of material misstatement**

**Introduction**

The standard requires that auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform other audit procedures.

The standard provides guidance on the following:

1. Risk assessment procedures and sources of information about the entity and its environment including its internal control.

2. Understanding the entity and its environment, including its internal control.

3. Assessing the risk of material misstatement.

4. Communicating with those charged with governance and management.

5. Documentation.

**NB:** To understand an entity and its environment means an understanding of the following aspects:

(a) Industry, regulatory, and other external factors, including the applicable financial reporting framework (like; insurance companies, leasing companies, banking companies, textile industry etc.).

(b) Nature of the entity, including the entity’s selection and application of accounting policies (like; sugar, textile, hotel, tourism, services, etc.).

(c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements (like; growth maximization, cost effectiveness, quality leadership, downsizing, etc.).

(d) Measurement and review of the entity’s financial performance.

(e) Internal controls.

**Risk Assessment Procedures and Sources of Information about the Entity and Its Environment Including Its Internal Control**

**Risk Assessment Procedures & Sources of Information**

The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal controls.

a) Inquiries of management and others within the entity;

b) Analytical procedures; and

c) Observation and inspection.

The auditor is not required to apply all the risk assessment procedures for each aspect of the understanding required. However, all the above risk assessment procedures are applied in the course of obtaining the required understanding. In addition to the above procedures, the auditor may obtain information by making inquiries of the entity’s legal counsel or of valuation experts that the entity has used. Reviewing information obtained from external sources such as reports by analysts, banks, or rating agencies, trade and economic journals or regulatory or financial publications may also be useful in obtaining information about the entity.

a) **Inquiries**

The auditor obtains information from management and those responsible for financial reporting. However, useful information can be obtained from others within the entity like production staff, internal audit personnel and other employees. Inquiries from others may provide an auditor with the following information:

• Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. (Such persons include the representatives of board of directors, chief finance officers who are responsible of designing internal control)

• Inquiries directed towards internal audit personnel provide info related to their activities concerning the monitoring and effectiveness of the entity’s internal control and whether management has satisfactorily responded to any findings from these activities.

• Inquiries of employees involved in initiating, processing or recording complex or unusual transactions (like; accounts managers etc.) may help the auditor in evaluating the appropriateness of the selection and application of certain accounting policies.

• Inquiries directed towards in-house legal counsel (like; company secretary, legal advisor etc.) provide info related to such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.

* Inquiries directed towards marketing or sales personnel may provide info related to changes in the entity’s marketing strategies, sales trends, or contractual arrangements with its customers.

b) **Analytical procedures**

These include ratio analysis, trend analysis, and common size analysis of financial as well as non financial information pertaining to the entity. These procedures enable auditor to identify situation where significant fluctuations exist, relationships are not present as per expectations or unexpected relationships exist.

c) **Observation and Inspection** *(walk through procedures)*

It may support inquiries of management and others and also provide information about the entity and its environment. Such audit procedures ordinarily include the following:

• Observation of entity activities and operations

• Inspection of documents (such as business plans and strategies), records and internal control manuals.

• Reading reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors’ meetings).

• Visits to the entity’s premises and plant facilities.

• Tracing transactions through the information system relevant to financial reporting (walkthrough).

**d) Discussion among the Audit Team**

The members of the audit team should discuss the susceptibility of the entity’s financial statements to materials misstatements. Such discussions would foster sharing of knowledge and exchange of information.

**Internal Control**

Understanding of Internal Control is used by the auditor to identify types of potential misstatements and to consider factors that affect the risks of material misstatements and design the nature, timing and extent of further audit procedures.

**Definition of internal control**

Internal controls is the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

**Components of internal control**

(a) The control environment

(b) The entity’s risk assessment process

(c) The information system, including the related business processes relevant to financial reporting and communication.

(d) Control activities

(e) Monitoring of controls

**The Control Environment**

It encompasses the following elements:

(a) Communication and enforcement of integrity and ethical values.

(b) Commitment to competence.

(c) Participation by those charged with governance.

(d) Management’s philosophy and operating style.

(e) Organizational structure.

(f) Human resource policies and practices.

Auditor should evaluate how these components have been incorporated into the entity’s processes.

