## INTRODUCTION TO INTERNAL AUDITING

**INTERNAL AUDIT VS EXTERNAL AUDIT**

Internal auditors and external auditors have different but complementary objectives:

***The external auditor*** The external auditor seeks to test the underlying transactions that form the basis of the financial statements.

***The internal auditor*** The internal auditor, on the other hand, seeks to advise management on whether its major operations have sound systems of risk management and internal controls.

The **main similarities** between internal and external audit are as follows:

• Both the external and internal auditor carry out testing routines and this may involve examining and analyzing many transactions.

• Both the internal auditor and the external auditor will be worried if procedures were very poor and/or there was a basic ignorance of the importance of adhering to them.

• Both tend to be deeply involved in information systems since this is a major element of managerial control as well as being fundamental to the financial reporting process.

• Both are based in a professional discipline and operate to professional standards.

• Both seek active co-operation between the two functions.

• Both are intimately tied up with the organization’s systems of internal control.

• Both are concerned with the occurrence and effect of errors and misstatement that affect the final accounts.

• Both produce formal audit reports on their activities.

There are, however, many **key differences** between internal and external audit and these are matters of basic principle that should be fully recognized:

• The external auditor is an external contractor and not an employee of the organization as is the internal auditor. Note, however, that there are an increasing number of contracted-out internal audit functions where the internal audit service is provided by an external body.

• The external auditor seeks to provide an opinion on whether the accounts show a true and fair view, whereas internal audit forms an opinion on the adequacy and effectiveness of systems of risk management and internal control, many of which fall outside the main accounting systems.

**INTERNAL AUDIT DEFINED**

Internal auditing is an **independent**, objective **assurance and consulting activity** **designed to add value and improve an organization’s operations**. **It helps an organization accomplish its objectives** by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

***‘Independent’*** The concept of independence is fundamental. Internal auditing cannot survive if it is not objective. All definitions of internal audit feature an element of independence, although its extent, and how it is achieved, is a topic in its own right. The audit function must have sufficient status and be able to stand back from the operation under review for it to be of use. If this is not achieved, then this forms a fundamental flaw in the audit service and some internal audit functions may not be able to subscribe to the standards.

***‘Assurance and consulting’*** This part of the definition refers to the fundamental shift in the role of internal audit. The shift makes clear that the past tinkering with the advice and consulting aspect of auditing is now a full-blown additional consultancy arm of the function. Internal audit may provide advice and assistance to management in a way that best suits each manager’s needs. Even consulting work should take on board the impact of risks and IIA says that: ‘during consulting engagements, internal auditors should address risk consistent with the engagement’s objectives and should be alert to the existence of other significant risks’. Meanwhile the primary role of internal audit is to provide independent assurances that the organization is, or is not, managing risk well. Internal audit can provide assurance on the extent to which controls are able to address risks but cannot give any absolute guarantees.

***‘Activity’*** The fact that the internal audit function is an activity is important. This means it is a defined service, although not necessarily located within the organization (e.g. it may be outsourced).

***‘Designed to add value’*** As a service, auditing has to form a client base and understand the needs of the organization. Here the service role should lead to a defined benefit to the organization rather than internal audit working for its own mysterious goals. Adding value should be uppermost in the minds of chief audit executives (CAE) and this feature should drive the entire audit process.

***‘And improve an organization’s operations’*** This brings into play the notion of continuous improvement. The auditors are really there to make things better and not inspect and catch people out. In one sense, if the BoD through the audit committee cannot demonstrate how the auditors improve the business, there is less reason to resource the service.

***‘It helps an organization accomplish its objectives’*** The task of internal audit is set firmly around the organization’s corporate objectives. Making an organization successful is the key driver for corporate governance (a badly governed organization will not be successful), for risk management (where risks to achieving objectives are the main focus) and internal controls (that seek to ensure objectives are realized). Moreover, it is the search for long-term corporate success that must steer the internal audit shop, or there is little point setting up the team.

***‘Systematic, disciplined approach’*** Internal audit is now a full-blown profession. This means it has a clear set of professional standards and is able to work to best practice guidelines in delivering a quality service. One measure of this professionalism is that the organization can expect its auditors to apply a systematic and disciplined approach to its work. Be it consulting or assurance work, IIA requires that: ‘The board should establish policies and procedures to guide the internal audit activity.

***‘Evaluate and improve’*** we have mentioned the need to focus on making improvements in the organization and part of this search for improvement entails making evaluations. Internal audit set what is found during an audit against what should be present to ensure good control. This necessarily entails the use of evaluation techniques that are applied in a professional and impartial manner to give reliable results. Many review teams leave out the evaluation aspect of review work and simply ask a few questions or check a few records and their results are not robust. Internal audit, on the other hand, has built into its definition the formal use of evaluation procedures to support steps to improve operations.

***‘Effectiveness’*** Effectiveness is a bottom-line concept based on the notion that management is able to set objectives and control resources in such a way as to ensure that these goals are in fact achieved. The link between controls and objectives becomes clear, and audit must be able to understand the fundamental needs of management as it works to its goals. The complexities behind the concept of effectiveness are great, and by building this into the audit definition, the audit scope becomes potentially very wide.

**SCOPE AND OBJECTIVES OF THE INTERNAL AUDIT DEPARTMENT**

The internal audit activity should evaluate risk exposures relating to the organization’s governance, operations and information systems regarding the:

* Reliability and integrity of financial and operational information.
* Effectiveness and efficiency of operations.
* Safeguarding of assets.
* Compliance with laws, regulations, and contracts.

