**EGERTON UNIVERSITY**

**Attempt Question ONE and choose TWO other questions**

1. a. Define the term **ETHICS** as applied in auditing (3.5 mks)

*Refers to prescribed moral standards that may or may not be prescribed by law, those that auditors, in carrying out their duties are expected to uphold. Without ethics, audit may be add little value to the organization, and the opinions and recommendations made would carry little or no weight.*

b. Discuss the **FOUR** Principles and **SIX** rules of conduct that constitute ETHICS that are relevant to the profession and practice of auditing (20 mks)

*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.*

*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. 41840*

***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.*

1. The scope of internal auditing is found in the Institute of Internal Auditors’ Implementation Standards.
   1. Describe the scope of the internal audit function (12 mks)

***Reliability and integrity of financial and operational information*** *Internal auditors review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.*

***Effectiveness and efficiency of operations*** *Internal auditors should appraise the economy and efficiency with which resources are employed. They should also review operations or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations are being carried out as planned.*

***Safeguarding of assets*** *Internal auditors should review the means of safeguarding and, as appropriate, verifying the existence of such assets.*

***Compliance with laws, regulations and contracts*** *Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws, regulations and important contracts that could have a significant impact on operations and reports, and should determine whether the organization is in compliance.*

* 1. What are the implications of the wide scope of internal audit function with specific reference to

*The scope of internal auditing defined above is wide and this has several implications:*

***a. Expertise*** *Great expertise is required from auditors to enable them to provide advice on the wide range of key control objectives.*

***b. Safeguarding assets*** *It is necessary to establish who is responsible for investigating fraud since this is resource-intensive.*

***c. The compliance role*** *Controls over compliance may include an inspection routine and audit’s role in this should be clearly defined.*

***d. Information systems*** *The audit of management information systems (MIS) is crucial since this may involve reviewing MIS as part of operational audits, or these systems can be audited separately.*

***e. Value for money*** *The concept of economy, efficiency and effectiveness (or VFM) is another sensitive issue. Auditors can assist management’s task in securing good arrangements for promoting VFM or alternatively undertake a continual search for waste and other poor VFM.*

***F, Management needs*** *A wide scope requires a good understanding of the operations being reviewed and it is necessary to include management’s needs in the terms of reference by adopting a more participative style.*

***g. Specialists*** *The four elements of the key control objectives may require specialists in each of the defined areas and the level of expectation may place great demands on the audit service.*

1. Discuss the composition and the role of the audit committee, and explain the linkage between the audit committee and the internal and external audit functions (23.5 mks)

*The audit committee (AC) is a standing committee of the main board and tends to consist of a minimum of three non-executive directors (NEDs). Most audit committees meet quarterly and they are now found in all business and government sectors for larger organizations. The format is normally that the NEDs sit on the audit committee and the CFO, external audit, and CEO attend whenever required. The committee will have delegated authority to act in accordance with its set terms of reference and also investigate areas that again fit with their agenda.*

***The Role of the Audit Committee***

*An audit committee will be established by the main board to perform those duties that the board decides should be properly allocated to this specialist forum. The role of the audit committee may therefore incorporate some the following components in its terms of reference.*

1. ***The external audit process****- To review the external audit process and make recommendations to the board where appropriate.*

*2. The final accounts- To consider the annual accounts and the external audit report that attached to these accounts.*

*3.* ***Systems of internal control****- To consider the adequacy of systems of internal controls. The current move to require directors to report on their systems of internal control means that this is starting to assume a higher profile.*

*4.* ***Internal audit*** *Involvement in the appointment of the internal auditors and ensuring that the internal audit function operates to professional standards and performs well and discharges its responsibilities under the audit plan and strategy.*

*5.* ***Risk management-*** *The audit committee will ensure that there is an effective system of risk management within the organization and that this system supports the controls which, in turn, provide a reasonable expectation of achieving organizational objectives.*

*6.* ***Compliance and propriety****- An oversight of systems and procedures is in place to ensure compliance with regulations, policies, laws and procedures and the organization’s code of conduct. Also ensure that the organization is able to prevent, detect and respond to fraud and allegations of fraud.*