**The Entity’s Risk Assessment Process**

It is the process of identifying and responding to **business risks that affect entity’s financial reporting**. Such process includes how management:

1. Identifies risks that affect entity’s ability to produce financial statement that give true and fair view,

2. estimates their significance,

3. Estimates likelihood of their occurrence and

4. Decides upon actions to manage them.

Risks relevant to financial reporting include:

– Internal events, and

– External events and circumstance that may occur and adversely affect an entity’s ability to:

• initiate,

• Record,

• Process, and

• report the financial information.

Risks can arise **due to circumstances** such as the following: (internal/external)

a) Changes in operating environment

b) New personnel

c) New or revamped information systems

d) Rapid growth

e) New technology

f) New business models, product or activities

g) Corporate restructurings

h) Expanded foreign operations

i) New accounting pronouncements

**iii) Information system, including the related business processes, relevant to financial reporting and communication**

The information system consists of:

1. Infrastructure (physical and hardware components),

2. Software

3. People

4. Procedures and

5. Data

Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of IT.

**Communicating with those Charged with Governance and Management**

The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor’s attention.

**Documentation**

The auditor should document:

(a) The discussion among the engagement team regarding the susceptibility of the entity’s financial statements to material misstatement due to error or fraud, and the significant decisions reached;

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the internal control components, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures;

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level; and

(d) The risks identified and related controls evaluated.

**DOCUMENTING THE INTERNAL CONTROL SYSTEM**

**Benefits of Internal Control to the entity**

Based on our previous studies we can now identify the following principal benefits that may arise for an entity from a sound system of internal control:

a) Assurance that all transactions are completely and accurately processed.

b) Confidence that only authorized transactions takes place.

c) Assurance that adequate documentation supporting transactions is created and retained.

d) Assurance that the company’s assets and liabilities are correctly stated, in order for them to make informed decisions on the operations of the business.

e) Minimization of the risk of fraud and misappropriation of assets.

**Benefits of Internal Control to the auditor**

Of course, if the audit client benefits from a sound system of internal control, it is likely that the auditor will also be benefited. All of the above stated benefits help to promote a situation where the financial statements present a true and fair view. In simple terms, a good system of internal control will make life easier for the auditor.

**Auditor’s work on the Internal Control**

International standards on auditing emphasize the importance of internal control to the auditor by stating that auditor should:

a) Obtain an understanding of the accounting and internal control system sufficient to plan the audit and develop an effective audit approach, and

b) Use professional judgment to assess the components of audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

At an early stage in their work auditors will have to decide the extent to which they wish to place reliance on the internal controls of the enterprise. As the audit proceeds, that decision will be kept under review and, depending on the results of their examination, they may decide to place more or less reliance on these controls.

**Categories of Internal Control**

These are often summarized by using the mnemonic SOAP MAPS as follows:

a) Supervision

b) Organization

c) Arithmetic and Accounting

d) Physical

e) Management and Monitoring

f) Authorization

g) Personnel

h) Segregation of duties

**a) Supervision**

There should be adequate supervision of work to ensure that controls are being complied with. Possible application: a supervisor or manager reviews and checks the work of a subordinate.

**b) Organization**

Enterprises should have a formal, documented organization structure with clear lines of responsibility. Possible application: lines of authority within an organization make it clear which individuals are responsible for decisions and transactions

**c) Arithmetic and Accounting**

The company should ensure that there are adequate controls to ensure the completeness and accuracy of its financial records. Possible application: standard accounting procedures such as the use of control accounts, reconciliation procedures and the performance of arithmetic checks on accounting records.

**d) Physical**

There should be adequate physical control to ensure the security and safekeeping of its assets such as plant and machinery, valuable inventory items and cash. Possible application: banking cash immediately, controlling access to inventory areas; electronic tagging of inventory and portable non-current assets.

**e) Management and Monitoring**

There should be sufficient controls in existence to ensure management can effectively control the business operations.

Possible application: the use of budgeting and standard costing systems; the establishment of an internal audit department

**f) Authorization**

All transactions should be authorized. Possible application: authorization of purchases, cash and bank payments, sale of non-current assets, sales to customers on credit, bad debt write offs.