***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.

**IMPLICATIONS OF THE WIDE SCOPE**

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

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

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

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

***4. 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.

***5. 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.

***6. 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.

***7. 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.

**INDEPENDENCE**

There are several key Attributes that make clear the significance of auditors’ independence:

• The internal audit activity should be independent, and internal auditors should be objective in performing their work.

* The internal audit activity should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.

• The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

* Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.
* If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

**The Meaning of Independence**

Independence means that management can place full reliance on audit findings and recommendations. There are many positive images that are conjured up by this concept of independence:

***1. Objectivity***

Behind this word is a whole multitude of issues that together form a complex maze. The main problem is that the whole basis of objectivity stems from a human condition of correctness and fair play. Any models that involve a consideration of the human condition have to deal with many psychological matters, and at times irrational behavior. Although objectivity is located in the mind, it is heavily influenced by the procedures and practices adopted.

***2. Impartiality***

Objectivity may be seen as not being influenced by improper motives while impartiality is not taking sides. The question of impartiality is important because there is a view that internal audit, like all other units, will work in a politically advantageous way. This may result in audit taking the side of the most powerful party in any work that impact on the political balances within an organization. If this is allowed to occur unchecked then the audit evidence that supports any audit report may be secured with a view to assisting one side only.

***3. Unbiased views***

When an audit report states that ‘the audit view is *. . .*’ this should provide a comment on the state of internal controls. Where used to provide an advantage for the audit function, credibility is risked. The other aspect of audit bias is where certain officers/sections have been earmarked as ‘poor, uncooperative or suspect *. . .*’ we go into an audit looking for any material that supports our original contentions. If taken to the extreme, the audit function will become a hit squad, conjuring up cases against people it does not like. It is difficult to build professional audit standards using this model.

***4. Valid opinion***

Readers of audit reports require the auditors to complete work to professional standards with the audit opinion properly derived from this work. This opinion must make sense having reference to all relevant factors. The audit role is not to please nominated parties or simply maintain the status quo; it is to present audit work in a professional and objective manner.

***5. No spying for management***

Professional objectivity means that audit does not fall into the trap of acting as spies for management, particularly where managers feel that their staffs are not performing.

***6. No ‘no-go’ areas***

There are senior managers who adopt a particularly aggressive stance to managing their areas of responsibility. All outsiders are treated with great suspicion. In fact there is a correlation between professional incompetence and this threatening posture, i.e. the less able the manager the more aggressive he/she becomes. If this results in certain areas being deemed out of bounds to internal audit then this means that audit’s independence is impaired and they will have a lesser role. If audit can be kept away from certain areas then this restricts the audit field, and if this trend is allowed to continue it could set a damaging precedent. The net result may be that the audit field becomes relegated to defined parts of the organization only. This is playing at auditing far removed from the demands of any professionally based audit practice.

***7. Sensitive areas audited***

To achieve its full status internal audit must be able to audit sensitive areas. Unlike the no-go areas, this potential barrier arises where the necessary skills and techniques are not available to the audit unit thus making it impossible to cover high-level areas. Where the audit scope is set within basic accounting systems for low-level checking, little important work can be undertaken and audit independence will not have been secured.

***8. Senior management audited***

There is a view that system controls are primarily located within the management processes that underpin the operations. Where audit fails to incorporate this factor into the scope of audit work, a great deal will be missed. The problem is that managers may not wish to be audited, particularly where this exposes gaps in their responsibility to establish

***9. No backing-off***

We do not expect auditors to back down without a valid reason when confronted by an assertive manager. This is not to say that auditors march unchecked across the organization, unaware of any disruption they might be causing to front line operations. It does, however, mean that they will pursue audit objectives to the full in a diplomatic and professional manner. If this is not the case then audit will be vulnerable to criticism from all sides. Audit reports would then reflect what managers allowed the auditor to do rather than the work required to discharge the terms of reference for the audit. In this instance audit can claim very little real independence.

**INTERNAL AUDIT COMPETENCIES**

The first thing that needs to be in place to ensure competent internal auditors is effective human resource policies and practices. Here we are concerned with the attributes of successful internal auditors. Auditors should possess the following competencies:

* Proficiencies in applying internal auditing standards and procedures *. . .*
* Proficiency in accounting principles and techniques *. . .*

• An understanding of management principles *. . .*

• Appreciation of accounting, economics, commercial law, taxation, finance, quantitative methods and IT.

• Skilled at dealing with people and communicating *. . .*

• Skilled in oral and written communications

**TRAINING AND DEVELOPMENT**

Training is an important aspect of developing internal auditors, and has to be carefully planned in line with a career developmental programme. We first distinguish the following terms:

* Training—programmes for getting people to learn to do things differently.
* Development—untaught activity to increase/improve performance.
* Education—formal courses to develop knowledge and qualifications.
* Learning—acquiring better skills, knowledge and attitudes.

There are various ways that audit staff may be trained and developed:

1. ***Specialist skills training via internal or external skills workshops*** These can be extremely efficient in terms of auditor development.
2. ***Professional training*** This may be based on passing examinations of a defined professional body such as the Institute of Internal Auditors, CPA or CIA, which is a completely different form of training from skills-based courses.
3. ***The training co-ordinator*** appointing a training co-ordinator is a positive way of promoting various training programmes, particularly where the co-ordinator can undertake some of the actual training.
4. ***Directed reading*** This is one way of encouraging auditors to research aspects of internal audit. The department should subscribe to all relevant journals and publications.

