AUDITING BOOK

ACCOUNTING PROFESSION OPTION

for Rwandan Schools

Senior 6 Student Book

EXPERIMENTAL VERSION

Kigali, 2023

FOREWORD

Dear Student,

Rwanda Basic Education Board (REB) is honoured to present Senior 6 Auditing book for the students of **Accounting Profession Option,** which serves as a guide to competence-based teaching and learning to ensure consistency and coherence in the learning of the Auditing. The Rwandan educational philosophy is to ensure that you achieve full potential at every level of education, which will prepare you to be well integrated in society and exploit employment opportunities.

The government of Rwanda emphasizes the importance of aligning teaching and learning materials with the syllabus to facilitate your learning process. Many factors influence what you learn, how well you learn and the competences you acquire. Those factors include the relevance of the specific content, the quality of teachers' pedagogical approaches, the assessment strategies and the instructional materials available. In this book, we paid special attention to the activities that facilitate the learning process in which you can develop your ideas and make new discoveries during concrete activities carried out individually or in groups.

In competence-based curriculum, learning is considered as a process of active building and developing knowledge and meanings by the students where concepts are mainly introduced by an activity, situation or scenario that help the students to construct knowledge, develop skills and acquire positive attitudes and values.

For efficient use of this textbook, your role is to:

- Work on given activities which lead to the development of your skills;
- Share relevant information with other students through presentations, discussions, group work and other active learning techniques such as role play, case studies, and conduct research;
- Participate and take full responsibility for your own learning;
- Draw conclusions based on the findings from the learning activities.

To facilitate you in doing activities, the content of this book is self-explanatory so that you can easily use it yourself, acquire and assess your competences. The book is made of units as presented in the syllabus. Each unit has the following structure: the unit title and key unit competence is given and it is followed by the introductory activity before the development of Auditing concepts that are connected to real world of economic environment.

The development of each concept has the following points:

- Learning activity which is a well set and simple activity to be done by students in order to generate the concept to be learnt;
- Main elements of the content to be emphasized;
- Worked examples; and
- Application activities to be done by the user to consolidate competences or to assess the achievement of objectives.

Even though the book has some worked examples, you will succeed on the application activities depending on your ways of reading, questioning, thinking and handling calculations problems not by searching for similar-looking worked out examples.

Furthermore, to succeed in Auditing you are asked to keep trying; sometimes you will find concepts that need to be worked on before you completely understand. The only way to really grasp such a concept is to think about it and work-related problems found in other reference books.

I wish express to my sincere appreciation to the people who contributed towards the development of this book, particularly, REB staff, ICPAR officers and OAG officer, development partners, Universities Lecturers and Secondary School Teachers for their technical support. A word of gratitude goes to Secondary Schools Head Teachers, Administration of different Universities (Public and Private Universities) and development partners who availed their staff for various activities.

Any comment or contribution for the improvement of this textbook for the next edition is welcome.

Dr. MBARUSHIMANA Nelson

Director General, REB.

ACKNOWLEDGEMENT

I wish to express my sincere appreciation to the people who played a major role in the development of this Auditing book for Senior 6 students in Accounting Profession Option. It would not have been successful without active participation of different education stakeholders.

I owe gratitude to ICPAR, OAG, different universities and secondary schools in Rwanda that allowed their staff to work with REB in the in-house textbooks production initiative.

I wish to extend my sincere gratitude to Universities Lecturers, Secondary school teachers and staff from different education partners whose efforts during writing exercise of this book were very much valuable.

Finally, my word of gratitude goes to the Rwanda Basic Education Board staff who were involved in the whole process of in-house textbook elaboration.

Joan MURUNGI

Head of CTLR Department

ACRONYMS AND ABBREVIATIONS

ACCA	: Association of Chartered Certified Accountants
AGM	: Annual General Meeting
AICPA	: American Institute of Certified Public Accountants
AR	: Audit Risk
CAATs	: Computer-Assisted Audit Techniques
CPA	: Certified Public Accountants
CR	: Control Risk
DR	: Detection Risk
FIFO	: First In First Out
FRW	: Rwandan Francs
GAAPs	: Generally Accepted Accounting Principles
GDN	: Goods Delivery Note
GRN	: Goods Received Note
HR	: Human Resources
IAASB	: International Auditing and Assurance Standards Board
IAS	: International Accounting Standards
ICEQs	: International Control Evaluation Questionnaires
ICMA	: International Capital Market Association
ICPAR	: Institute of Certified Public Accountants of Rwanda
ICQs	: International Control Questionnaires
ICS	: Internal Control System
IFAC	: International Federation of Accountants
IOU	: I Owe You
IR	: Inherent Risk
ISQC	: International Standards on Quality Control
IT	: Information Technology
NSR	: Non-Sampling Risk
OAG	: Office of Auditor General
PIE	: Public Interest Entity
PPE	: Property, Plant and Equipment

R&D : Research and Development

REB : Rwanda Education Board

RQB : Recognised Qualifying Body

RSB : Recognised Supervisory Body

SR : Sampling Risk

SSAP : Statement of Standards of Accounting Practices

TB : Trial Balance

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UNIT 1 FUNDAMENTAL CONCEPTS IN AUDITING

Key unit competence: To be able to explain the fundamental concepts in auditing

Introductory activity

MUKESHIMANA decided to set up a business for selling flowers after S6 Accounting. She got up early in the morning, visited the market, and then set up a stall by the side of the road. She started selling different kinds of flowers. She was able to sell and gain some income from the business. For the first year, everything went well.

However, MUKESHIMANA thought that she could sell more flowers if she was able to transport more to the place where she would sell them. She also knew that there were several other roads nearby where she could sell flowers.To achieve her ambition of selling more flowers; she needed to buy a van and recruit more employees to transport flowers to different selling points.

MUKESHIMANA realized the need for more money to expand her business. Therefore, she requested her rich friend Alex to invest in the business.

Alex found out the potential of MUKESHIMANA's business and decided to invest in it, but he did not want to be involved in the management of the business and bear liablities in case of failure its failure (bankruptcy).

He therefore suggested the following to MUKESHIMANA:

- To establish a limited liability company;
- To be the major shareholders (over 51%) and be entitled for more dividends
- Mukeshimana to be the managing director of the company

At the end of the first year of trading as a limited liability company, Alex received a copy of the financial statements. He noticed that the profit of the company was lower than expected, and this lowered significantly his dividends.

He knew that MUKESHIMANA is being paid salary and she might not give much attention to the performance of the company (making profit for the company).

To have proper understanding of the performance of the business, there was a strong need of Alex to engage the third parties to provide annual assurance services on financial statements of the company.

Referring to the passage above, answer the following questions:

1. How do you call the work done by the third parties appointed?
2. What do you think about the work done by the third parties and the work performed by MUKESHIMANA as managing Director?
3. What are the advantages that Alex will obtain from the work performed by the third parties?
4. Differentiate the work of MUKESHIMANA from the work performed by the third parties.

1.1. Key terms applied in auditing

Learning activity 1.1

Analyze the photos above and answer the questions below:

1. Who is the auditor?
2. How do you call the work performed by the auditor?
3. What are main principles of audit?

1.1.1. Meaning of key terms

a) Audit

An **audit** is an official independent examination of the accounts or accounting systems of an entity.

Audit is defined as an independent examination of books of accounts and vouchers of business with view of forming an opinion/ judgment as to whether these have been kept properly according to the company's Act and as to whether or not the statements present a true and fair view of the financial position of a business.

An audit is an exercise that auditors carry out in order to be able to give the statutory opinion whether financial statements give a true and fair view.

An audit is an independent examination and expression of an opinion on a set of financial statements.

b) Assurance

The International Standards on Auditing (ISA) give a definition of an assurance engagement as " one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. "

Assurance means confidence. In an assurance engagement, an 'assurance firm' is engaged by one party to give an opinion on a piece of information that has been prepared by another party.

The opinion is an expression of **assurance** about the information that has been reviewed. It gives assurance to the party that hired the assurance firm that the information can be relied on.

c) Auditor

An auditor is a person who conducts an audit. An auditor is a person authorized to examine and verify the books of account of an organization.

An auditor is a qualified accountant appointed by the shareholders, government, or management of a company to examine independently the financial information.

d) Auditing

Auditing may be defined as the examination of financial statements covering the transactions over a period and ascertaining the financial position of an organization on a certain date in order that the auditor may issue a report on them. It means that the auditing is the application of auditing principles and methods as may be considered as necessary by an auditor.

e) Integrity

An auditor should be straightforward, honest and sincere in his/her approach to his/her professional work.

f) Objectivity

Is not to allow bias, conflict of interest or undue influence of others to override professional or business judgments

g) Professional Independence

The auditor is an agent/watchdog for the shareholders and must be independent of directors and management who look after the interests of shareholders in a company or of the government.

The profession requires the auditor to be independent so as to be able to express a balanced opinion on the accounts presented by the directors to the shareholders whose company he has audited.

h) Professional competence and due care

To maintain professional knowledge and skils at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently in accordance with applicable techniques.

i) Confidentiality

The state of keeping or being kept secret or private, the auditor should not disclose any information to the third party.

j) Professional behavior

Auditor should comply with laws and avoid any actions, which discredit the profession.

k) Planning

Planning is the process of thinking regarding the activities required to achieve a desired goal

l) Impartiality

Is the principle holding that decisions are based on objective evidence obtained during audit, not on the basis of bias or prejudice caused by influence of different interests of individuals or other involved parties.

m) Evidence

During the audit, the auditor can collect the evidence through the working papers. He/she can surround his/her opinion on the audit evidence.

n) Consistency

The consistency principle states that once you decide on an accounting method or principle to use in your business, you need to stick with and follow this method or principle consistently throughout your accounting periods.

o) Legal Frame Work

The business activities may run within the rules and legal formalities. To protect the rights of the interested party, rules must be applied/followed.

p) Working papers preparation

Audit working papers are documents which contain all information gathered from the company audited and show all evidences to help the auditor to prepare the final report and to form his/her opinion.

q) Internal Control

The auditor will examine the accounting system and internal control in operation.

r) Report

Report is the end product of the external audit process or of the performed audit work.

s) Professional skepticism

Professional skepticism is defined in the ISAs as an attitude that includes a questioning mind, being alert to conditions, which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Application activity 1.1

1. What is the meaning of assurance in auditing?
2. Briefly explain the following terms.
   a. Integrity
   b. Objectivity

1.2. Objectives, advantages and disadvantages of auditing

Learning activity 1.2

1. Is it important to know the objectives of audit?
2. What are the objectives of audit you know?

1.2.1. Objectives of auditing

The objectives of audit may be classified into two categories:

a) Primary or principal objectives of auditing

- To determine the accuracy of financial statements or accounts;
- To prove the true and fair view of the company's financial state of affairs;
- To confirm that the proper books of accounts are being kept or not;
- To prepare audit report;
- To confirm the exactitude of final accounts.

b) Secondary or subsidiary objectives of an auditing

- To detect errors;
- To detec frauds;
- To prevent errors;
- To prevent frauds ;
- To assist the client to improve their accounting systems;
- To find out whether the internal control system is working properly or not;
- To advice the management.

1.2.2. Advantages and disadvantages of auditing

a) Advantages of audit

For the shareholders:

- Shareholders are assured that directors and management are acting to the best of their interests ;
- They use audited accounts to determine amount to be paid to dead partner;
- They use audit report to admit a new partner by examining his/her business;
- Audit ensures that regulations and statutory requirements are followed.

For the employees:

- Audit keeps accounting staff vigilant and careful in their work;
- Employees ensure their job security and continuity of good remuneration by the audited company;
- Act as a detective and preventive measure against errors and frauds.

For the state:

- Audited companies ensure the accomplishment of fiscal duties regarding companies (payment of taxes and social contributions);
- The government is assured that public funds are being well used;
- The government ensures continuity of business for the purpose of general interests of the people;
- The state ensures that books of accounts are maintained according to legal requirements and companies Act.

For the management of an enterprise and third parties in general:

- Audit provides assurance and credibility to the accounts for interested parties;
- Third parties not taking active part in the organization are protected;
- Audited accounts minimize disputes between parties;
- Audited accounts are acceptable as the basis of ascertaining tax liability;
- The auditor promotes general management efficiency by advising management.

b) Disadvantages of auditing

- If the auditor has many clients, planning and personnel problems lead to inefficient audit, leaving errors and frauds undetected. Thus, increasing auditor's liability to third parties.
- It is expensive and third parties may not be able to afford it.
- The audit report provides information that may otherwise be confidential to competitors.
- A qualified report may affect the company's credibility with third parties.
- An audit can disrupt the client's (audited company) work.
- Audited figures may be altered (changed) leading to inaccurate opinion.
- May prompt trade unions to demand for higher wages for their employees e.g. in cases of unreasonable reserves.
- An audit can lead to conflict between the internal auditor and management in cases where the internal auditor co-operates with the external auditor.
- Revelations of weaknesses in the management letter or letter of weaknesses may make managers to resign. Thus, leading to apathy in the organization.

Application activity 1.2

1. Explain the advantages of audited accounts to shareholders.
2. What are the primary or main objectives of auditing?

1.3. Types of Audits according to the different classifications

Learning activity 1.3

G&P Partners is an auditing firm, registered in Rwanda to provide an audit and advisory services since 2010. For the year ended 31st December 2021, G&P Partners received the assignement from different clients as follows:

1. On 05th January 2021, G&P Partners singed an engagement letter with Sika Ltd for providing the audit opinion on their financial statements and compliance with company's procedures manuals, rules and regulations. Sika Ltd agreed with auditor also to conduct its audit in every 3 months until the end of the year.
2. On 20th March 2021, during the annual general meeting, Bwiza Ltd appointed G&P Partners as a new auditor to conduct an audit of their annual accounts.
3. On 01st April 2021, G&P Partners signed an engagement letter with office of auditor general to conduct an audit for one of government projects to evaluate whether the project objectives were attained or not and to evaluate whether the transcations passed by the project coordinator were made in economic, efficient and effective manner.

Question

From the above assignment received by G&P Partners, List the types of audits that will be conducted.