**g) Personnel**

Employees should be appropriately qualified and of suitable caliber to perform the required tasks. Possible application: recruiting the right people for the job; training them effectively, motivating and rewarding employees in an appropriate way.

**h) Segregation of duties**

There should be an appropriate division of responsibilities to reduce the opportunity for fraud and manipulation. This is a fundamental control procedure designed to ensure that one person does not have sole charge of a transaction from beginning till end. Perfect segregation of duties exists where each of the main stages in a transaction are under the control of a different person.

**Documenting the system**

Documenting the system is an extremely important stage in the audit; Auditing standards state that in planning the audit, auditors should obtain and **document** an understanding of the accounting system and control environment **sufficient to determine their audit approach**. The various methods of ascertaining and recording the system may be summarized as follows:

1. Organization chart

2. Narrative notes

3 Flowcharts

4 Internal control questionnaires (ICQs)

5 Internal control evaluation checklists (ICEC)

**Illustration 1: Laikipia University College proposed administrative structure**

**Narrative Notes**

This is a simple and apparently convenient way of describing systems. Having ascertained the system, the auditor draws up a narrative description of it for the audit files. An example might be:

Sales invoices are prepared by Mr.\_\_\_\_\_ They are checked by Mrs. \_\_\_\_\_ and then passed to Mr. \_\_\_\_\_ for recording in the customer’s account in the sales ledger etc.

Shortcomings of the method:

1. Notes can take up a disproportionate amount of space

2. Notes may be difficult to interpret

3. What happens if personnel change?

**Flowcharts**

This is becoming an increasingly widely used technique for recording accounting systems in audit files. A flowchart is a diagrammatical representation of an accounting system. A good flowchart will be supplemented with narrative.

Flowcharts have the following advantages:

(i) They portray the flow of documents through the system and enable the auditor to relate those movements with procedures and checks carried out as part of that system.

(ii) They show the movement of documents in such a way that, when properly prepared, the sources and destinations of all documents will be clear.

(iii) They help to highlight weaknesses in the control of the business.

(iv) They enable audit tests to be clearly related to weaknesses in the accounting system. Standard symbols are used to represent documents, operations and checks carried out. Flow lines are used to join up the symbols and represent the movement of documents. Dotted lines are used to represent the flow of information between documents.

**Essentials of flowchart**

Internal control evaluation flowcharts *must* highlight the following:

(a) The *sequence of operations* happening to each document (e.g. authorization, checking, matching, filing)

(b) The *segregation of staff duties* and who is responsible for each operation.

**Internal control questionnaire**

Having *ascertained, confirmed and recorded* the system, the auditor now needs to carry out a preliminary evaluation of the system in order to make a decision as to whether he will:

• Rely on internal controls and adopt a systems audit approach, or,

• Perform extensive substantive testing, using a verification approach to the audit.

An ICQ is a formal and usually standardized document which comprises:

1. A list of internal controls in existence and

2. Highlights any weaknesses.

Features:

• Used in large company audit

• Used to place reliance on internal controls

• Used to design audit approach

Objectives:

(i) To **ascertain a** clients systems of accounting and internal control

(ii) To **evaluate** the control system thus recorded, and hence

(iii) To **identify** those controls which indicate strengths in the system upon which the auditor will seek to place reliance, and

(iv) To **identify** those areas over which there are weak or no controls and which therefore must be subjected to more extensive substantive testing and reported by inclusion in the Management Letter.

**Designing an ICQ**

(I) It is good practice when designing ICQs to state, as a brief introduction:

(a) A list of control objectives which each sub-system under consideration should seek to achieve

(b) Any business considerations specific to the enterprise under review which should be taken into account.

The reason for this is essentially to highlight for the audit staff key areas for their consideration to the audit staff.

II) The questions in an ICQ should be designed to ascertain whether the control objectives are being achieved and should therefore cover such aspects as:

(a) Instructions given to staff in the performance of their duties

(b) Authorization procedures

(c) Documents and procedures used to originate transactions

(d) Recording procedures

(e) Sequence of procedures

(f) Custody procedures

(g) Relative independence of the persons involved at each stage of a transaction (i.e. segregation of duties).

(III) The questions should be framed such that a Yes/No answer is given, with a No answer usually indicating a control weakness.

