## INSPECTION OF ACCOUNTS AND FINANCIAL CONTROL PROCEDURES

Inspection of accounts refers to an inspection, correction, and verification of business accounts, conducted by an independent qualified accountant. We sample just a few accounts and look at ways of investigating them, and discuss fraud auditing. In addition, we shall discuss the internal controls that we expect over some processes, namely:

1. From the statement of financial position
2. Equity
3. Property, plant and equipment.
4. Investments **(READING ASSIGNMENT!)**
5. Bank and cash.
6. From the statement of comprehensive incomes
7. Revenue (Recap- covered in detail in the revenue process).
8. Purchases
9. Salaries and wages.
10. Interest expenses.
11. Directors emoluments

Note that we are only concentrating on a few accounts. Please refer to the references for resources where more information may be sought.

NOTE; the following are the general tests/ verification methods that are conducted when gathering audit evidence.

(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, reperforming 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.

**VERIFICATION OF SPECIFIC ASSETS/ LIABILITIES FOR INCORPORATED BODIES**

1. **FROM THE STATEMENT OF FINANCIAL POSITIONS**
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. Equity transactions are usually few but have huge monetary amounts. The internal controls expected are:

* Authorization: All transactions relating to equity should be properly authorized by the BoD.
* Custody and record keeping: the custody of check stock certificates should be with the firm or the appointed agents e.g. banks, or trust companies. Records of equity transactions should be maintained and updated.
* Periodic reconciliation: Periodically reconcile missing certificates with outstanding share capital.

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

􀂃 No other shares have been issued and not recorded.

􀂃 Valuation of shares for non-cash consideration is proper and conforms to accounting principles.

􀂃 Reserves are properly classified and presented

􀂃 All owner’s equity transactions authorized by BoD.

􀂃 Shares shown as issued have actually been issued.

􀂃 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 and reconcile this with the dividends paid.
4. Check minutes of meetings of directors for authorization of any movement of capital.
5. **PROPERTY, PLANT AND EQUIPMENT**

PPE is usually among the largest items in the statement of financial position. The purpose of a PPE audit is to ensure that:

* All PPE owned by the company is maintained.
* Expenses for repairs and maintenance are segraegated from purchase costs.
* Purchaes of new PPE is authorized.
* Freight is included as part of the cost of the PPE.
* PPE records are maintained and updated as PPE is received and disposed.
* Deppreciation expenses accurately calculated and classified.

The following controls should be in place over the PPE.

* There should be written authorization to purchase PPE
* Custody over movable assets should be with the company.
* There should be maintenance of records- asset register that is regularly updated.
* There should be regular reconciliation of PPE, where the PPE movement schedule is drawn.

The audit procedures over PPE are:

* Examine PPE for existence and condition.
* Vouch the cost of new PPE to invoices and other purchase documents.
* Obtain a schedule of casualty insurance over PPE in relation to their market values. Inadequate insurance or self insurance should be properly disclosed in the books of accounts.
* Recalculate depreciation using the company methods, ensuring its accuracy and proper classification.

1. **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.
9. Trace a sample of entries in the cash receipts journal to remittance advice, deposit slips, and bank statement.
10. For a sample of days, examine the signature on the deposit slip and the check endorsements for proper authorizations.
11. Compare the dates for recording a sample of cash receipts transactions in the cash receipts journal with the date the cash was deposited in the bank noting any significant delays, and proper cutoff.
12. Examine a sample of remittance advice for proper classification.

**VERIFICATION OF CERTAIN EXPENSES ITEMS:**

**A. DIRECTOR’S FEES**

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.

**C.SALARIES AND WAGES**

**Control Objectives**

The control objectives in respect of a wages and salaries system are as follows:

(a) Payment of wages and salaries should be made only in respect of the client's authorized employees.

(b) Payment should be made at authorized rates of pay.

(c) Wages and salaries payments should be in accordance with records of work performed, e.g. time, output, commissions on sales.