1.3.1. Forms of organizations

a) Auditing of a sole proprietorship

This is a form of audit of the accounts of a private individual or sole trader. An auditor is asked to audit the accounts of a private individual or a sole trader. He/she must get clear instructions in writing from his/her client as to what he/she is expected to do i.e. his/her duties, nature of work, scope of work etc and will be clearly defined in the engagement letter.

Advantages of auditing of the accounts of sole trader are:

- Assured that his/her accounts are properly kept or not;
- Audited accounts are helpful in confirming that the profit or loss has been made;

- Sole trader agents are kept vigilant (in the case of consignment);
- Taxes are assessed and paid very well;
- Audited accounts are basis for obtaining bank loans and public markets.

b) Auditing of partnership

The scope and conduct of auditing and rights and duties of the auditors are determined on the basis of the agreement between the firm and auditor (engagement letter). While conducting auditing of partnership firm, the auditor must also consider the partnership Deed.

Advantages of auditing of partnership

- Avoids any financial dispute among partners.
- Third parties are assured that there are no frauds.
- Helps in the valuation of goodwill of a dead partner and incoming partner.
- Expertise of audit contributes to increase profit, better management and compliance with tax laws.

Distinction between auditing of partnership firm and auditing of a limited liablity company

Auditing of partnership	Auditing of limited company
▪ Is not compulsory and is purely voluntary	▪ Is compulsory under the provisions of the company's Act
▪ An auditor doesn't need to be certified unless required under partnership agreement	▪ An auditor must be a qualified, and a practicing certified accountant.
▪ Scope of audit depends on agreement between auditor and patners	▪ Scope of audit is defined by companies Act
▪ Rights and duties, powers and responsibilities are contractual	▪ Rights and duties, powers and responsibilities are statutory
▪ Auditor's reports are issued to the partners	▪ Auditor's reports are issued to the shareholders
▪ Extent of work of an auditor depends on the agreement between auditor and partners	▪ Extent of work of an auditor is as per the provisions of the Company' Act

c) Audit of limited company

An audit of a limited liability company is an examination of the financial statements of a company, such as the income statement, cash flow statement, and balance sheet. Audit provides to investors and regulators the confidence in the accuracy of a corporation's financial reporting.

During the audit of a limited liablty company, it is clarified whether the financial statements are fairly presented and free from material misstatements.

The auditor's role is to examine annual final accounts of the company and make sure they are correct and reliable but not to manage those accounts.

1.3.2. According to the nature of work

a) Private Audit

Private or voluntary audit is that audit which is not legally required. It is conducted in line with the agreement between the auditor and the client (audited company), and is not governed by any particular law.

This audit is conducted to obtain an audit report for the use by different users of the financial statements(management for an organization, investors, employees etc...).

The private audit includes the audit of sole trader, and audit of partnership. The contract (engagemennt) between auditor and his/her clients is important because:

- It defines the scope of audit;
- It is the basis of charging the audit fees;
- It is the basis of the information to include in the report;
- It serves as an evidence;
- It protects both parties;
- It prevents misunderstanding between parties;
- It is legal binding;
- It specifies the rights and duties of both parties;
- It can be used to solve disputes between parties;
- It minimizes risks;
- It outlines expectation for both parties.

b) Statutory Audit

Statutory audit is the audit conducted under the provisions of the companies Act.

Distiction between statutory audit and private audit

Statutory audit	Private audit
▪ It is mandatory. ▪ It is regulated by the law. ▪ It is compulsory. ▪ The appointment of auditor is done in line with the provisions of company's Act. ▪ The report is addressed to members/shareholders. ▪ The scope of the auditor's work is defined by the provisions of company's Act. ▪ The auditor is independent of all parties to the company. ▪ The auditor's rights and duties are defined within the provisions of company's Act and cannot be limited by any party. ▪ The auditor is liable to third parties. ▪ The auditor will perform pure audit work.	▪ It is not mandatory. ▪ It is not regulated by the law. ▪ It is not compulsory. ▪ The appointment of auditor is done privately. ▪ The report is addressed to the owners or management. ▪ The scope of auditor's is determined by the agreement between the auditor and the client. ▪ The auditor's independence will be limited by the client. ▪ The auditor's rights and duties can be limited by his client or suspended. ▪ The auditor may not be liable to third parties. ▪ The auditor may do both accounting and audit work.

Similarities between statutory and private audits

- In both audits, the auditor's duties and scope of work can be increased by the client.
- In both audits, the auditor earns the audit fee.
- Both audits are conducted at the end of the year when the records have been balanced and closed off.
- In both audits, the auditors apply similar techniques and audit tests.
- Both auditors might be the members of professional accountants' body like ICPAR, ACCA, and IFAC.
- In both audits, valuable advice is provided to the client at the end of audit work.
- Both audits are used as basis for decision-making.
- Both safeguard company's assets.

- In both audits, the auditors issue audit reports.
- Both audits are concerned with the review of the activities of the company.
- They are concerned with the preventive measures against errors and frauds.
- They are concerned with the strength of the ICS.

c) Internal Audit

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

The report of internal audit is used by the management for the improvement of internal control system.

The internal auditor carries out checking work throughout the year. Although, he/she is an employee of the organization, he/she is given some form of independence in order to perform his/her duties as required.

d) External Audit

An external audit is an objective examination by an auditor to examine the company's books of accounts and determine if the company's financial statements are fair and true. An auditor also determines if the company follows accounting standards and systems. An independent auditor reviews the accounts and provides the reassurance and transparency to the company›s shareholders about the correctness of the accounts.It makes the company and its financial statements more credible and respected.

External audit is conducted by an independent auditor who is not an employee of the organization.The external auditor is appointed by owners of a business andby the shareholdres in a case of a limited company.

The main purpose of external audit is to provide an audit report on financial statements audited. The audit report is used by the shareholders and third parties like bank managers, creditors, and income tax authorities.

Differences between Internal Audit and External Audit

Internal Audit	External Audit
▪ It is conducted on behalf of the management. ▪ It is not regulated by any statutes or Act. ▪ It is a kind of continuous exercise; ▪ It is conducted by any competent accountant. ▪ It is conducted by an employee of the company. ▪ It is aimed at strengthnning the company's ICS. ▪ Its scope is determined by the management. ▪ The repot is strictly used by the management. ▪ It is not a legal requirement to a business; ▪ It is conducted as part of the company's routine work. ▪ The internal auditor cannot be liable to third parties.	▪ It is conducted on behalf of shareholder or government . ▪ It is conducted according to the requirement of the companies Act. ▪ It is conducted periodically or once a year at financial year end. ▪ It is conducted by a qualified auditor according to the companies Act. ▪ It is conducted by an independent professional. ▪ It is aimed at proving the true and fair view of the state of affairs. ▪ Its scope is determined by the companies Act. ▪ The report produced is used by the owners and third parties. ▪ It is a legal requirement for all limited companies. ▪ It is conducted to assess the company's performance. ▪ The external auditor may be liable to third parties.

Differences between an internal Auditor and External Auditor

Internal Audit	External Audit
▪ He/she is an employee of the company . ▪ He/she reports to the management ▪ He/she is not liable for professional misconduct. ▪ The scope of his/her work is determined by the management	▪ He/she is an independent contractor who is an external party to the company. ▪ He/she reports to the owners or shareholders or government. ▪ He/she is liable for professional misconduct. ▪ The scope of his/her work is determined by statute,i.e.Companies Act.

▪ He/she is not liable for damage by third parties. ▪ He/she perfoms continuous audits which are assessment of the company's control. ▪ His/her job is to assess the efficiency of the company as an aid to the better management. ▪ He/she is paid a salary determined by the management. ▪ He/she has no right to attend an Annual General Meeting. ▪ He/she can be removed by the management. ▪ His/her independence during the course of his/her work may be limited by the management. ▪ He/she is appointed by the management. ▪ His/her report is used only by the management. ▪ His/her report may be ignored by the management.	▪ He/she is liable for damages to third parties who suffer loss as aresult depending on his/her report to make a decision. ▪ He/she perfoms final audits. ▪ His/her main duty is to assess the true and fair view of the company's performance. ▪ His/her remuneration is determined by the board of directors, shareholders or registrar. ▪ He/she has a right to attend an AGM. ▪ He/she can be removed only by shareholders or government. ▪ His/her independence cannot be limited by whatever party. ▪ His/her appointment is as per the Companies Act,i.e. Board of directors,Shareholders and Registrar of Companies. ▪ His/her report is used by shareholders and third parties. ▪ His/her report is taken seriously by all parties.

1.3.3. According to the time

a) Final audit (periodic/Detailed/Complete Audits)

It is conducted at the end of the financial period when accounts have been closed off, and financial statements have been prepared and approved.

Advantages of final Audit

- Chances of figures being changed are minimal.
- It is flexible as the auditor can prepare good programme to cover all areas well.
- It is very ideal for small business whose transactions are few and can be audited at one sitting.
- It is not expensive.
- This audit does not interrupt the client's work.
- It eliminates notes taking which are a phenomenon of other audits.

Disadvantages of final audit

- The delays may occur if there is large volume of work.
- The frauds and errors are discovered after the close of the year. Sometimes, it is too late to rectify or take preventive measures.
- As the financial periods of most of the clients end on the same date , it becomes difficult for the auditor to deploy audit staff adequately.

b) Interim Audit

Interim audit is conducted to a particular date within the accounting period. It is conducted within the accounting period usually half yearly. It is a kind of audit which is conduted between the two periods or during transitional period. It is aimed at assessing the company's performance in order to pay interim dividends.

Advantages of interim audit

- It facilitates completion of the final audit.
- Errors and frauds can be more quickly found and detected during the course of the year.
- It is ideal for situations under which the company is required to publish figures for purposes of paying interim devidend.
- It is less expensive than continuous audits because the auditor will spend less time in the company in interim audit.
- It has a moral effect on the staff of the client in that they will be upto date .

Disadvantages of Interim audit

- Figures already audited can be changed/altered after this audit.
- It will interrupt the client's work as his/her books will be taken away for the purpose of audit.
- It involves a lot of notes taking.
- The client's staff may develop the habits of depending upon the audit's staff to solve their accounting problems.
- Since it is aimed at the declaration of interim dividends, the management may manipulate the accounts to show more profits so as to declare better dividend which will amount to a big fraud.
- This means additional work.

c) Continuous Audit

It is that audit which involves detailed examination of the books of accounts at regular intervals of 1, 2 or 3 months. Continuous audit is applied where:

- Financial businesses whose transactions must be up to date to prevent errors and frauds;
- The number of transactions are too numerous to audit at the end of the year;
- There are no satisfactory internal control systems; in risky businesses where decision making has to be made timely and accurately;
- It is desired to present the accounts just after the end of the financial year for example in banks;
- The statement of accounts is required to be presented to the management after every month or each quarter;
- There is no satisfactory internal control system in operation.

Advantages of continuous audit

- Easy and quick discovery of errors.
- Quick presentation of accounts.
- Moral check on staff.
- Keeps client's staff regular.
- Audit staff can be kept regular.
- Efficient audit.

Disdvantages of continuous audit

- Alteration of figures.
- Altered by dishorest clerk.
- Dislocation of client's work.
- This method is expensive.
- It involves extensive note taking so as to avoid alteration of figures.

Distinction between continuous audit and Interim audit.

Internal Audit	External Audit
▪ The work of audit is carried on up to any date according to the convenience of the auditor and his/her client.	▪ The work of audit is up to a definite date according to the instruction of the client.
▪ The verification of assets and liabilities is done after the balance sheet has been prepared at the end of the accounting period.	▪ The assets and liabilities are verified when such audit is conducted.

▪ No trial balance is prepared. ▪ The object is not to know the profit and loss.	▪ The trial balance has to be prepared and checked. ▪ The interim audit is conducted with the object of finding the profit or loss.

1.3.4. According to the method of approach

According to the method of approach ,various types of audits are:

a) Procedural audit

A procedural audit is an examination and review of the internal procedures and records of an organization in order to ascertain their accuracy and reliability.The main purpose of this audit is to ascertain whether the internal procedures are reliable or not.

Advantages of procedural audit

- This audit will provide a feedback to the management.
- The audit will reveal which procedures are outof dated and uneconomical and which calls for replacement.
- It will identify the strength or weakness in ICS.
- It will reveal the management weakness in supervising the company's operations.
- It will ensure co-ordination of the company's operations which may boost its profitability.
- It will reveal whether procedures in accounting department are working propely or not.

Disadvantages of procedural audit

- It may be a very expensive audit.
- It may be frustrated for the management.
- It may mean duplication of effort if the same procedures are examined in the final audit.
- This type of audit may be tedious in particular if the company has numeruos procedures.

b) Management audit

Management audit is an independent and systematic analysis and evaluation of a company's overall activities and performance. It is a valuable tool used to detremine the efficiency,functions,accomplishments and achievements of the company.

The purpose of this audit is to prepare a report on the effectiveness of the management from the point of view of the profitability and efficient running of the business.

Advantages of management audit

- It will improve the quality of the management in the business.
- It will identify how decisions are made in a business.
- It will reveal the weaknesses of the management.
- It will reveal the efficiency of budgetary system and its management.

Disadvantages of management audit

- It may lower the morale of top management.
- It is not possible for the mangement and audit staff to reveal their inefficiencies during the auditor's presence and this may lead to a biased report.

c) Vouching Audit

Vouching audit is that audit where the auditor checks each and every transaction right from the origin in the books of prime entry till they are posted and the final accounts are prepared from the amounts posted.

d) Balance sheet audit

The term balance sheet audit means verification of the value of assets,liabilities,the balances of reserves and provisions and the amount of profit earned or loss incurred by a business during the year.

The balance sheet items are verified by checking the following;

- Description
- Ownership (recording of items)
- Net Book Value (NBV=cost less totaldepreciation)
- Existence (physical existence of the asset)

Advantages of a balance sheet audit

- Less expensive because it only checks the balance sheet items.
- Results in a balanced opinion because the balance sheet contains the most important items the auditor's report is based on.
- Chances of changing figures after the audit are minimal.

Disadvantages of a balance sheet audit

- It is partial audit and not therefore suitable to limited companies.
- It is only applicable to companies with a strong internal control system.
- If undertaken for a limited company, it may increase the auditor's liabilities because it covers a limited area.

e) Standard audit

This is a type of audit, which is conducted to ascertain whether the client accounting system complies with the required levels of standards set by the professional bodies.