(IV) An ICQ should carry such basic information as:

(a) The name of the document (ICQ)

(b) The system to which it relates (e.g. purchasing cycle)

(c) The client to whom it relates

(d) The accounting period under review

(e) Evidence of who has prepared and reviewed the document

(f) The provision of columns for:

- Yes and No answers

- comments where neither Yes or No are applicable

- indicating the significance or otherwise of apparent weaknesses

**Criticism on ICQs**

• ICQs represent an attempt at a formalized, systematic, approach to the audit of large complex organizations.

• It is however increasingly apparent that such questionnaires can become too complex, lengthy and detailed for meaningful evaluation of accounting systems.

• There is a danger that ICQs can provoke too formalized an approach to an assignment; that will be concentrating as they do *on the controls* themselves *rather than upon the fraud or irregularity that the controls* *are designed to prevent.*

**Internal Control Evaluation Checklists**

To overcome the above discussed possible shortcomings, many auditing practices have amended their approach to internal control evaluation by the adoption of a different type of document, *Internal Control* *Evaluation Checklists* (ICEC).

The ICEC is designed to determine; whether desirable internal controls are present and using key control questions to ascertain where specific frauds or errors are possible.

It is normally employed where system’s information has *already* been recorded (usually in the form of flowcharts). Key questions are asked in an ICEC, the answers to which prompt further supplementary questions.

Reference is made to a supporting flowchart which is the means of ascertaining the existing systems. This makes the ICEC document shorter and less complex, but it may require more skill and judgment on the part of the auditor to interpret the completed form. Note that virtually all the rules applicable to the construction of an ICQ apply to the construction of an ICEC.

**Limitations of the effectiveness of Internal Control**

It is possible to reduce the volume of transaction testing required in conducting an audit if the internal controls are sound and are operating effectively, but it is not likely that an auditor will be able to rely on internal controls entirely. This is because all control systems have inherent limitations such as:

1. The need to balance the cost of the control with its benefits

b) The fact that internal controls are applied to regular, recurring transactions, not one off yearend adjustments or unusual transactions, which are often large and subject to error.

c) The potential for human error

d) The possibility of fraudulent collusion (two or more persons operating together) to ‘get round’ controls that segregate duties. For example; the supervisor responsible for checking and authorizing overtime claims could collude with employees, to enable excess overtime payments to be claimed.

e) The abuse of authority and override of controls by senior managers or the owners of the business. Abuse of authority might involve ordering personal goods through the firm. It is very easy for directors and managers of organizations of any size to instruct staff to bypass normal procedures such as the requirement for authorization for payments.

f) The obsolescence of controls which have not changed to reflect changes in the business activities or organization.

In practice, the training of auditors always involves a warning never to rely on internal controls entirely, no matter how effective they may appear to be. Hence some verification of transactions is always carried out as part of the auditor’s work.

**AUDIT EVIDENCE**

Auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

**Concept of Audit Evidence**

Audit evidence is all the information used by the auditor in arriving at the conclusions on which his opinion is based and includes the information contained in the accounting records underlying the financial statements and other information. It is obtained from audit procedures performed during the course of audit and may include audit evidence obtained from other sources such as pervious audits and a firm’s quality control procedures for client acceptance and continuance.

Accounting records generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in formal cost allocations, computations, reconciliations and disclosures. The entries in the accounting records are often initiated, recorded, processed and reported in the electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity’s financial reporting, operations and compliance objectives.

Auditor obtains most of the audit evidence from accounting records of the entity. If accounting records do not provide sufficient audit evidence, the auditor obtains other audit evidence.

Other information that the auditor may use as audit evidence includes:

• Minutes of meetings;

• Confirmations from third parties,

• Analysis’ reports;

• Comparable data about competitors (benchmarking);

• Controls manuals;

• Information obtained by the auditor from such audit procedures as inquiry, observation; and inspection;

• And other information developed by, or available to, the auditor that permits the auditor to reach conclusions through valid reasoning.

**Sufficient appropriate Audit Evidence**

Sufficiency: The measure of quantity of audit evidence.

Appropriateness: The measure of quality i.e. relevance and reliability in providing support of detecting misstatements in account balance classes of transactions and disclosures and relevant assertions.

