**AUDITING II: INTRODUCTION**

**TYPES OF AUDITS**

* External audits (to be covered in topic on internal audit).
* Internal audits (to be covered in topic on internal audit).
* Government/ public sector audits.

**CLASSIFICATION OF AUDITS**

* Financial audits (to be covered in topic on internal audit)
* Operational audits (to be covered in topic on internal audit)
* Compliance audits (to be covered in topic on internal audit)
* Information systems audits (to be covered in topic on IS audits)
* Integrated audits - this type of audit consists of a combination of financial, operational and compliance, and IS audits for an organization.
* Forensic audits.

The foremost aim of forensics is to establish the truth behind a particular situation by immediately capturing data to identify the perpetrator and establish proof for criminal proceedings to aid law enforcement. It also aids the organization in protecting the assets from future criminal activities and in gaining an understanding about the perpetrators and their actions.

**DEMAND FOR AUDITS**

The demand or the need for audits can be explained by:

* Agency theory

The agency theory views the organization as a “nexus of contracts”. Due to the separation of ownership from management, managers may not always act in the best interest of the owners. This causes an agency conflict. One of the ways to reduce this conflict is to incur monitoring costs such as audit fees. Thus agency conflicts increase the demand for audits.

* Stakeholder hypothesis

Besides shareholders, there are others with interests in the organization whose interests should be taken into account. Examples are creditors and the public whose taxes are used to bail out ailing firms. This is the basis for statutory audits.

* Information hypothesis/ Transaction cost economics

This theory is based on the concept of “bounded rationality” and “homo economicus”. A person chooses the best option based on the available information. This theory aims to explain how forms are formed, and contends that firms are formed to minimize costs. Management control structures must then be put in place to help minimize costs. Audits come in to ensure that the objective of cost minimization is achieved.

**THE AUDIT PROCESS**

You went through the audit process in AUDITING 1. A typical audit will follow the following steps.

1. Audit appointment-

Please refer to appointment of auditors- initial auditors, subsequent auditors, casual vacancy, qualification/ disqualification of auditors, and independence.

1. The engagement letter/ audit charter.

The purpose, responsibility, authority and accountability of the audit function or audit assignments should be appropriately documented in an audit charter or engagement letter. The audit charter or engagement letter should be agreed and approved at an appropriate level within the organization(s). The audit charter should be subject to an annual review or more often if the responsibilities are varied or changed. An engagement letter may be used by the internal auditor to further clarify or confirm involvement in specific audit or non-audit assignments. For an external audit, an engagement letter should be normally prepared for each audit or non-audit assignment. The audit charter or engagement letter should be detailed enough to communicate the purpose, responsibility and limitations of the audit function or audit assignment. The audit charter or engagement letter should be reviewed periodically to ensure the purpose and responsibilities have been documented. What are contents of the audit charter?

1. Initial planning
   1. Knowledge of the business

Here, the auditor seeks to understand the business- the management, the industry it operates in, the culture, and the tone at the top. Among the sources for such information include interviews with management and employees, management accounts, review of policy manuals for the organization, e.t.c.

* 1. Risk assessment

Risk assessment is a technique used to examine auditable units in the audit universe and select areas for review to include in the annual plan that have the greatest risk exposure. The auditor should use an appropriate risk assessment technique or approach in developing the overall audit plan and in determining priorities for the effective allocation of audit resources. The auditor should perform a risk assessment to provide reasonable assurance that all material items will be adequately covered during the audit. Audit strategies, materiality levels and resources can then be developed. The audit program and/or plan may require adjustment during the course of the audit to address issues that arise (new risks, incorrect assumptions, or findings from the procedures already performed) during the audit.

* 1. Overview of general internal control procedures

An auditor must gain an understanding of the general internal control procedures in place. The internal control procedures to be examined will be on areas judged to be at risk of material misstatement (RMM). The review of such internal control procedures must be documented. There are several methods of documenting internal controls, namely:

* Flow charts.
* Narrative notes.
* Internal control questionnaires (ICQs).
* Internal control evaluation checklists (ICEC).

Beyond merely establishing the existence of internal controls, the auditor should seek to know whether the controls have been implemented, and that they are working as they should. Here, among other techniques, an auditor could observe the internal controls in practice. From this overview of general internal control procedures, an auditor is ready to make a detailed audit plan.

1. Preparation of the audit plan/ program

The auditor should plan the audit coverage to address the audit objectives and comply with applicable laws and professional auditing standards. The auditor should develop and document a risk-based audit approach. The auditor should develop and document an audit plan that lists the audit detailing the nature and objectives, timing and extent, objectives and resources required. The auditor should develop an audit program and/or plan and detailing the nature, timing and extent of the audit procedures required to complete the audit.

1. Accounting systems review.
2. Considering ways to gather audit evidence.
3. Substantive tests- Substantive Analytical Review Procedures (ARPs) and tests of details (Transaction level procedures).
4. Compliance tests: Review of financial statements (Compliance with standards, material misstatements, legal requirements).
5. Audit report- Format of report, Opinions expressed- Qualified, unqualified, adverse and disclaimer.

**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.

**(In the assignment, you will research on factors that may erode independence of an auditor, and ways of enhancing auditors’ independence)**

**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.

**REASONABLE ASSURANCE   
what is reasonable assurance?**

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

**How reasonable assurance is achieved?**

It is achieved by obtaining audit evidence.

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

**Audit Risk and Materiality**

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

**Responsibility for the Financial Statements:**

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

**AUDIT RISK AND MATERIALITY**

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

**Audit Risk**

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