These may include:

- Statement of standards of accounting practices (SSAP);
- International Accounting Standards (IAS);
- Generally Accepted Accounting Principles (GAAPs).

1.3.5. According to the public sector's audit

Main Objective

The main objective of public sector's audit is to provide assurance to parliament, the government and the public that government departments, ministries and agencies are operating and accounting for their performance in accordance with the Act of Parliament, the relevant regulations and public interests.

The three main types of public sector's audits

a) Financial audit

It focuses on determining whether an entity's financial information is presented in accordance with the applicable financial reporting and regulatory framework.

This is accomplished by obtaining sufficient and appropriate audit evidence to enable the auditor to express an opinion as to whether the financial information is free from material misstatement due to fraud or error.

b) Performance audit

It focuses on whether interventions, programs and institutions are performing in accordance with the principles of the economy, efficiency and effectiveness and whether there is room for improvement.

Performance audit is executed against suitable criteria, and the causes of deviations from those criteria or other problems are analyzed.

The aim is to answer key audit questions and to provide recommendations for improvement.

c) Compliance audit

It focuses on whether a particular subject matter is in compliance with identified criteria obtained from laws and regulations. Compliance auditing is performed by assessing whether activities, financial transactions and information are, in all material respects, in compliance with the existing laws and regulations governing the audited entity.

Application activity 1.3

1. Explain the following types of audits according to the time factor.
   a. Final audit
   b. Interim audit
   c. Continuous audit
2. Give the advantages and disadvantages of procedural audit.

1.4. Investigation

Learning activity 1.4

Analyze the photos above and answer the follow questions:

1. What do you see on the image above?
2. Differentiate these persons according to their work

1.4.1. The difference between auditing and investigation

a) The meaning of investigation

Investigation is an act that involves the examination of accounts and the use of accounting procedures to discover financial irregularities and to follow the movement of funds and assets in and out of organisations.

Investigation is an inquiry commissioned by a client for some purpose. Investigating is a kind of special audit with a limited or extended scope according to the purpose for which it is conducted.

b) Difference between auditing and investigation

Auditing	Investigation
▪ It is an examination of the books of accounts and vouchers of a business .	▪ It involves a searching inquiry into the company's affairs.
▪ It covers one financial period.	▪ It may cover more than one financial period.
▪ It is conducted for the owners of the business(shareholders).	▪ It may be conducted on behalf of shareholders,but generally it is conducted on behalf of outsiders.
▪ It is usually restricted to the books of accounts.	▪ It is not limited to any area.
▪ It is conducted to prove the true and fair view.	▪ It is conducted to investigate the extent of a fraud.
▪ It is conducted by a qualified auditor according to the companies Act.	▪ It is conducted by any competent professional e.g. Lawyer,tax assessors.
▪ It is conducted without suspicion.	▪ It is conducted where there is suspicion of a fraud.
▪ It is a legal requirement for all limited companies.	▪ It is not a legal requirement for the business.

1.4.2. Characteristics and reasons of investigation

a) Characteristics of investigation

- Investigation is an enquiry.
- Investigation implies systematic and critical examination of accounts and records of a business enterprise for a specific purpose.
- It is conducted for a specific purpose (suspicion).

- Its specific purpose may be evaluated of state of affairs or establishment of a fact.
- Conducted for a non-fixed period (any time) and any person (police, lawyers, consultants, etc.) and describes a fact not an opinion.

b) Reasons for investigation

Investigation is carried out due to the following reasons:

Purchase of a company

When an individual is interested to purchase a business, he/she can appoint an accountant of his/her choice to carry out investigation in respect of business which he/she wants to purchase. The main purpose of this investigation is to find out the details about this purchase. If the investigation report is in favor of this business, then it can be purchased.

Admission of a new partner

An investigation may arise, either on behalf of a person intending to bring capital in order to become a partner, or for the existing proprietors who intend to take in a partner. If the investigation is arranged by the prospective partner. The main purpose will be to ascertain whether to become a partner is beneficial or not. In this case, investigation will be similar as in the case of a purchase of a business.

Fusion of the companies (Acquisition of a Merger)

Mergers mean to convert two or more business enterprises into one unit. In this case, one business enterprise can acquire the assets or shares of another enterprise. The most important term that must be negotiated in a merger arrangement is the price the acquiring firm will pay for the acquired business. In mergers or fusions, a larger firm generally takes over a small one and assumes all management control.

Before the merger of two or more business enterprises, investigations are carried out through some accountants by the firm, which intends to acquire other firms.

The main purpose of these investigations is to find out the details about financial position of the other businesses.

Prospecting of the investments (Prospective investment)

Some individuals or firms might be interested to make some investments in the form of shares or debentures of other companies. In order to make their decisions, they want to know the details about the financial standing of those companies. For this purpose, they can arrange some investigations through some accountants.

Prospecting of a loan or investigations on request for loans (Prospective lending)

Some banks carry out some investigation before advancing loans to some business enterprises. Similarly, some suppliers need independent investigation's reports before granting credit facilities to their clients.

Suspicion of fraud or fraud investigation (Fraud)

Investigations are carried out on the instructions of management to detect fraud if the behavior of some employee is suspicious. If the fraud is concerned only with the section of the work e.g. the entry of dummy workmen on a wages sheet by one clerk, the extent of the investigation should be restricted to that one section.

On the other hand, if misapplication of cash is the result of collusion between two or more employees then the investigation can be extended to various sections or departments of the organization.

Legal or statutory investigation

Investigation conducted to satisfy some legal requirements. The following cases indicate when a legal investigation can be conducted:

- An investigation by the liquidator of a company where directors are suspected of fraud regarding the affairs of the company;
- An investigation by a trustee in a bankruptcy where the bankrupt is suspected of having acted fraudulently in the past.

c) Steps of investigation

- Determine the scope/objectives of investigation.
- Planning the investigation (Formulate investigation program).
- Establishment of the fields of application (by examining or studying various records).
- Analysis and interpretation of findings/results.
- Preparation of the investigation's report/writing of the investigation report.

d) Report of investigation.

On the completion of investigation, the report is submitted to concerned parties. The report submitted in respect of an investigation should cover the following points:

- Reference to instruction given by the client;
- Reference to basic documents covering information obtained;

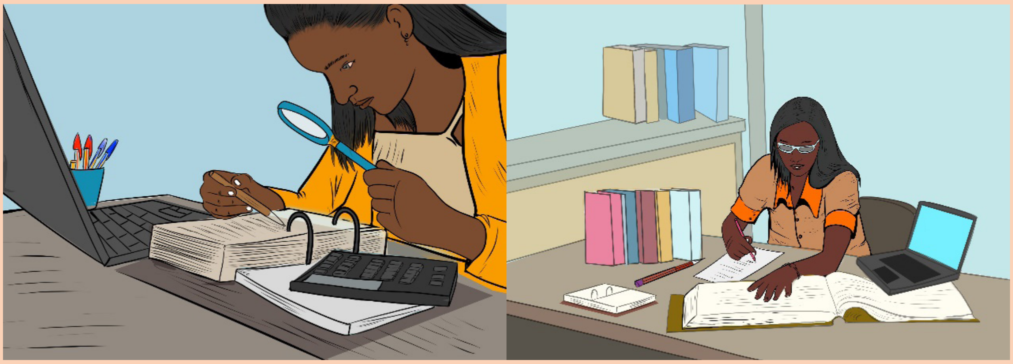
- General outline of the work done;
- Summary of information obtained;
- Recommendations in accordance with information obtained.

Application activity 1.4

1. The scope of investigation is very large than the scope of accounting. State some areas in which investigation should be applied.
2. What are the steps of investigation?

1.5. Auditing and acccounting

Learning activity 1.5



1. Observe carefully the pictures above and establish the difference among them.

1.5.1. Difference between auditing and accounting

Accounting	Auditing
▪ It involves preparation of books of accounts. ▪ It is a continuous process during the financial period. ▪ It is not conditionned. ▪ It is conducted without vigilance.	▪ It is an independent examination of books of accounts. ▪ It is conducted usually at the end of the period. ▪ It is conditionned on prepared books of accounts. ▪ It is conducted with vigilance.

▪ In accounting, the work is conducted without independence.	▪ It is conducted independently.
▪ It is essential to all businesses.	▪ It is a statutory requirement for all limited companies.
▪ It is conducted by an accountant.	▪ It is conducted by a qualified auditor.
▪ It involves a tedious process of preparing the accounts.	▪ It is conducted in form of final touches to what has been prepared by the accountant.

1.5.2. Benefits and limitations of an audit

a) Benefits of an audit

- The shareholders of a company are given an independent opinion as to the true and fair view of the accounts that have been prepared by management.
- The use made by third parties such as suppliers and banks adds confidence in the performance of a company.
- While not responsible for detecting fraud, the very fact that an audit is carried out and may uncover evidence of fraud, can help to mitigate against such risks.

b) Limitations of an audit

- Every item is not checked. In fact, only test checks are carried out by auditors.
- Auditors depend on representations from management and staff.
- Evidence gathered is persuasive rather than conclusive.
- Auditing is not purely an objective exercise. Judgments have to be made in a number of areas.
- The timing of an audit.
- An unqualified audit opinion is not a guarantee of a company's future viability, the effectiveness and efficiency of management, nor that fraud has not occurred in the company.

Application activity 1.5

1. You are a shareholder in AKARABO Co.Ltd. What are the benefits could you get from an audit?
2. Explain the limitations of an audit

Skills lab activity 1

Using two learning groups, one being as an accountant and another as an auditor. Students visit library and pairs exchange roles as the teacher supports accordingly. Let students present their views on the similarities between auditing and accounting.

End unit 1 assessment

1. Write short notes on the following:
   a. Statutory Audit
   b. Private Audit
   c. Interim Audit
2. Explain the term continuous audit and outline its advantages and disadvantages.
3. What are the types of audits according to the time factor?
4. Give the difference between Auditing and Accounting
5. Explain the following principles of auditing:
   a. Objectivity
   b. Professional Independence
6. What are the elements of an investigation report?

UNIT 2 LEGAL AND PROFESSIONAL REQUIREMENTS

Key unit competence: To be able to describe the legal and professional standards required for an auditor

Introductory activity

MURENZI has recently completed his Certified Public Accountant (CPA) course and got an offer in KM audit firm. On his first audit assignment, the audit Partner instructed him to observe the auditing standards and professional ethics. Further, he was requested to carry out his engagement with due diligence and be able to mitigate any ethical threats/ challenges. Given that it was his first engagement assignment, he was not sure about the professional and legal requirements of the auditors. Furthermore, he did not know the ethical threats partaning to the profession of auditing and their mitigation strategies.

In response to his problem, the auditor decided to consult the senior auditor KEREKEZI with whom deployed to carry out the audit of BETA Co Ltd financial statements for the period ended 31 December 2020, prepared in conformity with common rules. MURENZI got ample explanations from the colleague. Thereafter, he started the audit and the audit was done as guided by the audit partners. The auditor conducted the audit in conformity with international standards on auditing, local requirements, and observed the professional requirements.

Questions

1. Why is it necessary for an auditor to comply with national and international regulations on auditing?
2. In case the auditor does not comply with national and international regulations on auditing, what happens?

2.1. Audit standards

Learning activity 2.1

INEZA BAKERY produces different products from wheat flour like bread, cakes etc. it has records of financial transactions. The management of this bakery needs the help for checking if their records are accurate according to General Accepted Accounting Principles.

1. As students in S6 Accounting, what do you think could be the International Standards on Auditing that would applied while checking the financial records of INEZA BAKERY?
2. What are the fundamental principles of ethics that you must fulfil in order to become a member of professional body like ICPAR/IFAC?

2.1.1. International standards on auditing

a) Meaning of International Standards on Auditing (ISAs)

International standards on auditing are professional standards for the performance of financial audit of financial statements.

b) Structure of International Standards

The International standards are structured as follows:

- **Introduction:** includes the purpose, scope and subject matter of the ISA plus the responsibility of the auditor.
- **Objective:** consists of a clear statement of the ISA's objective in relation to the audit area that the ISA addresses.
- **Definitions:** of applicable terms used in the text.
- **Requirements:** clearly stated as 'the auditor **shall…'**
- **Application and other explanatory material:** more precise explanations of what requirements mean or are meant to cover.

These standards are issued by International Federation of Accountants (IFAC) through the International Auditing and Assurance or guarantee Standards Board (IAASB). ISAs are mandatory in some jurisdictions for the audit of company's accounts.

c) Process of setting Standards

- The IAASB identifies new developments.
- The IAASB appoints a task force to draft a standard.
- Consultation takes place.
- An "exposure draft" is produced; essentially a draft standard issued welcoming comments from the profession and any other interested party.
- The task force considers comments and may make amendments.
- The Standard is finalised and formally approved by the IAASB.

Examples of international standard on auditing

- IAS200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
- IAS210: Agreeing the Terms of Audit Engagements
- IAS230: *Audit Documentation*
- IAS500: Audit evidence
- IAS530: Audit sampling
- IAS700: Forming an opinion and reporting on financial statements

2.1.2. Ethical duties of auditors according to International standards on auditing

The IESBA Code of Ethics provides ethical guidance for members in its five fundamental principles such as: **integrity, objectivity, professional competence and due care, confidentiality** and **professional behavior.**

a) Fundamental principles of ethics

All members and students must comply with these five fundamental principles set out in IESBA Code of Ethics.

- **Integrity**: to be straightforward and honest in all professional and business relationships.
- **Objectivity**: Not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.
- **Professional competence and due care:**
  - To attain and maintain professional knowledge or skills at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation.
  - To act diligently in accordance with applicable technical and professional standards.

- **Confidentiality:** To respect the confidentiality of information acquired as a result of professional and business relationships.
- **Professional behavior:** to comply with relevant laws and regulations and avoid any action that the professional accountant knows or might discredit the profession.