The quantity of audit evidence needed is affected by:

- The risk of misstatement (the greater the risk, the more audit evidence is likely to be required); and

- The quality of such audit evidence (the higher the quality, the less may be required).

Accordingly sufficiency and appropriateness are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality. Audit evidence obtained through same audit procedures may be relevant to certain assertions but not relevant to other assertions. The auditor often obtains evidence about an assertion from different sources or of different nature.

Evidence about an assertion is not a substitute for evidence regarding another assertion.

**Sources of obtaining Audit Evidence**

i) **Internal source** - through accounting system, management, employees, underlying documentation etc.

ii) **External source** - third parties, i.e. suppliers, customers bankers legal advisers and other parties who have knowledge of the enterprise.

**Nature of Audit Evidence**

i) Visual

ii) Oral

iii) Documentary

**Reliability of Audit Evidence - Generalizations**

Following generalizations are considered useful in assessing the reliability of audit evidence (subject to certain important exceptions):

i) Audit evidence obtained from independent sources outside the entity is more reliable.

ii) Evidence generated internally is more reliable when related controls are effective.

iii) Evidence obtained by an auditor directly is more reliable than that obtained indirectly or by interference e.g. Bank balance confirmation certificate received by an auditor is more reliable than the bank statement obtained from the management or observation of a control rather than making inquiry about the application of a control.

iv) Written evidence is more reliable than oral representation.

v) Audit evidence provided by original documents is more reliable than that provided by photocopies and facsimiles.

**Other factors relating to Audit Evidence**

i) Information on which audit procedures are based should be sufficiently accurate and complete. Therefore, auditor should also test the system for generating such information while using it for his procedures.

ii) Auditor’s reliance increases when audit evidence obtained from one source is consistent with another source; if it is inconsistent further procedures may be performed.

iii) Cost of obtaining the audit evidence is also considered when obtaining it.

iv) While forming an audit opinion, the auditor does not have to examine all the items or obtain all the evidences which might be available. He can reach a conclusion by examining a sample of such transactions. He also relies on persuasive evidences. However, if evidence is less than persuasive, he does not consider it reliable.

**Assertions in obtaining Audit Evidence**

(a) Assertions about classes of transactions and events for the period under audit;

(i) Occurrence – transactions and events that have been recorded have occurred and pertain to the entity;

(ii) Completeness – all transactions and events that should have been recorded have been recorded;

(iii) Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cutoff – transactions and events have been recorded in the proper period.

(v) Classification – transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end.

(i) Existence – assets, liabilities, and equity interests exist;

(ii) Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity;

(iii) Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded;

(iv) Valuation and allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations – disclosed events, transactions and other matters have occurred and pertain to the entity;

(ii) Completeness – all disclosures that should have been included in the financial statements have been included;

(iii) Classification and understandability – financial information is appropriately presented and described, and disclosures are clearly expressed;

(iv) Accuracy and valuation – financial and other information are disclosed fairly and at appropriate amounts.

**Audit procedures for obtaining audit evidence**

Auditor performs audit procedures to obtain an understanding of the entity, its environment and to assess risks of material misstatement. Procedures are also applied to test operating effectiveness of internal controls and for detection of material misstatements at assertion level.

The auditor always performs risk assessment procedures to provide a satisfactory basis for assessment of risks at financial statement level. In addition to these risk assessment procedures, which alone are not sufficient, the auditor performs audit procedures in the form of tests of control and substantive procedures.

Tests of controls are applied when auditor expects to rely on operating controls. Through tests of controls, he tests the controls to support the risk assessment. These are also applied when substantive procedures alone do not provide sufficient appropriate audit evidence. Nature and timing of audit procedures may be affected by the entity’s data retention policies or their practice to convert source documents into computer images through scanning, means of communication being used by the entity e.g. electronic messaging rather than written purchase orders.

The auditor uses one or more types of audit procedures described below:

(i) Inspection of Records or Documents

It consists of examining records or documents whether internal or external, in paper form, electronic form, or other media. Inspection provides evidence of varying degrees of reliability depending on their nature and source and in the case of internal records, on effectiveness of controls over their production.