(d) Payroll and payroll deductions (tax and social security) should be calculated accurately.

(e) Payment should be made to the correct employees.

(f) Liabilities to the tax authorities for tax and social security should be properly recorded.

**CONTROL PROCEDURES - WAGES AND SALARIES**

**(a) Approval and control of documents**

i) There should be written authorization to employ or dismiss any employee.

ii) Changes in rates of pay should be authorized in writing by an official outside the wages department.

iii) Overtime worked should be authorized in advance by a manager/supervisor,

iv) An independent official should review the payroll and sign it.

v) The wages cheque should be signed by two signatories and agreed with the signed payroll.

vi) Where weekly pay relates to hours at work, clock cards should be used. There should be supervision of the cards and the timing devices, particularly when employees are clocking-on or off.

vii) Where a piece work system operates, payment should only be made for work of an appropriate

quality which has been inspected and approved.

viii) Personnel records should be kept independently of the payroll department for each employee giving details of engagement, retirement, dismissal or resignation, rates of pay, holidays etc, with a specimen signature of the employee.

ix) A wages supervisor should be appointed who could perform some of the authorization duties

listed above.

**(b) Arithmetical accuracy**

(i) Where appropriate, payroll should be prepared from clock cards, job cards etc, and a sample checked for accuracy against current 'rates of pay.

(ii) Payroll details should be checked for '.he accurate calculation of deductions e.g. tax, social security, pensions, trade union subscriptions etc

**(c) Control accounts**

(i) Control accounts should be maintained in respect of each of the deductions showing amounts

paid periodically to the inland Revenue, trade unions etc.

(ii) Overall analytical checks should be carried out to highlight major discrepancies e.g. check against budgets, changes in amounts paid over a period of time, check against personnel records.

(iii) Management should exercise overall review and control.

**(d) Access to assets and records**

Ideally, payment should be made by cheque or by direct transfer into the employees’ bank account. If payment is made in cash, the following procedures should be in place:

(i) Employees should sign for their wages.

(ii) No employee should be allowed to take the wages of another employee.

(iii) When wages are claimed late, the employee should sign for the wage packet and the release of

the packet should be authorized.

(iv) The system should preferably allow the wages to be checked by the employee before the packet is opened, by using specially designed wage packets.

(v) The wages department should preferably be a separate department with their personnel not involved with receipts or payments functions.

(vi) The duties of the wages staff should preferably be rotated during the year, and ensure that no employee is responsible for all the functions in respect of any particular department.

(vii) The employee making up the pay packets should not be the employee who prepares the payroll.

(viii) A surprise attendance at the pay-out should be made periodically by an independent official.

(ix) Unclaimed wages should be recorded in a register and held by someone outside the wages department until claimed or until a predefined period after which the money should be rebanked. An official should investigate the reason for unclaimed wages as soon as possible.

**Tests of Controls - Wages and Salaries**

A suggested program of tests of control is set out below. This can, of course, be modified to suit the particular circumstances of the client.

(a) Test sample of time sheets, clock cards or other records, for approval by responsible official. Pay particular attention to the approval of overtime where relevant.

(b) Test authority for payment of casual labor, particularly if in cash.

(c) Observe wages distribution for adherence to procedures ensuring employees sign for wages, that unclaimed wages are re-banked etc.

(d) Test authorization for payroll amendments by reference to personnel records.

(e) Test control over payroll amendments.

(f) Examine evidence of checking of payroll calculations (e.g. a signature of the financial controller).

(g) Examine evidence of approval of payrolls by a responsible official.

(h) Examine evidence of independent checks of payrolls (e.g. by internal audit).

(i) Inspect payroll reconciliations.

(j) Examine explanations for payroll expense variances.

(k) Test authorities for payroll deductions.

(l) Test controls over unclaimed wages.

**PURCHASES**

**Control Objectives**

Purchases are often made on credit and so the purchases cycle includes payables. You also need to bear in mind that 'purchases' has a wide meaning in terms of the purchases cycle as purchases will include not only inventory items but also all types of expense and the purchase of non current assets.