***5. Training through work*** Programmed audits enable audit management to ensure auditors are rotated and exposed to a variety of audits and experiences. It is possible to designate smaller audits as ‘training audits’ where they form part of the auditors’ personal development programme.

***6. The audit review*** The audit review process enables audit managers and team leaders to direct the work of junior staff and also provides experience in staff management.

***7. Professional affiliations*** These can be part of continuing professional development (CPD) and stimulate group discussions.

***8. The audit manual***

This sets out the defined methods and procedures required to discharge

**THE EVOLUTION OF THE AUDIT FUNCTION**

It is important to understand the roots of internal auditing and the way it has developed over the years.

***1 Extension of external audit*** Internal audit developed as an extension of the external audit role in testing the reliability of accounting records that contribute to published financial statements. The IIA.UK & Ireland have suggested this link between external and internal audit:

*The nineteenth century saw the proliferation of owners who delegated the day-to-day management of their businesses to others. These owners needed an independent assessment of the performance of their organizations. They were at greater risk of error, omissions or fraud in the business activities and in the reporting of the performance of these businesses than owner-managers. This first gave rise to the profession of external auditing. External auditors examine the accounting data and give owners an opinion on the accuracy and reliability of this data. More slowly the need for internal auditing of business activities was recognized. Initially this activity focused on the accounting records. Gradually it has evolved as an assurance and consulting activity focused on risk management, control and governance processes. Both external audit and internal audit exist because owners cannot directly satisfy themselves on the performance and reporting of their business and their managers cannot give an independent view.*

***2 Internal check*** The testing role progressed to cover non-financial areas, and this equated the internal audit function to a form of internal check. Vast numbers of transactions were double checked to provide assurances that they were correct and properly authorized by laid-down procedures. The infamous ‘audit stamp’ reigned supreme indicating that a document was deemed correct and above board.

***3 Probity work*** Probity work arrived next as an adaptation of checking accounting records where the auditors would arrive unannounced at various locations and local offices, and perform a detailed series of tests according to a preconceived audit programme. Management was presented with a list of errors and queries that were uncovered by the auditors. The auditors either worked as a small team based in accountancy or had dual posts where they had special audit duties in addition to their general accounting role.

***4 Non-financial systems*** The shift in low-level checking arose when audit acquired a degree of separation from the accounting function with internal audit sections being purposely established. This allowed a level of audit management to develop which in turn raised the status of the audit function away from a complement of junior staff completing standardized audit programmes.

***5 Chief auditors*** Another thrust towards a high profile, professional audit department was provided through employing chief internal auditors (or chief audit executives) with high organizational status.

1. ***Audit committees*** Audit committees bring about the concept of the audit function reporting to the highest levels and this had a positive impact on perceived status. Securing the attention of the board, chief executive, managing director, non-executive directors and senior management also provides an avenue for high-level audit work, able to tackle the most sensitive corporate issues.

***7 Professionalism*** The Institute of Internal Auditors (IIA) has some history going back over 50 years. In 1942, IIA was launched. Its first membership was started in New York City, with Chicago soon to follow. The IIA was formed by people who were given the title internal auditor by their organizations and wanted to both share experiences and gain knowledge with others in this new professional field. A profession was born that has undergone many changes over subsequent years.

**THE DEVELOPMENT OF INTERNAL AUDIT SERVICES**

The developmental process outlined above highlights the way the function has progressed in assuming a higher profile and a greater degree of professionalism, and these developments over the last 20 years may likewise be traced:

***1 Internal check procedures***

Internal audit was seen as an integral component of the internal checking procedures designed to double-check accounting transactions.

***2 Transaction-based approaches***

The transactions approach came next, where a continuous program of tests was used to isolate errors or frauds.

***3 Statistical sampling***

Statistical sampling was later applied to reduce the level of testing along with a move away from examining all available documents or book entries.

***4 Probity-based work***

Probity-based work developed next, again featuring the transaction approach where anything untoward was investigated.

***5 Spot checks***

It was then possible to reduce the level of probity visits by making unannounced spot checks so that the audit deterrent (the possibility of being audited) would reduce the risk of irregularity. Moreover, most internal auditors assumed a ‘Gotha’ mentality where their greatest achievements resided in the task of finding errors, abuse and/or neglect by managers and their staff.

***6 Risk analyses***

The transaction/probity approach could be restricted by applying a form of risk analysis to the defined audit areas so that only high risk ones would be visited. Each unit might then be ranked so that the high risk ones would be visited first and/or using greater resources.

***7 Systems-based approaches***

Then came a move away from the regime of management by fear to a more helpful service. Systems-based audits (SBA) are used to advise management on the types of controls they should be using. Testing was directed more at the controls than to highlight errors for their own sake.

***8 Operational audits***

Attention to operational areas outside the financial arena provided an opportunity to perform work not done by the external auditor. The concepts of economy, efficiency and effectiveness were built into models that evaluated the value-for-money implications of an area under review.

***9 Management audit***

Management audit moves up a level to address control issues arising from managing an activity. It involves an appreciation of the finer points relating to the various managerial processes that move the organization towards its objectives.

***10 Risk-based auditing***

Many internal audit shops have now moved into risk-based auditing where the audit service is driven by the way the organization perceives and manages risk. Rather than start with set controls and whether they are being applied throughout the organization properly, the audit process starts with understanding the risks that need to be addressed by these systems of internal control.