(ii) Inspection of Tangible Assets

It consists of physical examination of the assets. It may provide reliable audit evidence of their existence cannot necessarily about other assertions.

(iii) Inquiry

It means seeking information of knowledgeable persons throughout the entity or outside the entity. Those may be formal written or informal oral. It provides an auditor with new information or corroborative evidences. It may also bring to high information different from the one possessed by the auditor. Certain oral inquiries might be got confirmed through written representations.

(iv) Confirmations

It is a specific type of inquiry. It is the process of obtaining a representation of information or an existing condition directly from a third party. Confirmations are sought from debtors, creditors, bankers, legal advisors etc.

(v) Recalculation

It consists of checking the mathematical accuracy of documents or records. It can be performed through use of information technology.

(vi) Re-performance

It is the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control, either manually or through the use of CAATs, for example, re-performing the aging of accounts receivable.

(vii) Analytical procedures

It consists of evaluations of financial information made by a study of plausible relationship among both financial and non-financial data. It includes investigation of significant fluctuations found and the relationship that are inconsistent.

**Audit evidence through audit procedures**

The auditor needs to generate sufficient appropriate audit evidence that will allow a conclusion to be reached based on this. Audit evidence, is obtained from audit procedures performed during the course of audit, such as:

• Test of control (compliance test)

• Test of details (substantive test)

• Analytical procedures (substantive test)

**Audit Procedures based on the understanding of Internal Control**

Auditor’s understanding of the control environment, determines the audit procedures. A strong control environment would provide more confidence about the effectiveness of internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allows the auditor to conduct some audit procedures at an interim date rather than at period end. If there are weaknesses in the control environment, the auditor ordinarily conducts more audit procedures at period end rather than at an interim date, seeks more extensive audit evidence from substantive procedures, modifies the nature of audit procedures to obtain more persuasive audit evidence, or increases the number of locations to be included in the audit scope.

**Appropriate Audit Approach**

The auditor’s understanding of the internal control would enable him to select an appropriate audit approach. These audit approaches may be as follows:

1. Apply tests of control only for a particular assertion.

2. Apply substantive procedures only for a particular assertion may be because auditor failed to identify any effective controls relevant to assertion.

3. Combined approach i.e. applying both tests of operating effectiveness of control’s and substantive procedures for the same assertion.

However, irrespective of the approach selected the auditor designs and performs substantive procedures for each material class of transactions, account balance and disclosures. In the case of very small entities, there may not be control activities and auditor may have to apply only substantive procedures.

**Considering the Nature, Timing and Extent of Audit Procedures**

**Nature**

The nature refers to:

• The purpose i.e. (tests of controls or substantive procedures) and

• Their type, i.e. inspections, observation, inquiry confirmation, recalculation, re-performances or analytical procedures.

**Timing**

Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.

**Extent**

Extent refers to sample size or number of observations of a control activity (quantity of audit evidence). It depends on auditor’s judgment after considering materiality, the assessed risk and the degree of assurance the auditor plans to obtain.

**Nature**

The nature refers to the purpose i.e. (tests of controls or substantive procedures) and their type, that is, inspections, observation, inquiry confirmation, recalculation, re-performances or analytical procedures. Certain audit procedures may be more appropriate for some assertions than others.

**THE GENERAL AUDIT ENVIRONMENT**

**Introduction**

Audit is now a complete profession and features in larger organizations in all sectors. This entails the use of competent staff, a respected role in the organization and robust quality assurance arrangements that underpin the defined services that are provided. Audit environment encompasses the following key areas, among others.

1. Audit Professionalism
2. Auditing Standards
3. Due Professional Care
4. Professional Consulting Services

**Audit Professionalism**

Auditing needs defined standards and this contributes to the development of professional audit services. Before studying the various standards attached to auditing we list the main features of a professional discipline:

1. Training programme

2. Common body of knowledge

3. Code of ethics

4. Sanctions

5. Control over services

6. Qualified practitioners

7. Morality

8. Technical difficulty

9. Examinations

10. Journals

11. Professional body

12. Compliance with rules

13. Service to society

Auditing is able to meet all of the above measures and is now firmly established as a professional discipline. This has been a huge achievement as, ten to twenty years ago; it certainly was not the case. Having a firm professional base allows the audit community to plan for the future and track the way it needs to progress as its newly acquired high profile places it firmly on the boardroom agenda.