The control objectives are as follows. To ensure that:

a) Purchased goods/services are ordered under proper authority and using proper procedures

b) Purchased goods/services are only ordered as necessary for the proper conduct of the business operations and are ordered from suitable, approved suppliers

c) Goods/services received are inspected for quality, quantity and description

d) Invoices and related documentation are properly checked and approved as being valid before being entered as trade creditors

e) All valid transactions relating to payables (suppliers' invoices, credit notes and adjustments), and only those transactions, should be accurately recorded in the accounting records.

**Control Procedures over Purchases and Payables**

As with the sales system, there are a large number of controls that may be required in the purchases cycle due to the importance of this area in any business and once again, the following list is classified by type of control.

**(a) Orders**

(i) Requisition notes for purchases should be authorized.

(ii) All orders should be authorized by a responsible official whose authority limits should be pre-defined.

(iii) Major items e.g. capital expenditure, should be authorized at an appropriate level, possibly by the Board of Directors

(iv) All orders should be recorded on official documents showing suppliers' names, quantities ordered and price.

(v) Copies of orders should be retained as a method of following up late deliveries by suppliers.

(vi) Re-order levels and quantities should be pre-set and preferably recorded in advance on the requisition note.

**(b) Receipt of goods**

(i) Goods inwards areas should be identified to deal with the receipt of all goods.

(ii) All goods should be checked for quantity, quality and description. Goods received notes should be raised for all goods accepted. The GRN should be signed by a responsible official.

(iii) GRNs should be checked against purchase orders and procedures should exist to notify the supplier of under or over-deliveries. GRNs should be sequentially numbered and checked periodically for completeness.

**(c) Invoicing and returns**

(i) Purchase invoices received should be stamped with an approval grid and given a unique serial number to ensure purchase invoices do not go astray.

(ii) Purchase invoices should be matched with goods received notes and company orders and should not be processed until this is done.

(iii) The invoice should be checked against the order and the GRN, and casts and extensions should also be checked.

(iv) The invoices should be signed as approved for payment by a responsible official independent of the ordering and receipt of goods functions.

(v) Invoice sequential numbers should be checked against purchase day book details.

(vi) Input VAT should be recorded separately from the expense element of the invoice total.

(vii) Invoices should be properly allocated to the nominal ledger accounts, perhaps by allocating expenditure codes. A portion of such coding should be checked independently.

(viii) Batch controls should be maintained over the posting of invoices to the purchases day book, nominal ledger and purchase ledger.

(ix) A record of goods returned should be kept and checked to the credit notes received from suppliers.

**(d) Purchase ledger and suppliers**

(i) A payables ledger control account should be maintained and regularly checked against balances in the purchase ledger by an independent official.

(ii) Payables ledger records should be kept by persons independent of the receiving of goods, invoice authorization and payment routines.

(iii) Statements from suppliers should be checked against the ledger account.

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**TESTS OF CONTROL**

As already noted, tests of control should be drawn up so as to check that control procedures are being applied and to achieve control objectives. One suggested way to design tests of control for a particular situation is to list the documents in a transaction cycle and generate appropriate tests of control for each document. We shall illustrate this approach here in connection with the purchases cycle (Note that a similar technique could be applied to other transaction cycles!)

**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.

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, for the purposes of generally accepted auditing standards (GAAS), the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. Fraud may involve:

* 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.

**Categories of 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 of USA 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.

**RESPONSIBILITY FOR THE PREVENTION AND DETECTION OF FRAUD**

The primary responsibility for the prevention and detection of fraud rests with both management and those charged with governance of the entity. It is important that management, with the oversight of those charged with governance, places a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior, which can be reinforced by active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts concerning the entity’s performance and profitability.

**FRAUD DETECTION (PRACTICAL: FRAUD DETECTION USING BENFORD’S LAW)**

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.

**FRAUD DETECTION USING BENFORD’S LAW**