**SHOULD THE EXTERNAL AUDITOR DEPEND ON THE WORK OF THE INTERNAL AUDITOR IN EXECUTING THEIR FUNCTIONS?**

The major question is whether the external auditor should or should not rely on the work of the internal audit function while conducting external audits. If the external auditor could be able to rely on and use the work of the internal auditor, the result would be substantial savings in the cost and time taken to conduct the audit. Before the external auditor can rely on work done by the internal auditor he should consider the following:

i)  **Organizational status:**

The internal auditor is in most cases an employee of the entity and therefore cannot be independent, however the external auditor should evaluate to what extent he is free in performing his duties and communicate with external auditor and consider any constraints placed upon his work. Ideally, internal auditor should be reporting to the highest level of management and should be free from other operating responsibility.

ii)  **Scope and Objectives of Internal Audit Function:**

The external auditor should examine the range and aim of the assignments assigned to internal auditors by the management and whether management acts on internal audit recommendations.

iii)  **Technical Competence:**

The external auditor should ascertain whether staff of the internal audit function has adequate technical training and proficiency as auditors.

iv)  **Due Professional Care:**

The external auditor should consider whether the internal auditor has performed his work with reasonable care and skill i.e. work is properly planned, supervised and reviewed. He should also consider existence of working papers, work programs, audit manuals etc.

**LIAISON AND COORDINATION**

In the conduct of an external audit, the extent of liaison between the external auditor and the internal auditor would normally encompass the following:   
i) initial planning to formulate a joint approach to minimize the tests performed by the two auditors i.e. tests level, sample selection, documentation of work performed, review and reporting procedures.   
ii) Regular meetings between the internal and external auditors during the year.   
iii) Exchange of knowledge between the two auditors i.e. the external auditors should be informed of any significant matter that comes to the knowledge of internal auditor which he believes may affect to work of external auditor. Similarly the external auditor should inform the internal auditor of any significant matters which may affect his work.

**Influences on the Internal Audit Role**

***1 Contracting out internal audit***

All internal auditing departments are under threat where the in-house unit may be deleted, downsized or replaced by an inspectorate, quality assurance or operational review service.

***2 Globalization***

The big picture of internal auditing must include that it is a discipline universally applicable throughout the world. The IIA’s professional standards are applied in each member country with slight changes in terminology to accommodate local requirements, and there now exists a Global IIA (Institute of internal auditors) with relevant representation from across the world.

***3 Quality management***

The continuing interest in quality management is derived from a desire to secure excellence in service/product delivery. This allows a top downwards review of existing practices. Internal auditors are well versed in the principles and practice of management, which is examined in IIA and other audit examinations.

***4 The compliance role***

There is some debate on the role of internal audit in compliance with procedure. The technical view argues we have moved away from detailed checking as the profession developed. One may now audit corporate systems of importance to the entire welfare of the organization. However, there are organizations such as banks and retail companies that make great play of compliance checks and have a need for an audit service to advice mgt on compliance.

***5 Independence***

Much has been written on independence and it is no longer treated as an esoteric entity that is either held on to, or given up through greed or ignorance. A response to the threat of external competition from the big accountancy firms was that they could not be independent. This argument is insufficient. Independence is perceived more practically as the basic ability to do a good job.

***6 The expectation gap***

Audit services will have to be properly marketed, which is essentially based on defining and meeting client needs. This feature poses no problem as long as clients know what to expect from their internal auditors. It does, however, become a concern when this is not the case, and there is a clear gap in what is expected and what is provided.

***7 Legislation***

This is an important component in the development of internal auditing:

• It may alter the audit role by providing additional work.

• It may bring into the frame competitors for the current audit contract.

• It may impact the status of internal auditing, e.g. any moves towards mandatory audit committees or for that matter mandatory internal audit.

***8 Corporate governance, risk management and control***

As suggested by the new definition of internal auditing, these three concepts now form the framework for the design and provision of the internal audit service. This is why the next three chapters deal with these topics.

**THE AUDIT COMMITTEE**

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.

#### AUDITING OF INCORPORATED AND UNINCORPORATED ASSOCIATIONS

***ACCOUNTS AND AUDIT REQUIREMENTS OF AN INCORPORATED ASSOCIATION***

This topic explains in general terms, some requirements of the companies Act (CAP 486), (hereafter referred to as “the Act”. It also provides suggestions on how problems that commonly occur might be avoided. The topic should be interpreted in the context of external audits. In addition, the focus shall be on public companies, where disclosure and reporting requirements are more stringent in comparison to private companies.

**ACCOUNTS REQUIREMENTS**

After the end of a financial year, the company must arrange for accounts for the year to be prepared that present fairly the operations of the company. The accounting records must be kept in such a manner to enable this to occur. The accounting records must be kept for seven years after the completion of the transactions to which they relate. The accounts (and the audit committee's statement) must be submitted to the auditor in sufficient time to enable the auditor to audit and furnish a report on the accounts.

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At a minimum, the following are the requirements to enable the accounting obligations of a corporation to be fulfilled.

1. That accounts are prepared.

2. That the Audit Committee's statement and report, and the directors’ report is prepared.

3. Accounts with the Audit committee's statement attached are submitted to the auditor.

4. Auditor's report is furnished to the audit committee and the BoD.

5. All of the above documents are laid before members at the AGM within five months after the end of the financial year.

6. Annual (periodic) return, accompanied by all of the documents referred to above, is lodged with the registrar of companies before the deadline for submission. A similar return is to be lodged to the Kenya Revenue Authority, together with any outstanding tax liability. A copy should also be availed to the Capital Markets Authority (CMA) as required in the case of listed companies.