Compliance with the fundamental principles may potentially be threatened by a broad range of

Circumstances. The IESBA Code of Ethics categorises them as follows:

- **Self-interest** (e.g. financial interests, concern over employment security)
- **Self-review** (e.g. decisions made and reviewed by same person)
- **Advocacy** (not improper provided it does not result in misleading information)
- **Familiarity** (e.g. long association, acceptance of gifts)
- **Intimidation** (e.g. threat of dismissal)

Possible safeguards to above threats of independence are:

- Setting the internal rules that for example no partners or staff have shares in audits client ;
- Setting client acceptance procedures ;
- Carry out an annual review of independence both for the whole firm ;
- Do a consultation procedure in case of doubt ;
- Second partner review of certain client ;
- Rotation of the engagement partner or rotation of senior auditor staff.

b) Specific guidance and notes

The IESBA Code of Ethics states that independence requires independence of mind and independence in appearance. In other words, the auditor must be, and must be seen to be independent.

- **Independence of mind** is the state of mind that permits the provision of conclusions without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
- **Independence in appearance** is the avoidance of facts and circumstances that are so significant a reasonable and informed third party would be likely to conclude that a firm's, or audit and Assurance team members, integrity, objectivity or professional scepticism have been compromised.

It is very important that the auditor is **impartial** and **independent** of management, so that he/she can give an objective view on the financial statements of an entity. The responsibility is always on the auditor not only to be independent but also to be seen to be independent.

Application activity 2.1

1. You are appointed as the auditor of XY Company. What are the main principles of ethics you need to observe during the audit?

2.2. Auditor of the company

Learning activity 2.2

Suppose you are the auditor of Star Ltd located at Nyagatare District and you have a neighbour who has new business. He/she wants to know the main responsibilities of an auditor. Help him/her to answer the following question:

1. What do you think could be the responsibilities of the auditor of Star Ltd Company?

2.2.1. Duties, obligations and rights of an auditor

a) Duties of an auditor

An auditor has to:

- Make a report to shareholders, ownersor government (for external auditors)
- Make a report to the management (for internal auditors).
- Assist in investigation.
- Certify that whether loans are properly secured and not at terms prejudicial to the interest of shareholders.
- Certify whether transactions conducted by the company are not prejudicial to the interest of shareholders.

b) Obligations of an auditor

An auditor must:

- Pass an approved set of professional examinations, set by a Recognised Qualifying Body (RQB) e.g. the ACCA, CPA, CA;

- Become a member (and stay member) of a Recognised Supervisory Body (RSB) e.g. ACCA, ICPAR;
- Not to be a director or employee of the company, or of any associated companies;
- Not to be an employee or business partner of a director or employee of the company or of any associated companies.

c) Auditor's rights

The auditors have powerful rights to:

- Access to all records needed (the books of the organisation at any time);
- Receive information and explanations of all transactions;
- Call for information and explanations from employees, managing agents, company secretaries, etc;
- Attend and receive notice (within 21 days) about general meetings and they have right to speak at general meetings on relevant matters;
- Visit the company's branches;
- Take a legal and technical advice;
- Remuneration;
- Sign the audit report.

2.2.2. Auditor's liability

a) Meaning of auditor's liability agreements

Auditor's limited liability agreements are contracts designed to ensure that auditors are not pursued for excessive losses, just reasonable proportion based on their responsibility.

b) Types of auditor's liability

Civil liability of Auditor for negligence: Civil liability is the legal responsibility for a payment to an aggrieved third party, due to the violation of a civil law, tort, or a breach of contract. Therefore, the auditor must exercise reasonable degree of skill and care in the performance of his/her duties.An auditor can be held liable for negligence of his/her duty if it is proved that:

- Negligence in the performance of his/her duty;
- A loss or damage as a result of his/her negligence;
- The loss was suffered by his/her client.

Criminal liability: responsibility for any illegal behaviour that causes harm or damage to someone or something which means open to punishment for a crime.

c) Sources of legal liability for an auditor

- The Legal Liability of Auditors to Third parties;
- Unjustified/unfair Lawsuits;
- Successful Lawsuits against Auditors.

Third parties: can be a person or group besides the two primarily involved in a situation, especially a dispute. Third parties may include any **individual shareholders, potential investors** and **the banks**. In these cases, there is no contract with the audit firm. Therefore, there is no implied duty of care. In order to hold the auditor criminally liable, the following must be proved:

- that the statement made was false in material facts;
- that the auditor wilfully made such a false statement, and;
- That the statement complained of has been made in any return report, balance sheet, certificate or any other document required to be made under any provision of the Companies Act.

It may be stated here that the court has the powers to relieve an auditor either partly or wholly; if a case is proceeding against him/her for negligence, default or breach of duty or trust provided it is satisfied that the auditor acted honestly and reasonably by taking into consideration all the circumstances of the case.

An auditor may be also held liable for damages to third parties, if they have suffered any loss relying on any balance sheet or any financial statement signed by him/her. Such liability arises where there is no direct contractual liability. It may arise in the following cases:

- Where the auditor has been proved negligence and any third party has suffered a financial loss due to negligence of the auditor;
- Where the auditor did not attach a disclaim to this report to the effect that the report was not intended to be relied upon by third parties;
- Where the auditor was made fully aware that third parties were going to rely on his/her report;
- Where the third parties can prove that no other external factors influenced their decision making except the auditor's report;
- Where the auditor owed a duty of care to the third parties;
- Where the auditor gives reference regarding his/her client's credit worthiness;

Although it is difficult to determine to which third parties the auditor will be liable. However, the auditor may be liable generally to the following **third parties**:

- Any person to whom he/she owes duty of care e.g. debtors or creditors of his/her client;

- Persons who may rely on his/her work provided the auditor knew that those persons will rely on his/her work e.g. bank managers, tax authorities etc;
- Any person who is affected due to his/her audit report e.g. the employees of his/her client.

The auditor can take the following steps to minimise the danger of any claim against him/her for negligence work:

- Gather conclusive evidence and supporting documents before passing any entries and drawing an opinion;
- Review the risky audit areas before releasing the final audit report to the shareholders;
- Withdraw his/her consent and give a public notice to this effect after registration of prospectus but before allotment of shares;
- Use well trained and experienced staff during the audit work who will carry out their duties completely;
- He/she should obtain supporting evidence e.g. letters of representation to prove his/her competences;
- Withdraw his/her consent in writing before such a prospectus has been registered and before it is for public use.

Application activity 2.2

Question

1. AMAHORO Ltd is an audit firm located in Bugesera District. It is appointed to audit the industry that manufactures agricultural products. The owner of AMAHORO Ltd asks for assistance on ways of minimising the risks/dangers of any claim against for negligence.

   How AMAHORO Ltd will minimize the risks of negligance?

Skills lab activity 2

Through internet search, students in their learning teams search different cases that can lead the auditor to criminal liabilities and civil liabilities.

End unit 2 assessment

1. What are the components of International Standards on Auditing?
2. Which of the following are not engagement standards issued by the IAASB?

   a) International Standards on Auditing

   b) International Standards on Quality Control

   c) International Auditing Practice Statements

   d) International Standards on Related Services

   e) International Standards on Assurance Engagements

   f) International Standards on Review Engagements
3. Under what circumstances an auditor may be held liable to a third party for negligence.
4. Which cases may lead an auditor to be held liable to criminal offense?

UNIT 3 AUDITOR'S APPOINTMENT

Key unit competence: To be able to describe the procedures for auditor's appointment.

Introductory activity

MODERN BUSINESS enterprise has been operating for ten years in manufacturing business industry. For the last ten years in operation, the business was characterized with high costs and thus affecting its profitability. The business owner thought of seeking advice from the expert.

After the consultation , the owner found it necessary to execute the following:

- Change the business's nature and become a limited liability Company;
- To issue more shares;
- To ensure that the produces are accessible to customers in their respective places;
- To increase the sales turnover;
- To reduce the number of sales staffs and be replaced by the sales agents, that will be provided the commissions on sales made.

After the structuring of the business, a new company named XY ltd and started its operations on 1st Jan 2016. This was followed with the appointed of board members.

Due to the fact that it was its first year of operation as a company, the shareholders were interested to know the performance of the company and thought of hiring an expert to review the financial statements of XY ltd for the period ended 31 December 2016 and give his/her independent opinion.

Questions

1. What is a professional name of a person who examines financial statements and other financial documents on behalf of shareholders?

2. What are procedures of appointing him/her?
3. What should that person consider before accepting the assignment?

3.1. Auditor's appointment procedures

Learning activity 3.1

On the appointment of the auditor, in the general annual meeting of the board of directors, shareholders and the management were discussing the basis under which the auditor of their famous company known as TWUNGANIRANE Ltd, would be recruited. They wanted to set ethical duties, rights and liabilities of their new auditor.

1. What should be the fundamental ethical principles of auditors?
2. What do you think are the rights of an auditor?
3. What are the auditor's liabilities?

3.1.1. Appointment of an auditor

It is a legal requirement of the Companies Act for all Limited Companies to appoint an auditor who will oversee the company's affairs for a given financial period.

a) Conditions and ways of appointing an auditor

- First auditor is appointed after the company's registration by the Board of Directors in 30 days and when fair to do, he/she is appointed by the registrar of companies.
- In case the above auditor is to resign, he/she must give a notice of 28 days in writing to the Board of Directors and for removal he/she is given 28 days.
- At the annual general meeting, the shareholders will have to appoint an auditor-28 days must be given to the out-going auditor in this respect.
- Automatic Appointment
  - If there is no resolution intended to remove the previous auditor, then he/she is automatically reappointed.
  - If the previous auditor does not give a notice of the resigning in writing (of 28 days) then he/she is deemed to be automatically re-appointed.

- If the auditor has not committed any act which disqualifies him/her automatically from being re-appointed.
- If after the annual general meeting, the shareholders disagree on who is to be the next auditor. (If no new auditor is appointed nor do they delegate this duty to the Board of Directors, then 7 days after the annual general meeting the Registrar of Companies will have to appoint a new auditor) assuming that the previous auditor has been removed.
- In addition, automatic re-appointment will be obvious accepted.

If he/she is not qualified for re-appointment e.g. due to misconduct or delays the annual general meeting. If the auditor has given a notice (28 days) in writing of his/her intention/unwillingness to be re-appointed. If a notice for a solution has been given by any one shareholder, intending to appoint someone else then the auditor cannot be automatically re-appointed.

b) Casual Vacancies

A casual vacancy may arise in the auditor's office due to any one of the following situations:

- The auditor's death –Directors will have to fill such a vacancy;
- The auditor is incapacitated, e.g. loss of limbs -Directors can fill such a vacancy;
- A doctor has to give a formal certificate to this effect;
- The auditor's resignation

This can only be filled by shareholders through an Extra Ordinary General Meeting. Explanation why the auditor is resigning is required, if due to disagreement, he/she can be reinstated by the shareholders and directors may be removed.

c) Procedures for appointing an auditor

Advertising

To enhance comply with the company's Act and other requirements in place, recruiting company should advertise for a vacancy of its offer of external auditor. The advertisement should be done through official different medium of communication such as company website, radios, news papers…etc.

Use of logos

A firm /auditor must have a practicing/auditing certificate to qualify him/her as registered auditor. The firm/ auditor's documentations should be designed logos representing him/her.

Tendering

Client companies can change auditors. In this regard, a firm/auditor may be approached to submit a tender for an audit. When approached to tender, an audit firm must consider whether they want to do the work and they must have regard for the ethical considerations, such as independence and professional competence. In addition, they need to consider fees and some other practical issues.

Fees

A member may quote whatever fee is deemed to be appropriate. The fact that one may quote a lower fee than another auditor is not in itself unethical. However, it does raise the risk of a threat to the principles of professional competence and due care in that the fee quoted may be so low as to make it appear to be difficult to perform the audit to the expected standards.

Therefore, it is wise to set out the basis of the calculation of the fee. The following factors should be considered when setting out a fee:

- What does the job involve?
- Is it audit and/or tax or is there some other complicated work involved?
- Which staff will need to be involved, numbers and quality? How long will they be required? Is the nature of the business complex?
- What charge out rates are to be applied?

The practice of undercutting fees has been called lowballing and can be seen in action generally where large audits are concerned. We have seen that having a lower fee may seem to have a negative impact on an auditor's perceived independence but there are other factors to be considered:

- Auditors operate in a market like any other business where supply and demand very often dictate the price;
- Fees may be lower due to reasons such as better internal audit functions;
- Simplified group structures within client companies;
- Auditing firms have increased productivity, whether through the use of more sophisticated IT or experience gained through understanding the client's business.

Other considerations

It is important that the auditor also considers a number of other issues:

- Can the audit assignment be fitted in to the audit firms current work plan?
- Is their suitable audit staff available?

- Will any specialist skills be required?
- What are the future plans for the company?
- Is there any training required for current staff and what will be the cost of that training?
- What work does the client actually want? Audit and/or tax?
- Is this the first time the company has been audited.
- Whether the client is seeking to change its auditors and if so what is the reason behind it?

Submitting an audit proposal

There is no set format. In fact, the client may dictate the format. Whatever the form of the tender submission, the following matters should be included in the proposal:

- The audit fee and the basis for its calculation ;
- An assessment of the needs of the client ;
- How the firm/auditor intends to meet the needs of the client ;
- Any assumptions made to support the proposal;
- The audit approach to be adopted by the firm ;
- A brief outline of the firm;
- Details and background of the key audit staff on the proposed engagement.

Evaluating the tender

Different clients will have different ways of evaluating a tender. Some of the more general points are listed below. It is important to bear these in mind when preparing a proposal:

- **Fee:** This can be the most vital point. Some clients go straight to this figure and do not even bother with the rest of the document.
- **Professionalism:** Auditors are expected to be professional. Remember, the audit team and the tender documents are often the first factors on which a prospective client forms an impression.
- **Proposed audit approach:** Clients are always looking for the least amount of disruption to their already busy schedules, so the shortest number of days on-site may be the key to winning a tender.
- **Personal service**: Fostering relationships is vital. Client should always feel he/she is getting value for money.

Acceptance of the firm/auditor

You have submitted a tender. You have been successful and the client has offered you the tender. Before you accept and commence the audit, you should carry out a number of procedures in order to comply with the provisions in ISQC1.