**Generally accepted auditing standards**

An auditor must follow the generally accepted auditing standards (GAAS) when auditing both corporations and incorporated bodies. The GAAS are as summarized below:

*General standards*

1. *The audit is to be performed by a person (s) with adequate technical training and proficiency as an auditor.*
2. *In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor (s).*
3. *Due professional care is to be exercised in the performance of the audit and preparation of the report.*

*Standards of fieldwork*

1. *The work is to be adequately planned, and the assistants, if any, are to be properly supervised.*
2. *A sufficient understanding of internal controls is to be obtained to plan the audit and to determine the nature, extent and timing of tests to be performed.*
3. *Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.*

*Standards of reporting*

1. *The report shall state whether the financial statements are presented in accordance with GAAPs.*
2. *The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.*
3. *Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.*
4. *The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases, where an auditors name is associated with financial statements, the report should contain a clear cut indication of the character of the auditor’s work, if any, and the degree of responsibility the auditor is taking.*

**Audit Ethics**

The Code of Ethics extends beyond the definition of auditing to include two essential components:

1. Principles relevant to the profession and practice of internal auditing;

2. Rules of conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the principles into practical applications and are intended to guide the ethical conduct of internal auditors.

1. ***Principles***

Internal auditors are expected to apply and uphold the following principles:

1. ***Integrity***

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

1. ***Objectivity***

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

1. ***Confidentiality***

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

1. ***Competency***

Internal auditors apply the knowledge, skills and experience needed in the performance of internal auditing services.

***2. Rules of Conduct***

***a. Integrity***

*Internal auditors*:

* Shall perform their work with honesty, diligence, and responsibility.
* Shall observe the law and make disclosures expected by the law and the profession.
* Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
* Shall respect and contribute to the legitimate and ethical objectives of the organization.

***b. Objectivity***

*Internal auditors*:

* Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.
* Shall not accept anything that may impair or be presumed to impair their professional judgment.
* Shall disclose all material facts known to them that if not disclosed, may distort the reporting of activities under review.

***c. Confidentiality***

*Internal auditors*:

* Shall be prudent in the use and protection of information acquired in the course of their duties.
* Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

1. ***Competency***

*Internal auditors*:

* Shall engage only in those services for which they have the necessary knowledge, skills and experience.
* Shall perform internal auditing services in accordance with the Standards for the Professional
* Shall continually improve their proficiency and the effectiveness and quality of their services.

The code of ethics is in fact a series of codes, each of which depends on the individual auditor, the audit unit and the entire organization. If there are gaps in any of these three parts, then a suboptimal position arises. The code of ethics creates a special bond between the auditor and the employer. The internal auditor’s position is easily abused and there are not many officers who will question the auditor’s behaviour particularly where it appears that audit reports to some unseen higher authority. The code counters this problem and should be applied in an educational mode where auditors are encouraged to adopt the code as part of the training and development process.

**THEORIES OF ETHICAL BEHAVIOR**

Ethics refer to moral standards that may or may not be prescribed by law. There are three theories of ethical behavior Viz:

1. Utilitarianism.
2. Rights based approach.
3. Justice based approach.

No one approach is superior to the others

The **utilitarian approach** focuses on the **consequences** of an action on the individuals affected. It focuses on ALL individuals affected and not just one party. An action conforms to this principle if it will produce more pleasure or happiness (or prevent more pain or unhappiness) than any other possible action. One disadvantage of applying this approach is the difficulty in measuring the potential costs and benefits of the actions to be taken.

The **rights based approach** assumes that individuals have certain rights and other people have a duty to respect those rights. Thus an adherent of this school of thought should undertake an action as long as it does not infringe the rights of any individual.

**The theory of justice** is concerned with issues of equity, fairness and impartiality. It involves two principles;

1. That an individual has the right to have the maximum degree of personal freedom that is still compatible with the freedom of others.
2. Social and economic actions should be to everyone’s advantage and available to all. A person in a position to accumulate wealth has an obligation to ensure others are not worse off as a result of his/ her gains.