A company should keep proper books of accounts in respect of:

a) Cash received and expended by the company;

b) Sales and purchases of goods by the company

c) All Assets and liabilities of the company; and

d) In case of a company engaged in production, processing, manufacturing, or mining activities, a production record as may be required by the authorities;

Books of account are to be kept at the registered office of the company. If kept at any other place, the registrar should be informed; Books of accounts and the financial report should give a true and fair view of the state of affairs of the company and should contain explanation of the transactions.

Before the accounts are submitted for audit, they must have a statement and report by the audit committee attached to them. It must be made out in accordance with a resolution of the committee and signed by two or more members of the committee and state:

(a) Whether or not the accounts present fairly the results of the operations of the company for the financial year and the state of affairs of the company as at the end of the financial year;

(b) Whether or not the committee has reasonable grounds to believe that the company will be able to pay its debts as and when they fall due; and

(c) Particulars of any subsidiaries of the company and of any trust of which the association is a trustee.

(d) Any benefits received directly or indirectly by officers as a result of contracts between the officer and the organization and/ or related party transactions.

**AUDIT REQUIREMENTS**

**QUALIFICATION OF AUDITORS**

For a person to qualify to be an auditor, he or she must have at a minimum the following qualifications.

1. A certified public accountant of Kenya certification (CPA-K).
2. Association of chartered certified accountant’s certification (ACCA).
3. Experience

**DISQUALIFICATION OF AUDITORS**

On the basis that an auditor must be in a position to perform his or her duties independently, the following persons are precluded from being appointed as an auditor:

(a) An officer;

(b) A partner, employer or employee of an officer;

(c) An employee;

(d) A partner or employee of an employee, of the company in question.

**DUTIES OF AN AUDITOR**

a) Duties of auditor under section are:

i) To give a report to the members on the accounts, books of accounts, and financial statements examined by him.

ii) Where any matter reported upon is answered in the negative or with a qualification he 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 financial statements and the auditors' report are to be considered.

b) To make a a report for inclusion in the prospectus.

c) To certify receipts and payments account in the statutory report.

d) To make report on declaration of solvency in case of voluntary winding up.

e) To exercise reasonable care and skill in carrying out his duties and make such inquiries as considered necessary.

**AUDITOR'S REPORT**

The auditor must furnish a report to the committee in sufficient time for the company to lay the accounts before members within five months after the end of the financial year. The report must state:

(a) Whether or not the auditor is satisfied that the accounts present fairly the results of the company's activities for the financial year and the financial state of the company at the end of the financial year. This requirement applies even if the accounts have been prepared on a cash basis of accounting as determined by the committee of management,

(b) Whether the auditor has examined the accounts and auditors’ reports of each subsidiary of the company and each trust of which the company is a trustee. In addition, the conclusions drawn from these examinations must be reported, and

(c) Whether the auditor has obtained all of the information and explanations required from the company.

The audit report on the financial statements falls into one of the following four categories:

• “Unqualified” or Clean Audit Opinion:

In this context, “unqualified” means that in the auditor’s professional opinion, the financial statements passed without any qualifications or exceptions. This is the most common audit outcome.

An unqualified opinion means that the auditor has obtained reasonable assurance that the financial statements are free of material misstatement, and fairly present in all material respects the company’s financial position as of the end of the most recent fiscal year and the results of operations and cash flows for the year, in conformity with GAAP. The terms “reasonable assurance” and “material” are important because they indicate that the auditor does not scope the audit procedures to provide absolute assurance or to detect all misstatements, but rather performs selective procedures to identify those misstatements of significance that might affect decision- making by an investor or other user who relies on the audit opinion.

• Unqualified Opinion with an Explanatory Paragraph:

This type of report is issued when the auditor believes the financial statements are fairly presented in all material respects in conformity with GAAP, but additional information should be disclosed. For example, an auditor might note a change in an accounting policy from a previous year, or that there is substantial doubt about the company’s ability to continue as a going concern.

• “Qualified” Opinion:

In a qualified opinion, the auditor reports that the financial statements are fairly presented in all material respects in conformity with GAAP, but with one or more specific exceptions, which the auditor describes. For example, the auditor might have identified a deviation from GAAP that has a material effect on the financial statements. In other instances, an auditor may not be able to obtain evidence to audit one or more areas of the financial statements. However, financial statements with such an opinion from the independent auditors are not acceptable to the CMA for purposes of satisfying a company’s reporting requirements, and the CMA would require the company to take corrective measures.

• Adverse and Disclaimer Opinion:

An adverse opinion is a failing grade that is issued when an auditor believes the financial statements taken as a whole are materially misstated or do not conform to GAAP. An adverse opinion typically signals significant problems that will make it difficult for a company to attract investors or access capital.

In a disclaimer of opinion, the auditor declines to express an opinion because he or she was unable to access enough information to form an opinion, or because the scope of the audit was restricted by the company. This, too, would typically signal significant problems. Financial statements with either an adverse opinion or a disclaimer of opinion are not acceptable to the CMA for purposes of satisfying a company’s reporting requirements, and the SEC would require the company to take corrective measures.