3.1.2 Acceptance procedures

a) Conditions before accepting the assignment

- Make sure there are no ethical issues that would prevent you from accepting this assignment.
- Make sure that you are professionally qualified to carry out the work requested and that your firm has the resources available in terms of staff, expertise and time.
- Check out references for the directors of the client firm especially if they are unknown to the audit firm.
- Consult previous auditors as a matter of professional courtesy and establish from them whether there is anything that you ought to know about this vacancy.

b) Conditions after accepting the assignment

- Make sure the resignation of the previous auditors has been properly carried out and that the new appointment is valid. A resolution by shareholders of the company is required.
- Submit a letter of engagement to the directors of the client company and ensure it is accepted and signed before any audit work is carried out.

ISQC1 states that a firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it:

- Has considered the integrity of the client and does not have any information that would lead it to conclude that the client lacks integrity,
- Is competent to perform the engagement and has the capabilities, time and resources to do so and
- Can comply with the ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. Where issues have been identified and the firm decides to accept or continue the relationship or a specific engagement, it should document how the issues were resolved.

In short, a firm must:

- Obtain relevant information;
- Identify relevant issues ;
- Resolve issues that are identified, and document that resolution.

c) Integrity of client

Matters to be considered:

- Identity and business reputation of owners, key management and those charged with governance;
- Nature of the client's operations and its business practices;
- Attitude of the owners, key management and those charged with governance towards matters such as aggressive interpretation of accounting standards and the internal control environment;
- Client's attitude to fees;
- Indications of inappropriate limitation in the scope of work;
- Indications that client may be involved in money laundering or other criminal activities.
- Reasons given for non-reappointment of previous auditors.

Information can be gathered through communications with previous auditors or other professionals who may have provided services and through other third parties such as bankers, legal counsel and industry peers. There is also a multitude of relevant databases where one can do some background research.

d) Competence of the audit firm

Matters to be considered:

- Does the firm have sufficient knowledge of the relevant industry and the relevant regulatory environment?
- Are there sufficient personnel within the firm having the necessary capabilities and competence and are experts/specialists available when needed?
- Are competent individuals available to perform engagement quality control reviews?
- Will the firm be able to complete the engagement within the reporting deadline?

Where a potential conflict of interest is identified, the firm should consider whether it is appropriate to accept the engagement.

- Need to consider any significant matters that may have arisen during the current or previous engagements of whatever description.
- SQC1 goes on to state that where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures (on the continuance of the engagement and the client relationship) should include consideration of: The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases,to regulatory authorities, and
- The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Some suggested procedures would include discussing with appropriate client management the appropriate action that the firm might make based on the relevant facts and circumstances. In addition, the firm should document the significant issues, consultations, conclusions and the basis for those conclusions.

3.1.3. Agreeing the terms of engagement

a) Terms of engagement

Once an engagement has been accepted, it is important to agree the terms. It is essential that both parties fully understand what the agreed services are. Any misunderstanding could lead to a breakdown in the relationship and could result in legal action.

ISA 210-terms of audit engagements establishes and provides guidance on:

- Agreeing the terms of an engagement with the client and;
- The auditor's response to a request by a client to change those terms to one that provides a lower level of assurance.

It states that the auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract. The terms should be recorded in writing.

The objective and scope of an audit and the auditor's obligations may be established by law, but the auditor may still find that an audit engagement letter will be informative for their clients. The main points to be clarified in the engagement letter would include:

- Confirmation of the auditor's acceptance of the appointment;
- The auditor is responsible for reporting on the accounts to the shareholders;

- The directors of the company have a statutory duty to maintain the books of the company and are responsible for the preparation of the financial statements;
- The directors are responsible for the prevention and detection of fraud;
- The fact that because of the test nature and other inherent limitations of an audit, there is the unavoidable risk that some material misstatements may remain undiscovered;
- The scope of the audit including reference to appropriate legislation and standards;
- There should be unrestricted access to whatever books and records the auditor needs in the performance of his duties.

Other points to be included:

- Arrangements regarding the planning and performance of the audit;
- The expectation of receiving from management written confirmation regarding;
- Representations made in connection with the audit;
- Request for the client to confirm in writing the terms of the letter;
- The fee to be charged and the credit terms;
- The form of any reports or other communication of results of the engagement;
- On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement;
- An auditor who, before the completion of the engagement, is requested to change the engagement to one, which provides a lower level of assurance, should consider the appropriateness of doing so. Where the terms are changed, both parties should agree on the new terms;

Note, the auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

b) Books and documents

ISQC1 states that the firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.

Unless otherwise specified by law or regulation, engagement documentation is the property of the audit firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Audit working papers belong to the auditor and cannot be taken over by another set of auditors taking over the audit assignment. In practice, the previous auditors provide the new auditors with enough carry over information such as the lead schedules behind the makeup of the financial statements.

The auditor owes a duty of confidentiality to the client, so documents about the client should not be given to third parties unless:

- The client agrees to the disclosure ;
- The disclosure is required by law or court order;
- Disclosure is otherwise in accordance with the rules of professional conduct.

The previous auditors should ensure that all the books and documents belonging to the client are returned promptly. In some cases, the previous auditors are allowed to keep the books where they are exercising a lien. This is a supplier's right to retain possession of a customer's property until the customer pays up what is owed.

Strict conditions that can be enforced:

- The books and documents must actually belong to the client;
- The auditor must have got them by proper means;
- The actual work must have been done and a fee note raised and given to the client;
- The fee must relate to the held documents. Financial statements and tax compliance work belong to the client, even if the auditor/ accountant has prepared them.

Change in auditors

Companies do actually change their auditors. It is important that auditors understand why a company may seek to change their auditor in a bid to prevent this from happening to them.

The following sets out the reasons why this can happen:

Audit fee

- Many companies perceive that an audit has very little value. In turn this makes the audit fee a very sensitive issue;
- The fee may be perceived to be too high. Remember, a lot of audit work may be done off site and the hours charged at the firms office will belong to the managers and partners, so the client might not understand why the fee is so high;

- It may not be seen as good value for money. For example, a client may have important tax work carried out for him. The fee charged may be way lower than that of the audit, probably due to the time involved, yet the client might see the value of this work far greater than that of the audit;
- The current fee might not appear to be very competitive. Other similar firms may be getting audit services for less;
- The client may put the audit out to tender to see whether the price is actually negotiable, even though he may have no intention of changing his auditor;
- The audit fee may breach the recommended level of overall practice fees as laid down by ethics and auditor may have no other alternative but to resign.

Audit firm may not seek re-election

- The auditor may choose not to stand for ethical reasons, such as he/she doubts the integrity of management.
- Conflicts of interest may have arisen such as competition between clients or maybe he/she has been offered some lucrative work by the client and he/she may have to resign the auditor.
- The auditor may have a disagreement with the client such as in the formulation of accounting policies.
- The auditor may simply not want to reduce his/her audit fee.

Problems related to the size of the company

- The company may be growing at such a rate that the audit firm no longer has the necessary resources, staff, time, and expertise, to allow it to retain the audit.
- It is important to apply the principle of professional competence and due care.
- Alternatively, the company may be constricting and it now finds that it can avail of the
- Audit exemption specified under relevant jurisdiction regulations.
- There is very little that the auditor can do in each of these cases.
- With small companies, the audit is almost a personal service. If the relationship breaks down, there may be nowhere to go except discontinue the relationship. Within a big firm with big audit clients, you could simply change the engagement partner.

- As part of the safeguards against the threats to independence, audit rotation was put forward. This is where the audit moves to another firm although in the previous point, rotating to another engagement partner within the same firm will mean the same thing.

Application activity 3.1

1. Go to the library and search in audit books, look on matters the auditor considers related to the integrity of the client.

Skills lab activity 3

Through the search in audit books from the library, make a summary to be presented in the class on the procedures for recruiting/appointing an auditor.

End unit 3 assessment

1. Higlight the procedures for appointing of an auditor?
2. Indicate the main terms of engagement as per ISA 210?
3. Provide the conditions for setting the remuneration of the auditor?
4. What are conditions for accepting the audit assignments?
5. What are conditions of engagement client must respect
6. Write down the main elements of engagement letter?

UNIT 4 | AUDITOR'S REQUIREMENTS

Key unit competence: To be able to describe the auditor's requirements

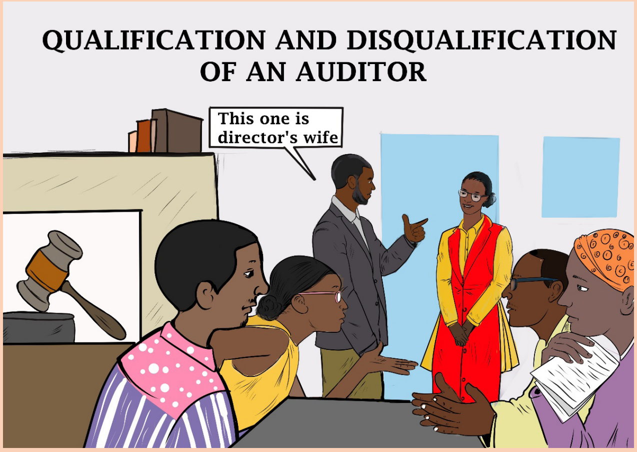
Introductory activity

Observe the above image then answer the following questions:

1. Why is it necessary for an auditor to have rights during the audit work?
2. What can happen to the auditor who does not perform well some of his/ her duties?
3. How do we call the specific characteristics that can allow someone to be an auditor?
4. How do we call the specific characteristics that can't allow someone to be an auditor?

4.1. Qualifications and disqualifications of an auditor

Learning activity 4.1



Observe the image above then answer the following questions:

1. What do you think those people are discussing about ?
2. Is it possible that the Board of Directors can select the manager's wife as an auditor of the company? If Yes or No, explain.
3. What can happen if the Board of Directors decide to select the manager's wife?
4. Are there any sanctions to the auditor who accepts the appointment after knowing that he/she is not eligible?

4.1.1. Qualifications of an auditor

A person to be appointed as an auditor of a company is required to hold some specific qualifications. These qualifications are given in company's Act of the country.

This section answers the following question: "**Who can be an auditor"?** The following are his/her qualifications and requirements:

- To be a member of one or more of the professional bodies which is specified in the first column of the accountants for example ICPAR, ICPAK, ICPAU and ACCA;
- Anyone authorized by the registrar of companies to do so (Should be a holder of a degree in accounting and have been in auditing environment);
- Must have passed a final exam of CPA, ACCA, CA;

- Must ensure that he/she has adherence to professional ethics;
- Must have a post-graduate experience in an auditing environment of not less than two years;
- Must be holding a practicing certificate given by the Professional Accountancy body like ICPAR, ICPAU, ACCA, and ICPAK.

4.1.2. Disqualifications of an auditor

This refers to the question of who cannot be an auditor. The following are parties who cannot be auditors:

- An officer or servant of the company-which means that an employee of a company cannot perform his/her own audit;
- A person who is partner or who is in employment of an officer of the company being audited;
- A person who was the director, employee or any other officer of the company to be audited, during three preceding years;
- The spouse or any other relative of a director of the company;
- Persons who are disqualified as auditors of the company's subsidiary or holding company or a subsidiary of a company's holding company;
- Body corporate -These are in form of limited companies. These cannot be auditors because of the following reasons;
  - These have limited liabilities status and if allowed to be auditors, this will expose the client to limited liabilities, which may ultimately lead to heavy losses.
  - Limited companies cannot express personal opinion, yet the Companies Act requires that the audit report contain an opinion paragraph (personal opinion) which millions of shareholders-owners of a limited company cannot express.
- A person who is indebted to the company for quite large sum of money or has given guarantee or security in connection with indebtness to any party who received or got such indebt ness;
- Directors, shareholders, managing agents, secretaries and treasures of the company;
- A person who is holding more than 5% of the company's authorized share capital.

Application activity 4.1

SCENARIO

KBC is a limited company that sells rice and sugar, MUGABO is the General Manager engaged by shareholders. KBC Ltd has shareholders in the whole country, and some of them don't have enough time to look at the performance of their business. After Covid-19 pandemic period some shareholders didn't receive their dividends due to the loss reported by the managment and was disclosed in the financial stements of the company for the period for the perioded ended 31December 2020. They had doubt that the financial statements were manipulated by the management. They decided to appoint an external auditor and requested MUGABO to look for a qualified auditor who can help them to know what had happened. MUGABO appointed his nephew TOTO as an external auditor. He perfomed the audit of the company and confirmed the same loss.

Required:

Specify the basis for disqualifications of an auditor.

4.2. Rights and removal of an auditor

Learning activity 4.2

Observe the above image then answer the following questions:

1. Is it necessary that an auditor must have specific rights? If Yes or No, explain.
2. What can happen if the client refuses to give to the auditor some of his/her rights?
3. What can happen to an auditor who does'nt perform well some of his/her duties?

4.2.1. Rights and duties of an auditor

a) Rights of auditors

The auditors must have certain rights to enable them to carry out their duties effectively. The principal rights auditors should have, excepting those dealing with resignation or removal, are set out below:

- **Right to access to the books of accounts of the organization at all times**
    - The auditor has a right to access to those books, which may be kept in the business and elsewhere.
    - Right to receive returns submitted by the branch office to head office.

"Books" will include books of accounts, statutory books (Memorandum, and articles), statistical books, costing books, minute books and all vouchers of whatever nature.

- **Right to request and receive**

The auditor has the right to request and receive from officers of the company such information and explanations as they consider as necessary for the performance of their duties.

- **Right to receive a notice of 21 days to attend the Annual General Meeting**

The auditor has the right to receive a notice of 21 days to attend the Annual General Meeting or Extra-Ordinary Annual General Meeting regardless of whether accounts are discussed at the same annual general meeting, but can only speak at this annual general meeting if the accounts are subjected to discussion.

- **Rights to make a statement at the Annual General Meeting**

The statement must be to do with accounts under discussion, and is bound to answer only those questions concerning the accounts if there pass through the Chairman of the annual general meeting. He/she has the right to correct wrong statements given by directors to do with accounts. He/she cannot cover omissions in the report through his/her statements at the annual general meeting in exercising this right.

- **Right to be indemnified**

He/she can be indemnified out of the company's assets against any liabilities incurred by him/her defending his/her name if this was tarnished by the company in any manner.

- **Right to visit the company's branches**

The statutory auditor has a right to visit the company's branches provided if these have no qualified auditor. During this visit, he/she has a right to over all books of accounts and vouchers of the same branch and has a right to access to returns (the returns the same branch has submitted to the head office).