1. ***Financial management-*** *To consider the finances and expenditure of the organization and ensure that there is a good financial reporting and budgeting system in place and that this feeds properly into the process for preparing the annual accounts.*
2. *Special investigations- The audit committee may request special investigation from the internal audit, compliance officer, external auditor and external specialists where there is a need to probe into sensitive problems that fall within its remit. (7 pts @2 mks each)(Composition- 3 mks)(Link internal/external audit and committee)*
3. “The risk of poor information systems and unreliable security and back-up arrangements leads to possible fraud, error, non-compliance with data protection rules, customer dissatisfaction and security breaches. Poor information systems can undermine an organization and its entire reputation may be at stake.”

Discuss in detail **SEVEN** Information systems (IS) risk areas (23.5 mks)

* *Theft of proprietary information (3.5) - 8 points@3 to 3.5 mks each.*
* *Sabotage of data or networks(3)*
* *Eavesdropping (3)*
* *System penetration(3)*
* *Abuse of Internet access(3)*
* *Fraud(3)*
* *Denial of service(3)*
* *Spoofing(3)*
* *Viruses(3)*

1. Discuss FOUR verification methods you would apply in regard to EACH of the following liabilities and expenses
2. ***VERIFICATION OF EQUITY***

*Equity consists of share capital and reserves. This part of the balance sheet represents interest of the owners in net assets of the entity. To verify the owners’ equity the auditor verifies following aspects:*

*􀂃 Share capital is properly classified and described in the accounts*

*􀂃 Movement in share capital is properly authorized and correctly presented*

*􀂃 Reserves are properly classified and presented*

*􀂃 Movements in reserves are properly authorized*

***VERIFICATION METHODS***

1. *Agree authorized capital with memorandum of association.*
2. *Agree issued capital with the certificate obtained from registrar.*
3. *Obtain list/ register of shareholders.*
4. ***VERIFICATION OF BANK BALANCES***

*Following points should be considered during verification of Bank Balances:*

1. *Agree the balances with the bankbook, and/or general ledger and bank statement.*
2. *In case of difference between bank book and bank statement obtain reconciliation for the bank accounts.*
3. *Check that outstanding cheques have been cleared with the bank statement subsequent to the year-end. If cheques have not been cleared subsequently ask for any special reason why they have not been cleared.*
4. *Check that uncollected cheques have been realized, with the statement for subsequent period.*
5. *Scrutinize the subsequent bank statement for dishonored cheques in order to detect worthless cheques deposited to conceal shortages.*
6. *Investigate any significant reconciling items of an unusual nature.*
7. *Investigate about outstanding stale cheques.*
8. *Obtain direct bank confirmation.*

***VERIFICATION OF CERTAIN EXPENSES ITEMS:***

***A. DIRECTOR’S FEE***

*a. Examine the Articles of Association of the company to ascertain mode of determining rates of fee.*

*b. Examine the minutes of meeting to ensure that only the fee rates agreed are paid to the directors.*

*c. Where fee is payable according to attendance at meetings, examine attendance to ensure that only attendance is paid.*

*d. Ensure that proper receipt is obtained from the payees.*

*e. Check that proper disclosure is made in the accounts as required by the Companies act.*

***B. INTEREST ON LONG TERM LOAN (FOREIGN CURRENCY)***

*i) Obtain loan agreement and read its terms and conditions.*

*ii) Check interest rate mentioned in the agreement.*

*iii) Check calculation of interest according to specified rate.*

*iv) Check accrual of interest in case of non-payment.*

*v) Check payment voucher with bank advice.*

*vi) Ensure that any gain or loss resulting from the translation has been properly accounted for.*

*vii) Ensure the following are properly disclosed:*

* + *Amount of interest;*
  + *Interest rate;*
  + *Penal interest, if any; and*
  + *Interest capitalized.*

*viii) See that whether any interest has been capitalized. If so examine that requirements of IAS-23 have been fully met and disclosure has been made accordingly.*