**WHAT AUDITORS LOOK FOR WHEN AUDITING INCORPORATED BODIES**

Audits help give investors, and the capital markets, the confidence to invest in public companies. Although clearly not a guarantee of the performance of such investments (which is affected by many factors), the close scrutiny provided by audits reduces “information risk” — the possibility that investment decisions will be based on inaccurate data. Without independent audits, investors would have to rely on management’s word that its financial statements are accurate. Many investors likely would be less willing to risk their assets on data that has not withstood independent scrutiny.

The auditor follows professional standards in examining the books against established criteria, typically GAAP, to determine whether the financial statements provided by management reflect the business’s operations and transactions during the time covered by those statements. The examination of the financial statements includes sales, cash receipts, inventory levels and valuation, outstanding bills, liabilities, payroll and other operating expenses. Auditors will typically visit company offices, production facilities and other locations to learn about the business and verify the existence of physical assets or operations reported in the financial statements.

Auditors also may compare **the company’s experience with industry trends and patterns** as they analyze whether the data makes sense. Individual metrics such as margins, inventory levels, uncollected revenues, late payments or debt levels that are out of line with similar companies may be an indicator that something is amiss and that further procedures are required. In designing the audit, the auditor will consider whether certain areas might require special scrutiny because of a company’s busi­ness model. For example, examining inventory and inventory controls may be particularly important when auditing a manufacturer or a retailer. Similarly, examination of loan documentation is important when auditing a financial institution.

In examining **internal controls** over financial reporting, auditors will seek to ensure that the company has established effective procedures to reduce the chances of errors or fraud. Internal controls can be as simple as requiring a second signature on checks over a certain amount or as complex as how and which employees are given access to sensitive information, including company data and computer programs.

THE AUDIT PROCESS

The audit process begins even before the auditor accepts an engage­ment with a prospective client. Prior to accepting an engagement, the audit firm will make a preliminary review to assess the potential risks, the nature and complexity of the prospective client’s business, and whether the audit firm has the resources and expertise to perform the audit. For banks, the auditor so appointed must be approved by the CBK before commencement of duty.

After accepting the engagement, the audit team meets with manage­ment of the company and the audit committee and begins to construct an audit plan based on an understanding of the company’s business, its risks, and its controls to mitigate such risks, with a focus on the likeli­hood of any material misstatements in the company’s financial state­ments. The auditors might review the public record, or gather informa­tion from outside analysts to learn about the industry and the company. The auditors determine the company’s significant accounts and the type of transactions the company is involved in to determine what audit procedures to perform and how to assign audit resources. The planning process includes identifying the necessary audit evidence and the most effective procedures for collecting it.

The amount of time required to complete an audit depends in large part on the complexity of the task. The audit process ends with the comple­tion of various quality control procedures prior to the audit firm’s issu­ance of its report, including review procedures performed by another executive of the audit firm.

**FINDING FRAUD**

The preparation of an audit plan helps auditors identify areas of potential vulnerability for misconduct that require added attention, and/or areas where the **risk of a financial misstatement** might be greater than in other areas. For example, employees who work on commission may be tempted to accelerate the recording of sales to boost their earnings. The auditor might focus extra attention on sales and revenue recognition and examine a relatively larger number of transactions or test transactions around the end of the period for appropriate cut-off procedures by the company.

Because the audit’s goal under professional standards is “reasonable assur­ance” — not absolute assurance — that the financial statements being au­dited are free of material misstatements, a properly planned and performed audit may not detect a material misstatement resulting from error or fraud. Audits typically involve testing a sampling of data and exercising judgment about audit evidence — what to collect, how much is necessary, the extent and nature of testing, and the best way to gather it. Because auditors do not examine every transaction and event, there is no guarantee that all ma­terial misstatements, whether caused by error or fraud, will be detected.

**FRAUD INVESTIGATIONS**

Fraud is big business and the real scale may be unknown. Incorporated bodies are especially prone to frauds in part due to the agency conflicts, and their sheer size, and weak regulations. Frauds arise when ‘things go wrong’ and this has implications for the system of internal control. **Types of fraud** include:

* fraudulent encashment of payable instruments
* misappropriation of cash
* theft of assets
* works services projects
* travel and subsistence
* instruments of payment received on false documents
* False claims for hours worked

Some of the main risk areas for employee fraud include:

* Debtors
* Cash
* Payroll
* Large capital contracts
* Revenue contracts
* Major computer acquisitions
* Computer access
* Portable attractive items (e.g. laptops)
* Public sector benefits
* Government grants
* Expenses Stock
* Cheques drawn
* Creditors and payments
* Mortgages Pensions
* Petty cash Recruitment references
* Overtime and employee claims
* Confidential information
* Corporate knowledge
* Employee bonus schemes
* Procurement

**DEFINING FRAUD**

The IIA define fraud as: ‘Any illegal acts characterized by deceit, concealment or violation of trust. These acts are not dependent upon the application of threats of violence or physical force. Fraud is a misrepresentation of fact with the intent of inducing someone to believe the falsehood and act upon it, and thus suffer a loss/ damage. Frauds are perpetrated by individuals, and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage. Fraud is a white collar crime.

**Other terms associated with fraud**

* **Employee fraud:**

This refers to use of fraudulent means by an employee to take money or other property from the employer. It involves falsification of some kind- false documents, lying, exceeding authority or violating company policies.

* **Embezzlement**

This is a type of fraud involving employees or non-employees wrongfully taking money or property entrusted to their care, custody and control, often accompanied by false accounting entries and other forms of cover-up/ lying.

* **Management fraud**

This refers to deliberate fraud committed by management that injures creditors and investors through materially misleading financial statements. It is also referred to as *fraudulent financial reporting*.