- **Rights to take legal and technical advice**

The auditor has a right to obtain advice from such experts as engineers, lawyers, solicitors and valuers. However, this advice must be interpreted from the auditor's own understanding of the prevailing circumstances in order to arrive at an opinion.

- **Right to Remuneration**

The auditor has the right to receive his/her fees provided after the completion of the audit work.

His/her work or if dismissed unlawfully during the course of the year, he/she has a right to the full year's fees.

- **Remuneration of an auditor**
  - If appointed by directors, they will fix his/her fees and expenses.
  - If appointed by the Registrar, he/she fixes his/her remuneration in liaison with Directors.
  - If appointed by shareholders, the same fix his/her fees or can delegate the powers to the Directors.
  - A retiring auditor who is automatically re-appointed at the AGM, unless a resolution is passes re-fixing his/her fees is entitled the same remuneration as in the previous periods.
  - If the auditor is required to do any other work other than his/her normal work, e.g. to prepare tax return, he/she is entitled to extra remuneration for that.
  - If an auditor is removed in the way prejudicial to his/her interest, e.g. unlawfully, he/she is entitled to a full year fees.
  - Any sum paid in respect of expenses to the auditor is part of his/her remuneration and should be reflected in the P&L Account.

- **Right to sign the Auditor Report**

An auditor or one partner in the firm of the auditors has a right to sign an audit report or authenticate any documents which the companies Act requires the auditor to sign e.g. a prospectus, engagement letter; interim report for payment of interim dividends, bankers reference to do with the company's financial strength, a report of the company's affairs when the management are resigning.

- **Rights in relation to written resolutions**

A right to receive a copy of any written resolution proposed.

- **Right to be heard at any general meeting**

On any part of the business of that meeting, that concerns them as auditors.

If auditors have not received all the information and explanations they consider necessary, they should state this fact in their audit report.

The companies Act make it an offence for a company's officer knowingly or recklessly to make a statement in any form to an auditor which:

- Conveys or purports to convey any information or explanation required by the auditor; and
- Is misleading, false or deceptive in a material particular.

b) Duties of an auditor

The auditors are required to report on every balance sheet (statement of financial position) and profit and loss account (statement of comprehensive income) laid before the company in general meeting.

The auditor must consider the following:

- Compliance with legislation;
- Truth and fairness of accounts;
- Adequate accounting record and returns;
- Agreement of account to records;
- Consistency of other information;
- Director's benefits.

4.2.2. Resignation and removal of an auditor

Nº	RESIGNATION OF AUDITORS	
1	Resignation procedures	Auditors deposit written notice together with statement of circumstances relevant to members/ creditors or statement that no circumstance exist .A statement of circumstance must always be submitted for a quoted company, even if the auditor considers that there are no circumstances that should be brought to the attention of members or creditors.
2	Notice of resignation	Sent by company to regulatory authority.

3	Statement of circumstances	Sent by: ▪ Auditors to regulatory authority ▪ Company to everyone entitled to receive a copy of accounts
4.	Convening of general meeting	Auditors can require directors to call an extraordinary general meeting to discuss circumstances of resignation. Directors must send out notice for meeting within 21 days of having received requisition by auditors.
5	Statement prior to general meeting.	Auditors may require company to circulate (different) statement of circumstances to everyone entitled to notice of meeting.
6	Other rights of auditors	Can receive all notices that relate to: ▪ A general meeting at which their term of office would have expired ▪ A general meeting where casual vacancy caused by their resignation to be filled ▪ Can speak at these meeting on any matter which concerns them as auditors.

NO	REMOVAL OF AUDITORS	
1	Notice of removal	▪ Auditor may be removed from his office before the expiry of his term, by the company only in a general meeting plus prior central government approval (except for removal of first auditor). ▪ Either special notice (28 days) with copy sent to auditor or if elective resolution in place, written resolution to terminate auditor's appointment. ▪ Directors must convene meeting to take place within reasonable time.
2	Representations	Auditors can make representations on why they ought to stay in office, and may require the company to state in notice that representations have been made and send copy to members.
3	If resolution passed	▪ Company must notify regulatory authority ▪ Auditors must deposit statement of circumstances at company's registered office within 14 days of ceasing to hold office. Statement must be sent to regulatory authority.

4	Auditor's rights	Can receive notice of and speak at: ▪ General meeting at which their term of office would have expired ▪ General meeting where casual vacancy caused by their removal is to be filled. ▪ to read the representations in the annual general meeting in the case were not sent in a reasonable time to shareholders

Companies Act places a requirement on auditors to notify the appropriate audit authority in certain circumstances on leaving office.

If it is a **major audit** (quoted company or major public interest company), the notification must be given whenever an auditor ceases to hold office.

If it is **not a major audit**, the notification is only required if the auditor is leaving before the end of his term of office.

The appropriate audit authority is:

- Secretary of state or delegated body (such as the Rwanda professional oversight board) if a major audit;
- Recognised supervisory body (e.g. ICPAR) for other audits.

Notice must inform the appropriate audit authority that the auditor has ceased to hold office and be accompanied by a statement of circumstances or no circumstances.

Application activity 4.2

1. A company's auditor can be removed before expiry of his/her term by one of the following:
   A. Shareholders
   B. Board of directors
   C. Central government
   D. State government
   E. A and B are correct answers
   F. All of the above
2. Remuneration of a company's auditor is fixed by one of the following :
   A. Shareholders
   B. Board of directors

C. Central government

D. Appointing authority

F. All of the above

3. Which among the following is not a duty of the auditor:

A. Checking errors and frauds

B. Correcting errors and frauds

C. Vouching with original documents

D. Preparing final accounts

E. No one of the above.

4. The duties of internal auditor are defined /given by :

A. Companies Act

B. Company low board

C. Management

D. A and C are correct answers

E. All of the above

Skills lab activity 4

With the help of a teacher, students should be required to identify the rights of an auditor and their applications.

End unit 4 assessment

1. While conducting the audit of a limited liability company for the year ended 31st March 2021, the auditor wanted to refer to the minute books. The management refused to provide the minute books to the auditor.

Required:

Specify one of the rights of the auditor.

2. Mugabo Ltd was formed on 1st August 2021 to manufacture computers, the directors are unsure to their responsibilities and the nature of their relationship with the external auditors. The audit partner has asked you to visit the client and explain to the directors more about the fundamental aspect of the accountability of the company and their relationship with the auditors.

Required:

What the auditors' rights under the companies Act?

UNIT 5 | AUDITOR'S RESPONSIBILITY

Key unit competence: To be able to exhibit auditor's responsibilities

Introductory activity

A case study

KARAMBIZI is an auditor who was appointed in PHILMAX Ltd Company. The company wanted to set terms of working framework for a new auditor. The management of the company wishes to know how to define general duties and legal professional responsibilities of an auditor.

Question

1. Highlight three duties of an auditor
2. What do you think are reasons that may lead to auditor's liabilities?
3. What do you think can be auditor's liabilities in relation to third parties?

5.1. Legal responsibilities and duties of an auditor

Learning activity 5.1

An auditor has been recruited in a company to help it secure operations, especially related to financial and procedural management operations.

1. What do you think are main duties of an auditor in a company?
2. What do you think are reasons which can make an auditor liable to the company?

5.1.1. Legal responsibilities of an auditor

Under the company'sAact, an auditor may be liable to the following parties:

- The client to whom he/she owes the primary duty of care;
- Third parties who have not privacy of contract but have relied on his/her opinion to arrive at a decision.

In general, the auditor's liability may arise due to:

- Breach of contract;
- His/her failure to discover material misstatement due to fraud;
- His/her failure to discover material misstatement due to error;
- Carelessness or dishonesty.

The liability of an auditor may arise in the following capacities:

- In his/her capacity as an auditor in private audits;
- In his/her capacity as an auditor as a statutory audit.

a) Liabilities of an Auditor under Private Audits

In such audits, the auditor's liabilities depend on the agreement between the auditor and the client. It is for that reason that an auditor insists that the agreement be in writing clearly, defining his/her duties, powers and responsibilities.

The auditor cannot be held liable for losses incurred as aresult of reliance on parts of the accounts not covered in the auditing agreement. The auditor's liabilities are limited to the areas specified in the scope. In order to minimize his/her liabilities, the auditor must:

- Be diligent and honest to reduce negligence;
- Should never sign a balance sheet he/she doesn't believe to be correct;

- Use disclaimers on his/her report to minimize liabilities resulting from his/her report.

In assessing the auditor's liabilities under private audit, the following should be assessed:

- That he/she was actually negligent with reference to the agreement;
- That out of negligence, the client suffered loss;
- That a person who has explicit contractual obligation with him/her has suffered the loss defined by the contract.

Note: Under private audits, the auditor must include a caveat and disclaimer to his/her report to the effect that it should not be used by any party to make any decision as the client may have limited his/her scope in the audit and that was liable to obtain all information which he/she considered as necessary to make an opinion.

b) Liabilities of an Auditor under Statutory Audits (Company's Act)

Under the Company's Act, auditors' liabilities cannot be limited by any agreement. The Act defines his/her duties, powers and responsibilities. Under the Company's Act, the auditors' liabilities can arise out of:

- Civil law
- Criminal law

Civil liability of the Auditor: These liabilities arise out of negligence. Under civil law, the auditor has the duty to care about the following:

- The client (in contract)
- Third parties whether he/she has contractual obligations or not.

The client (in contract)

The auditor due to this must exercise care and diligence in the performance of his/her duties. Even though negligence is proved against the auditor, there is no liability for negligence unless it can also be proved that the client also incurred loss out that negligence i.e. in case of third party liability. In order to sue the auditor successfully, the client must prove:

- The auditor was negligent;
- That out of the auditor's negligence, a client suffered a financial loss;
- That the financial loss is qualified and material.

Auditors' liabilities to Third parties

He/she can be liable to the third parties under the following conditions:

- Where the party has suffered a financial loss as a result or by relying on the report made by the auditor;
- Where it can be proved that the auditor did not use his/her professional skills and judgement during the audits;
- Where the auditor made report aware that such a report should be used by the third parties to make investment decisions;
- Where the auditor didn't attach the disclaimer on his/her report that such a report was not included to be relied upon by third parties;
- Where it can be proved that actually the third parties relied on the report;
- Where the parties can prove that no external factors whatever influenced their decision but just the audit report;
- Where the third parties were not warned not to rely on the audit report.

However, for any action to succeed against the auditor, the auditor must prove the following:

- The auditor was negligent;
- Due to negligence the third party suffered loss;
- The auditor knew or ought to have known that third parties could rely upon the account.

5.1.2. Duties of an auditor

- **Duty to make a report to shareholders or owners and duty to state the following in his/her report**
  - Whether in his/her opinion, he/she has received all information and explanations necessary for his/her opinion.
  - Whether in his/her opinion, the trading, profit and loss account exhibits the true and fair view of the profits or loss of the period.
  - Whether in his/her opinion, the balance sheet is properly drawn and exhibits a true and fair view of the company's financial position.
  - Whether proper books of accounts have been kept properly by the company and returns received from company's branches not visited by him/her.

- **Duty to call for information**
  - Whether loans have been properly secured except lands and building.
  - Whether securities have been sold below the purchase price.
  - Whether personal expenses have been debited to the profit and loss account and if so to debit the personal accounts of the employees concerned.
- **Duty to assist in investigations**

The auditor assists in carrying out investigation and provides support in investigation to the investigators but only if financial matters are provided on his/her working purpose.

- **Auditor's responsibilities in relation to fraud**

With the prospectus, an auditor has to be extra careful in approving any kind of information because if there is a misleading information, which can cause the loss to the company and third parties, they can hold him/her liable for damages. The auditor can relieve himself/herself of such liabilities under the following:

- If he/she withdraws his/her consent in writing before such prospectus has been registered and circulated for the public use;
- That after registration of prospectus and before the allotment of shares, he/she is knowing the misleading statement in the prospectus, withdrawn his/her consent and gives a public notice to this effect;
- That it was important to give such statement and that he/she has reasonable grounds, which he/she can substantiate e.g. letters of representation for proving that the statement was true.

In general, the auditor's liabilities to the third parties and client give arise to claims against the auditor on such grounds as:

- Failure to detect embezzlement by employees;
- Negligence on the part of the auditor or his/her staff;
- Improper accounts procedures, which may lead to fraud;
- Errors in the financial statement he/she is reporting on.

In order to minimize his/her liabilities to the third parties and the client while compiling his/her report, an auditor should:

- Enter into agreement with his/her client that another person should not use his/her report;
- Include a disclaimer in his/her report to the effect that any party to make any decision not included.

- **Criminal liabilities of an Auditor**

Arise when an auditor commits an act, which constitutes a crime. This includes wrongful performance of a statutory duty or breach of statutory obligation. The liquidator or receiver can sue an auditor as an officer of a company especially during receivership or liquidation during the course of winding up a company if he/she made wrong statement to them. In order to hold the auditor liable, the following should be proved:

- That the auditor made a statement that proved false in material facts;
- That the auditor wilfully made a statement, which was actually false knowing it;
- That the statement made was in any report, prospectus, balance sheet, certificate or any other document, which under the company Act, the auditor is required to authenticate;
- That the auditor made a statement as a statutory officer of the company.

In general, an auditor can be held liable under the companies Act for criminal acts under the following circumstances:

- If he/she fails to disclose material facts in the financial statements, knowing that they are material and that such non-disclosure will make the statement misleading;
- If the auditor does not use reasonable care and skills during the course of his/her audit;
- If the auditor wilfully contravenes any provisions of the act which under normal circumstances is supposed to follow during the course of his/her auditing e.g. If he/she fails to request returns from the branches;
- If he/she destroys secrets ,mutilates vouchers, documents books of accounts, certificates with the aim to destroy someone's opinion;
- If he/she falsifies or is privy to falsification of any document, prospectus, books of accounts or vouchers of the company with to deceive or defraud;
- If he/she knows that, a material has been omitted in the report or financial statements and does not reveal such fact.

Note: The main auditor cannot hold the liabilities of branch auditors.

- To certify statutory report in order to assure the owners about the number of shares allocated to promoters and whether such issue was conducted properly.
- Duty to certify the profit and loss account in the prospectus.