**Characteristics of fraudsters**

Unlike robbers, fraudsters are least suspected since they look just like everybody else- you and me. They are likely married, aged from teens to sixties, not tattooed or dreadlocked, educated beyond high school, member of a church, no arrest or criminal record e.t.c.

**THE FOUR COMPONENTS**

Fraud is an act of deceit to gain advantage or property of another with four main components:

1. **Motive.** There should be a motive for the fraud. This may be that the employee is dissatisfied or is in financial difficulties. In the case of non-employees there should be a reason why the fraud is perpetrated. Good human resource management keeps employees satisfied and lowers non-financial motives for engaging in frauds.
2. **Attraction.** The gain or advantage secured must have an attraction for the perpetrator. This varies and may provide a gain for an associated person, e.g. a mortgage applicant.
3. **Opportunity.** There must be adequate opportunity. Someone may wish to defraud an organization and know exactly what is to be gained, but with no opportunity, it may never occur. Preventive control should be used to guard against the possibility of fraud by reducing opportunities. In fact a report by the University of Nottingham Business School (commissioned by Business Defence Europe) based on a study of 200 firms, claims that middle managers are particularly likely to defraud because they have an in-depth knowledge of how their firms work and know how to cover their tracks.
4. **Concealment.** In contrast to theft, fraud has an element of concealment. It can be by false accounting which is a criminal offence. This makes it difficult to uncover and allows the fraud to be repeated.

**CAUSES OF FRAUD**

The causes of fraud will vary but in terms of reported government fraud the causes of fraud have been listed as:

* Absence of proper control
* Lack of separation of duties
* Collusion with persons outside organization or department
* Failure to observe control procedures
* Collusion within the department

**TYPES OF FRAUD**

There is no legal definition of fraud. The fraud may be carried out by insiders or outsiders and an organization may carry out fraud by, say, overstating its earnings. The various offences associated with fraud are:

***Theft*** This includes obtaining property by deception and false accounting.

***Bribery and corruption*** The Prevention of Corruption Acts 1889 to 1916 apply to local government and provide that ‘any money, gift or consideration paid or received shall be deemed to have been paid or received corruptly as an inducement or reward unless the contrary is proved’.

***Forgery*** A person is guilty of forgery if he makes a false instrument with the intention that he or another shall use it to induce someone to accept it as genuine and by reason of so accepting it, to do, or not to do some act to his own or some other person’s prejudice.

***Conspiracy*** This involves the unlawful agreement by two or more persons to carry out an unlawful common purpose or a lawful common purpose by unlawful means. This would cover collusion to override internal controls. There are other actions that fall under the generic category of fraud, including:

• Perjury.

• Concealment (of information).

**INDICATORS OF FRAUD**

Frauds are normally found through luck or third-party information while some are discovered during audit reviews, or through controls or by line management. Indicators of fraud are:

• Strange trends where comparative figures move in an unexplained fashion.

• Rewritten and/or amended documents may be evidence of unauthorized alteration to cover up fraud.

• Missing documents may signal a fraud where items are sensitive such as unused cheques or order forms.

• Tipp-Ex (erasing fluid) applied to documents may indicate unauthorized alterations.

• Photocopies substituted for originals can be readily tampered with since the photocopy may make it impossible to uncover alterations to the original.

• Complaints from suppliers that do not tie in with the records should alert one to a potential problem.

**FRAUD DETECTION**

Fraud can be detected in the following ways: the list is ordered from the most prevalent way of detecting fraud to the least.

1. Tip from employees

2. By accident

3. Internal audit

4. Internal control

5. External audit

6. Tip from customer

7. Anonymous tip

8. Tip from vendor

9. Notification by law enforcement officials.

**FRAUD PREVENTIVE TECHNIQUES**

The investigative process is reactive in that it is initiated as a result of an alleged fraud. Steps may be taken to guard against fraud. The importance of establishing sound controls cannot be overemphasized as most frauds could have been avoided with proper controls. We must also question an organization which fully resources the investigation of fraud while ignoring the control implications.

Unfortunately those charged with performing these investigations may have little incentive to push the control angle if it will result in less work being available for them. Key controls include:

* Good recruitment procedures
* Independent checks over work
* Supervision
* Regular staff meetings
* System of management accounts
* An employee code of conduct.
* Up-to-date accounts
* Good management information systems
* Clear lines of authority
* Publicized policy on fraud
* Controlled profit margins
* Good documentation
* Good staff discipline procedures
* Financial procedures
* Management trails
* Good communications
* Good controls over cash income
* Segregation of duties
* Stores/equipment control
* Anti-corruption measures
* Fraud hotline
* Good all-round systems of control
* Well-trained and alert management

Fraud risk management is now a major issue and, under its consulting arm, internal audit may need to spend some time helping managers ensure that the risk of fraud is properly understood and mitigated wherever possible. Note that any such activity should be carried out in conjunction with the corporate anti-fraud policy.

**FRAUD AWARENESS AUDITING**

Fraud examination combines the expertise of auditors and criminal investigators. Fraud detection is most likely as a result of voluntary confessions by perpetrators, tips, accident or luck on the part of auditors. Internal and external auditors detect around 20% of frauds. In fraud audits, you should:

* Float a mindset of sensitivity to the unusual, where nothing is standard.
* Note errors and omissions and FOCUS on exceptions, oddities, and patterns of conduct.
* “Think like a crook” to imagine ways controls may be subverted for fraudulent purposes.
* Examine cumulative materiality.