- Duty to certify the profit and loss accounts when managing agents resign, balance sheet and funds flow statement.

- **Other duties**
  - Whether loans are properly secured and not at terms prejudicial to the interest of the shareholders.
  - Whether transactions conducted by the company are not prejudicial to the interest of the shareholders.
  - Whether securities have been sold at the price, lower than cost.

Application activity 5.1

1. Identify how an auditor can minimise his/her liabilities in regards to his/her audit responsibilities.
2. Develop a guideline showing how the auditor's liabilities under private audit should be assessed.

5.2. Errors and frauds

Learning activity 5.2

A company found out some errors in the records of financial documents and wanted to resort to auditor's services to help the organisation in tracking errors.

1. What types of errors the auditor may discover in the company's financial records?
2. What are the procedures the auditor will apply to discover errors and frauds?

5.2.1. Types of errors and frauds

a) Errors

Definition of error: an error is an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure.

Errors detected/ disclosed by the Trial Balance

The purpose of the T/B is to check the accuracy and validity of the books. It specifically detects the following errors:

- **Single entry** i.e. failing to complete double entry. e.g. cash sales where sales A/C is credited but cash A/C not posted.
- **Overcast** (over debit or over credit of accounts) or **undercast** (under credit or under debit of accounts).
- **Two credits or two debits on the same side** without the corresponding entries.
- **Transfiguration** or **transposition** i.e. changing figures by mistakes when posting e.g FRW 58, 000 as FRW 85,000.
- **Summation or addition error** e.g. if the total is FRW 40,000 and you total FRW 50, 000.

Errors not detected/disclosed by the trial balance

- **Errors of original entry**

These errors originate from source documents e.g. invoices, vouchers, receipts, bank-paying sleep etc. These errors are carried throughout the accounting process i.e. from the journal to the ledger to the trial balance and eventually to the final accounts.

For example: goods were sold on credit for FRW 95,000, but was recorded in the sales invoice as FRW 59, 000 and the same figure is journalized.

- **Errors of Omission**

These are errors of omitting transactions from all books of accounts. If a transaction occurs and is not recorded anywhere, the T/B cannot detect such an error. If for example goods were bought for cash of FRW 65,000 and entries were not made in the cash and purchases account.

- **Errors of commission**

These errors are committed when an entry is made on wrong person's account or account title but the double entry properly effected. For instance, goods worth FRW 400,000 were sold to Jane on credit but Joan's account was debited instead of the correct account of Jane. The sales account being properly credited.

- **Errors of Principle**

These are making entries on wrong classes or types of accounts. For instance, if a capital expenditure for say purchase of a motor vehicle is made, and it is debited to the purchases account instead of the correct motor vehicle account. Or if an old fixed asset was disposed off and the proceeds from this disposal or sale is entered in the sales account

- **Compensating errors**

These errors cancel out in the trial balance. They are cancelled because the error on one side of the T/B is compensated by a similar error on the other side of the trial balance. For instance, if an item that appears on the debit side of the T/B

E.g, Purchases is overcast by FRW280,000 and by coincidence another account that appear on the credit side of the trial balance says the sales account was also overcast by FRW 280,000. These errors will neutralize each other and the TB will agree as if no error was made.

- **Errors of complete reversal entries**

These are committed when entries are made on wrong sides of the accounts. For instance, if wages totaling FRW 3,500,000 were paid cash and the bookkeeper debits the cash account and credits the wages account.

Material error is an error, which has a big effect on the accounting transactions and has effect on the financial statements of a business. To help you decide whether a particular item/transaction is material, you may consider looking at the following:

- The effect on an individual financial statement as well as the whole set of financial statements.
- The percentage of the possible error: for profit and loss account items, we usually calculate the percentage with reference to the profit before interest and tax figure. For Balance Sheet items, we usually calculate the percentage with reference to the total share capital and reserves or the total fixed assets. As a rule, an error less than 5% would be regarded as immaterial.
- Recurring or non-recurring error: recurring errors must be investigated no matter how small the percentage is. Recurring errors imply that there is a problem with the accounting system, which should be followed up.
- Statutory requirement: In general, if an error does not seriously affect the accounts users' decisions, we do not worry about this minor mistake. However, in the context of law, sometimes there is no room for the materiality concept. For example, if the Companies Act requires that a particular item must be disclosed in financial statements, it must be done even if the amount is only Frw1.

Immaterial error

Immaterial error is when an item is *immaterial*, we do not need to worry about it for both qualitative and quantitative aspects.

Trial balance checking

- Check casts of the trial balance, lists of debtors and creditors.
- Establish the mount of difference.
- Check balances from personal and impersonal ledger into the trial balance.
- While checking the balances, care must be taken to ensure that the closing balances are correctly entered in the right column.

Short cut method

- Look for an item of half that amount which might have been entered on the wrong side.
- If the difference is divisible by nine, it may mean an error of transposition of figures (69 written as 96 or 86 written as 68, etc).
- If the difference is a round sum, it is probable that the mistake has been made in totals of trial balance or carry forward of its figures.
- If the difference is of large amount, it is advisable to compare the trial balance with that of the previous year, in order to ascertain whether the figures under the different heads of account are very near the same as those of previous year.

Extensive checking

- Ascertain that all opening balances have been correctly brought forward in the current year's books.
- Check casts, cross casts and carry-forward the various books of original entries and ledgers.
- If the ledgers are self-balancing, the work would be restricted to checking the balances, postings and casts of only that ledger the trial balance of which does not agree..
- The postings from the various subsidiary books should then be checked into the impersonal ledger.
- The journal and subsidiary books should be scrutinized to see that the total debits and credits of each entry tally and there were no un-ticked items.

Measures to prevent errors

– Employ a strong internal control system and efficient internal check system.

– Award employees reasonable salaries according to their qualifications and experience. to reduce chance ofcommitting errors and raise their morale to work.

- Employment of qualified staff to prevent errors of principle.
- Institute an internal audit department where possible.
- Encourage clerks/staff to take their annual leave periodically so that their work. Performance can be assessed in their absence and any errors they had made revealed.
- Encourage inter-department transfers and rotation of duties at a surprise moment so as to cut down the continuity of an error.
- There should a close supervision of duties; particularly in sensitive areas of the business e.g. cash receipts and payments.
- Use specific reviews of what has taken place in any one given area.
- Use machines to record transactions e.g. adding machines, check-writing machines, etc.
- Management should insist on referees when engaging employees especially the accounting staff.

b) Fraud

Definition of fraud: fraud is an intentional misrepresentation of financial information by one or more individuals among the management, employees or third party collaboration in order to defraud the business on financial resources and assets. Example:

- Manipulation, falsification and alteration of record and document.
- Misappropriation of assets usually for personal use e.g. cash.

Types of the frauds

- **Embezzlement of cash**

This is the defalcation or misappropriation of moneyin, which you are responsible in a business intentionally.

Cash may be misappropriated by:

- Omitting to enter any cash which has been received;
- Entering fewer amount than what has been actually received;
- Making fictitious entries on the payment side of the cashbook;
- Entering much amount on the payment side of the cashbook than what actually has been paid.

- **Misappropriation of goods**

Misappropriation of goods is undersood as a cas where any may intentionally misappropriate business goods for his/her personal use.

- **Fraudulent manipulation of accounts**

It is committed by directors or managers with a purpose of showing more profits than what actually they are.This can be done to:

- Get a higher commission on profits;
- Ensure efficiency and smooth running of the business to shareholders;
- Obtain loans from financial institutions;
- Attract more investors to join the business;

Showing less profits than what actually they are in order:

- To purchase shares in the market at a lower price;
- To reduce or avoid the payment of income tax;
- To give a wrong impression about the success of the business to competitors.

Difference between errors and frauds

Errors	Frauds
These are unintentional.	These are intentional.
It is easier to detect errors by checking the posting.	It is difficult to detect frauds because they cross all the posting.
Errors are committed by lower-level staff.	Frauds are committed by the management staff.

Procedures of detecting errors and frauds

- **Control of source documents**
  - Examination of documents that support a recorded transaction or amount.
  - The direction of testing must be from the recorded item to the supporting document.
  - Tests existence or occurrence.
- **Document tracing (from supporting document to recorded item)**
  - Primary test for unrecorded items and therefore tests the completeness assertion.
  - The direction of testing must be from the supporting document to the recorded item.

- **Physical observation**
  - Auditor witnesses the physical activities of the client.
  - Differs from physical examination because physical examination counts assets, while observation focuses on client activities.
- **Direct confirmation**

The receipt of a written or oral response from an independent third party Auditor has client request that the third party respond directly to the auditor. Positive Confirmations asks for response even if balance is correct. Negative Confirmations asks for a response only if balance is incorrect. Examples: Banks – Confirm checking account and loan balances

- **Analytical examination**

Audits studies relationships among data. Unusual fluctuations occur when significant difference are not expected but do exist or when significant differences are expected but do not exist. Analytical examination is required during the planning and completion phases on all audits.

- **Examination of the annual accounts**

This involves the review of the financial information by the auditor.

5.2.2. Auditor's responsibilities in relation to fraud

ISA 240 the auditor's responsibility to consider fraud in an audit of financial statements, states quite clearly in paragraph 240.13 that the primary responsibility for the prevention and detection of fraud rests with the management and those charged with governance of the entity. It is their responsibility to establish a control environment to assist in achieving the orderly and efficient conduct of the entity's operations. It is up to them to put a strong emphasis on fraud prevention. The auditor does not have a specific responsibility to prevent or detect fraud, but he must consider whether it has caused a material misstatement in the financial statements.

Application activity 5.2

1. Establish measures an organisation should use in order to prevent errors
2. What are justifications clients could provide as proof for liablity of an auditor ?

Skills lab activity 5

In their learning teams, students will be shared the school accounting information system and documents, be requested to identify errors.

End unit 5 assessment

1. Define the following terms:

    a) Error

    b) Fraud

2. Describe the auditor's liabilities towards the third parties.
3. Describe five (5) types of errors in audit
4. Describe the duties of an auditor
5. What are the types of frauds?
6. What are auditor's responsibilities in relation to fraud?
7. What kinds of measures are to be put in place to prevent errors?
8. Describe the procedures, which can be used to detect errors and fraud

UNIT 6 | AUDITOR'S REGULATION AND ETHICS

Key unit competence: To be able to comply with auditor's regulation and professional ethics

Introductory activity

Financial and ethical reporting plays a significant role in sustainable commercial development, as it provides the information required to assess sustainable performance. In recent times, sustainability reporting has constantly increased and is now a common business practice.

The countries that set the financial and ethical standards. However, the recent role of emerging and developing nations requires that other regulations be devised regarding not only financial stability but also inclusiveness and economic development.

Because of the maturity of the institutional financial system and the efficient market mechanism, the countries suggested reasons for international differences concerning the context of financial reporting. This highlights the importance of the auditing profession regaining and retaining the confidence of the public, with duties performed in alignment with public interests.

Question

What would be the international standards adopted to support all contexts of auditing?

6.1. International auditing standards

Learning activity 6.1

Look the picture above, and answer the following questions:

1. What do you see in this picture?
2. Which elements do you see that can be used as auditing standards?

6.1.1. The role of International Auditing and Assurance Standards Board

International Standards on Auditing (ISAs) are set by the International Auditing and Assurance Standards Board (IAASB), a technical committee of the International Federation of Accountants (IFAC).

The IAASB is there to serve the public interest by setting high-quality international standards for auditing, quality control, review, other assurance, and related services, and by facilitating the convergence of international and national standards. In doing so, the IAASB enhances the quality and uniformity of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.

Auditors are subject to ethical requirements imposed by their professional bodies. One area where clients' requirements may conflict with the requirements for auditors to act ethically is whether the auditor should keep the affairs of clients' secret, or disclose them to others without obtaining the clients'consent. The auditor should comply with the code of ethics for professional accountants issued by the International Federation of Accountants.

6.1.2. International Standards on Auditing (ISA)

International Standards on Auditing (ISAs) are set by the International Auditing and Assurance Standards Board (IAASB), a technical committee of the International Federation of Accountants (IFAC). ISAs are produced by IAASB, a technical committee of IFAC. IAASB also produces other items of international guidance, such as the International Standard on Quality Control (ISQC).

The IAASB selects subjects for detailed study by way of a subcommittee established for that purpose. As a result of that study, an exposure draft is prepared for consideration by the IAASB. If approved, the exposure draft is widely distributed for comment by auditor bodies of IFAC, and to such international organisations that have an interest in auditing standards.

The key standards issued by the IAASB include:

Respective responsibilities, Audit planning, Internal control, Audit evidence, Using work of other experts, Audit conclusions and audit report

International Standards on Auditing	
No	**Title**
200	Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing
210	Agreeing the terms of audit engagements
220	Quality control for an audit of financial statements
230	Audit documentation
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with those charged with governance
265	Communicating deficiencies in internal control to those charged with governance and management
300	Planning an audit of financial statements
315	Identifying and assessing the risks of material misstatement through understanding the entity and its environment
320	Materiality in planning and performing an audit
330	The auditor's responses to assessed risks
450	Evaluation of misstatements identified during the audit

500	Audit evidence
501	Audit evidence – specific considerations for selected items
505	External confirmations
520	Analytical procedures
530	Audit sampling
540	Auditing accounting estimates, including fair value accounting estimates and related disclosures
550	Related Parties
560	Subsequent events
570	Going concern
580	Written representations
600	Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)
610	Using the work of internal auditors
620	Using the work of an auditor's expert
700	Forming an opinion and reporting on financial statements
705	Modifications to the opinion in the independent auditor's report
706	Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report
710	Comparative information – corresponding figures and comparative financial statements
720	The auditor's responsibilities relating to other information in documents containing audited financial statements
800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
810	Engagements to Report on Summary Financial Statements

6.1.3. The regulation of auditors

The accounting and auditing profession varies in structure from country to country. In some countries, accountants and auditors are subject to strict legislative regulation, while in others the profession is allowed to regulate itself.

Regulations governing auditors will, in most countries, be most important at the national level. International regulation, however, can play a major part by:

- Setting minimum standards and requirements for auditors;
- Providing guidance for those countries without a well-developed national regulatory framework;
- Aiding intra-country recognition of professional accountancy qualifications.