**AUDITORS RESPONSIBILTY REGARDING FRAUD**

* Auditors should understand fraud, assess fraud risks, design audit procedures to provide reasonable assurance of detecting material management fraud and employee fraud that could have material effect on financial statements and report on findings to management, directors, users of financial statements (at times), and outside agencies.
* Keep track of management estimates and closest reasonable estimates supported by audit evidence. This is because a lot of fraud involves manipulation of accounting estimates e.g. bad debts provisions.

**AUDITOR INDEPENDENCE**

Auditors’ independence from company management is essential for a successful audit because it enables them to approach the audit with the necessary professional skepticism. To help protect their independence, external auditors report to a company’s audit committee, who oversee the auditors’ work and monitor any disagreements between management and the auditor regarding financial reporting.

In the past, auditors often were hired by and reported to company management with varying levels of audit committee involvement. Many observers believed that relationship made it more difficult to maintain independence leading to high profile frauds.

**AUDIT OF UNINCORPORATED BODIES**

Financial information on unincorporated entities may be compiled by accountants for a number of different purposes. Depending on the purpose, unincorporated entities may not require full financial statements which give a true and fair view and comply with all applicable accounting standards. There is also no statutory requirements for such firms to have audits done- except for NGOs that have to make returns to the NGO control council.

**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.*

**Materiality**

Materiality indicates, in the auditors opinion, the level at which the quantitative or qualitative effects of misstatements will have significant impact on users evaluations. In not for profit organizations, the auditor should make separate materiality determinations for each **opinion unit.** A church’s opinion units are the core church activities, and other business like activities run by the church.

**Types of audit engagements**

These are as discussed earlier- Financial audits, compliance audits and performance/ operational audits.

**How to audit a not for profit organization**

Non-profit organizations include government entities, public colleges and universities, churches, e.t.c. A not-for-profit organization is held accountable to its various stakeholders for the use of funds received in various forms, such as fees, grants, donations or exchange contracts. The primary role of the audit is to ensure that the funds of the organization are used in a consistent and financially sound manner. An auditors opinion is meant to give reasonable assurance as to the absence of material misstatements, and conformity with accounting and financial reporting standards. An audit committee is charged with protecting the organization's financial assets as well as its name and reputation. The audit committee is generally comprised of three to five members drawn from the board of directors.

## Steps

## Things you’ll need:

* Auditing team or committee
* Inventory details
* Internal controls
  1. Select an audit team or committee from the members of the board or general membership. Choose candidates to help you in the auditing process, preferably who have some understanding of the auditing process and have experience in finance/ accounting.
  2. Develop a written plan for each account balance or class transaction selected for examination. Indicate the [relationship](http://www.ehow.com/relationships-and-family/) between the financial statement assertions and audit objectives.
  3. Check whether the inventories included in the balance sheet physically exist or not. Determine if the inventory quantities include all products, materials and supplies on hand.
  4. Inspect whether the entity has [legal](http://www.ehow.com/legal/) title or similar rights of ownership to the inventory. See if the inventory items are stated at proper cost.
  5. Check if the organization has proper internal controls for auditing. Verify the source of all fund receipts. Include a test of specific transactions in the audit program. Verify bank balances and number of securities owned.
  6. Prepare a list of payroll and sales taxes and other taxes applicable to the non-profit organization. Verify whether these are getting duly filed or not on a regular basis
  7. Check the budget lines for any overruns. In case of overruns, check for approvals.

**Non audit work**

This refers to work solely for the benefit of the entity requiring the work and does not provide for a basis for conclusions, recommendations, or opinions as would a financial audit. Examples of non audit work include- participating in committees in advisory capacity, providing advice on entity’s internal controls, e.t.c. The provisions for non audit work as per the standards are as follows:

1. Auditors should not perfom management functions or perfom management decisions.
2. Auditors should not audit their own work or provide non audit services that are significant to the audit subject matter.

Non audit work should only be permitted if all of the following safeguards are in place:

1. Preclude non audit personnel from planning, conducting or reviewing the audit work related to the non audit service.
2. Do not reduce the scope and extent of the audit work beyond the level that would be appropriate if the non audit work were performed by another unrelated party.
3. Document the consideration of the non audit service and rationale that providing the non audit service does not violate the overarching principles.
4. Establish and Document an understanding with the audited entity regarding the objectives, scope of work, and product of the non audit service and management responsibility for the substantive outcomes of the work before commencing work.
5. Include policies and procedures in the auditors’ quality control systems to ensure understanding and compliance with the independence requirements including management’s written understanding and compliance with its specific responsibilities.
6. Avoid non audit services that by their nature impair independence e.g operating the accounting system. Communicate with the management that this would impair the auditor’s independence in performing subsequent audit work.
7. Make all non audit services documentation related to an audit available for peer review.

**AUDIT OF PATNERSHIP ACCOUNTS**

**Advantages of audit of partnership accounts**

* Builds mutual trust.
* Mitigates chances of disputes.

**When an audit of partnership accounts may be required**

* Upon death or retirement of a partner.
* Request by partners who do not take active part in affairs of the firm.

**Audit procedure**

* Obtain and study the partnership agreement carefully.
* Study the Organizational structure of the firm.
* Ensure that the agreement has been signed by all the partners.
* Study the partner’s capital contribution and check for amalgamation with another firm.
* Review the Internal Controls.
* Check account balances for accounts or class transaction selected for examination.