The audit regulations are:

- Statutory regulation
- Licensing of auditors
- Delegated regulation by professional bodies within a legal framework (not self- regulation)

Regulatory mechanisms are:

- Statutory audit requirement
- Legal provisions on appointment and dismissal of auditors,
- Licensing of auditors
- Competence requirements
- Professional conduct rules
- Auditing standards
- Disciplinary procedures
- Governance rules for regulatory bodies

The regulation of audit is centrally concerned with the issue of ensuring that auditors follow best practice standards in conducting the audit, and are competent and independent; all of this being seen as essential in terms of auditors' capability to detect significant errors/omissions in financial statements and to report faithfully on them.

Application activity 6.1

1. What is IFAC in full?
2. What are the key standards issued by the ISA?
3. What are the purposes of International Standards on Auditing number 500 and 570

6.2. The fundamental principles of auditing

Learning activity 6.2

Look at the picture above and answer the following questions:

1. What are the activities carried out by the above persons?
2. Tell me about a time you faced an ethical dilemma.

6.2.1. The fundamental principles of auditing as per IESBA

The IESBA Code of Ethics provides ethical guidance. The five fundamental principles of ethics are as follows: **integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.**

Integrity**(S 110)**	Auditors should be straightforward and honest in all professional and business relationships. Integrity implies not just honesty but also fair dealing and truthfulness.

Objectivity**(S 120)**	Auditors should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgments.
Professional competence and due care**(S 130)**	Auditors have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques. Auditors should act diligently and in accordance with applicable technical and professional standards.
Confidentiality(S 140)	Auditors should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose such information to third parties without authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of auditors or third parties.
Professional behavior **(S 150)**	Auditors should comply with relevant laws and regulations and should avoid any action, which discredits the profession. They should behave with courtesy and consideration towards all with whom they come into contact in a professional capacity.

The **IESBA Code of Ethics** states that independence requires **independence of mind** and **independence in appearance.** In other words, the auditor must be, and must be seen to be, independent.

Independence of mind is the state of mind that permits the provision of a conclusion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

Independence in appearance is the avoidance of facts and circumstances that are so significant a reasonable and informed third party would be likely to conclude that a firm's, or audit and assurance team members, integrity, objectivity or professional scepticism have been compromised.

It is very important that the auditor is impartial and independent of management, so that he/she can give an objective view on the financial statements of an entity. The onus is always on the auditor not only to be independent but also to be seen to be independent. You will see that some situations will constitute such a significant threat to independence that an audit practice should not act as auditors if they arise.

The following examples of specific threats to independence are given in the code

- **Self-interest threats**

There are many examples of a self-interest threat arising in the Code. They fall into two general areas:

  – **Relationships**

Close relationships between audit staff and employees of audit clients can lead to a lack of independence if the interests of the audit firm and client become too closely aligned and audit staff lose objectivity. Close relationships also cause familiarity threats.

Examples of such self-interest threats are when:

- The audit firm has a financial interest in an audit client;
- Business relations between the firm and client are too close;
- Audit staff move to work at the audit client;
- The audit partner sits on the client board;
- There are family/personal relationships between audit staff/client;
- Audit staff are offered gifts/hospitality by client staff;
- Audit fees from a single client are a high percentage of the audit firm's total fees;
- The audit firm, or an individual on the audit engagement, enters a loan or guarantee arrangement with a client (that is not a bank or similar institution carrying out its normal commercial business).

If an auditor inherits shares in a client company, he/she should try and sell them as soon as possible, and keep the firm informed about what is going on.

Audit firms should not enter into close business relationships with clients other than that of the audit itself. They should not have joint ventures or joint marketing policies.

  – **Fee-related issues**

An audit is carried out for a fee. However, self-interest threats arise if the fees are so significant, or potentially so, that the audit firm loses its objectivity in relation to the audit client. A key area is the proportion of total audit firm income derived from a client. If it is too high, it indicates that the audit firm relies on that audit client too much to be independent.

Contingent fee arrangements are prohibited for audit or assurance engagements. Contingent fees are payable on condition of a favourable outcome being achieved. For example, a firm may charge a client seeking a listing on the stock exchange a contingent fee which is payable if the listing is successful.

- **Self-review threats**

If an auditor audits work he/she has carried out for a client, he/she is unlikely to be able to be objective about it.

There are two general circumstances in which this situation might arise:

If the audit staff member has recently worked for the audit client, or if the audit firm carries out more than audit for the audit client.

  – **Recent service at audit client**

Individuals who have been a director or officer of the client, or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion should not be assigned to the assurance team.

If an individual had been closely involved with the client before the period covered by the auditor's report, the audit firm should consider the threat to independence arising and apply appropriate safeguards.

  – **Other services**

Audit firms often offer a host of services other than audit. Examples include preparing accounts and financial statements, valuation services, taxation services, internal audit services, corporate finance services, IT services, temporary staff cover, recruitment services, litigation support and legal services. Some of these, for example, the routine preparation of tax returns, are not perceived to threaten independence; others, particularly where it seems that audit firm staff are acting on behalf of management, do affect independence.

Audit firms are not permitted to assume a management responsibility for the client. Activities which would be considered management responsibility include:

- Setting policies and strategic direction;
- Hiring or dismissing employees;
- Directing and taking responsibility for the actions of the entity's employees
- Authorising transactions;
- Controlling or managing of bank accounts or investments;
- Deciding which recommendations of the firm or other third parties to implement;

- Reporting to those charged with governance on behalf of management;
- Taking responsibility for the preparation and fair presentation of the financial statements;
- Taking responsibility for designing, implementing and maintaining internal control.

Activities that are routine and administrative, or involve matters that are insignificant, generally are deemed not to be a management responsibility and are permitted by the IESBA Code. Firms should not prepare accounts or financial statements for listed or public interest clients. For any client, assurance firms are also not allowed to:

- Determine or change journal entries without client approval;
- Authorise or approve transactions;
- Prepare source documents.

In addition, in relation to the other services listed above, auditors should not provide a valuation of an item that is going to be material to financial statements, they should not carry out transactions on the client's behalf when doing corporate finance work, and should not underwrite the client's shares.

Even if the services do not pose a threat to independence in themselves, independence might be threatened if the auditor carried out a lot of other services for a client, or if circumstances made the audit firm appear not independent. This will often be a matter of judgement for audit firms.

- **Advocacy threat**

If an audit firm is asked (or perceived) to promote their client or represent them, for example in a legal claim, then the auditor would be biased in favour of their client and would not be able to be objective.

This loss of objectivity gives rise to an advocacy threat.

Examples of circumstances that create advocacy threats include:

- The auditor provides legal support to an audit client in a legal dispute;
- The auditor acts as an advocate on behalf of an audit client in a dispute with a third party such as a tax disputes;
- The audit firm promotes shares in an audit client;
- The audit firm pitches a client reconstruction to a bank whilst undertaking corporate finance services;
- A partner or employee of the audit firm serves as a director or officer of an audit client.

The audit firm should ensure it does not accept work likely to cause an advocacy threat, and it should withdraw from an engagement if the risk to independence becomes too high.

- **Familiarity threat**

We have already looked at the potential problems caused by relationships between audit firm/staff and audit client/staff. These also cause a familiarity threat, when audit staff become too familiar with a client, which causes them to lose objectivity, and professional scepticism. Another familiarity threat is long association, where an audit firm or its personnel have been involved in the audit of a particular client over an extended period. This can also affect objectivity.

For the audit of private limited companies, this is an issue for audit firms to monitor themselves and take steps to avoid. The IESBA rules are more prescriptive in relation to public limited companies.

- **Intimidation threats**

An intimidation threat arises when a member of the audit team is deterred from acting objectively by threats (whether actual or perceived) from the directors, officers or employees of an audit client. Such a threat may arise where the total fees from an audit client represent a large proportion of the audit firm's total fees. Here the audit firm may be deemed to be dependent on the audit client and this dependence may mean that they are more likely to give in to any threats for fear of losing the audit client.

Similarly, an intimidation threat is created when an audit client threatens the firm with litigation or takes legal action against them. In this situation the relationship between client management and members of the audit team can no longer be characterised by complete candour and full disclosure and therefore the audit firm should stand down as auditors as the threat would be too significant to avoid by other means.

6.2.2. The professional duty of confidentiality

"Auditors have a professional duty of confidentiality. However, they may be compelled by law, or consider it desirable in the public interest, to disclose details of clients' affairs to third parties."

Confidentiality requires auditors to refrain from disclosing information acquired in the course of professional work except where:

- **Consent has been obtained** from the client, employer or other proper source or;
- There is a **public duty** to disclose, or;
- There is a **legal or professional right or duty** to disclose.

The auditor agrees to serve a client in a professional capacity both the auditor and the client should be aware that it is an implied term of that agreement that the auditor will not disclose the client's affairs to any other person with the client's consent or within the terms of certain recognised exceptions, which fall under obligatory and voluntary disclosures.

The auditors must first obtain an understanding of the non-compliance and disclose it to management. The client should be advised to report the non-compliance. If they do not do so then the auditors may report the matters themselves, but they are not obliged to do so. The recognised exceptions to the duty of confidentiality are as follows:

Voluntary disclosure	Obligatory disclosure
Voluntary disclosure may be applicable in the following situations: ▪ Disclosure is reasonably necessary to **protect** the **auditor's interests**, for example to enable him/her to sue for fees or defend an action for say, negligence. ▪ Disclosure is **authorized** by **statute**, for example where in an action an auditor is required to give evidence or discovery of documents. ▪ There is a **public duty** to disclose, say where an offence has been committed which is contrary to the public interest. ▪ **Disclosure** to **non-governmental bodies** (where statutory powers exist).	If an auditor knows or suspects his/her client to have committed **money-laundering, treason, drug-trafficking or terrorist offences,** he/she is obliged to disclose all the information at his/her disposal to a competent authority.

Application activity 6.2

1. Why an auditor should observe the professional ethics of integrity?
2. What will happen if an auditor knows or suspects his/her client to have committed money-laundering or terrorist offences?

Skills lab activity 6

By carrying out research,students in their learning teams, identify the area (audit process) where each of the standard would be applied and why

End unit 6 assessment

1. Explain the concept of objectivity with reference to external auditors, and outline five general threats to objectivity.
2. What is the principle of objectivity?
3. Describe the review process that firms should adopt to ensure that they have maintained independence.
4. When is an auditor:

   a) Obliged

   b) Allowed

   c) To make disclosure of clients' affairs to third parties?
5. In which of the following situations is it not appropriate to disclose confidential information?

   a) Client has granted permission

   b) To obtain evidence about an item in financial statements

   c) To fulfil a public duty

   d) To fulfil a legal duty to disclose
6. Which of the following is not a fundamental principle of professional ethics?

   a) Independence

   b) Integrity

   c) Objectivity

   d) Confidentiality
7. It is important that an auditor's independence is not questionable, and that he/she should behave with integrity and objectivity in all professional and business relationships. The following are a series of questions, which were asked by auditors at a recent update seminar on professional ethics.

   a) A B & Co, the previous auditors, will not give my firm professional clearance or the usual handover information because it is still owed fees. Should I accept the client's offer of appointment?

   b) Can I prepare the financial statements of a company and remain as auditor?

Required:

Discuss the answers you would give to the above questions posed by the auditors based on IESBA Code of Ethics.

UNIT 7 AUDIT PLANNING

Key unit competence: To be able to execute audit planning and risk assessment

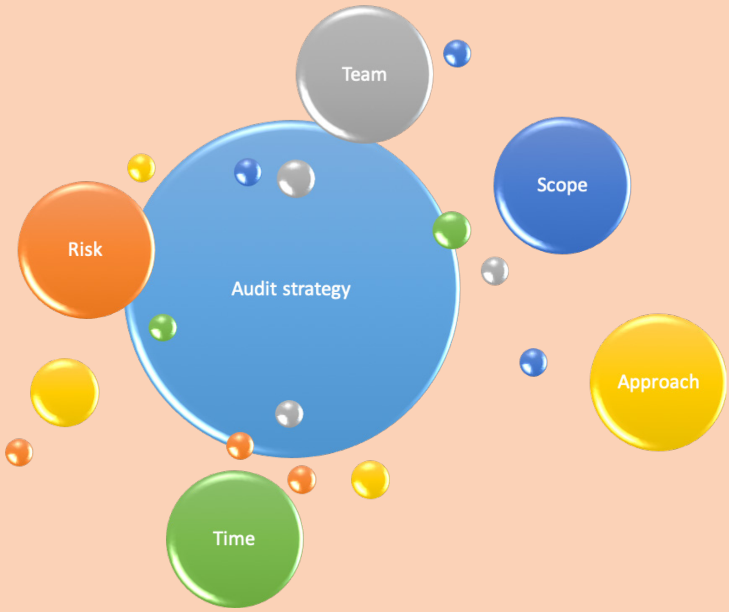
Introductory activity

Look the above picture, then answer the following questions:

1. What do you understand by audit planning
2. How do we call those activities around audit planning?

7.1. Audit planning

Learning activity 7.1



Look at the above image, then answer the following questions:

1. Why the audit work must be planned?
2. What do you mean by audit strategy?
3. State the general areas the auditor must consider when setting audit strategy.

7.1.1. Meaning and objective of audit planning

a) Meaning of audit planning

Audit planning means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audi workt in an efficient and timely manner.

b) The importance of audit planning

An effective and efficient audit relies on proper planning procedures. The planning process is covered in general terms by ISA 300 states that the auditor shall plan the audit so that the engagement is performed in an effective manner.

Audits are planned to:

- Help the auditor devote appropriate attention to important areas of the audit;
- Help the auditor identify and resolve potential problems on a timely basis;
- Help the auditor properly organise and manage the audit so it is performed in an effective manner;
- Assist in the selection of appropriate team members and assignment of work to them;
- Facilitate the direction, supervision and review of work;
- Assist in coordination of work done by auditors of components and experts.

Audit procedures should be discussed with the client's management, staff and/or audit committee in order to co-ordinate audit work, including that of internal audit. However, all audit procedures remain the responsibility of the external auditors.

A structured approach to planning:

Step 1: updating knowledge of the client and assessing risks

Step 2: Ensuring that ethical requirements are met, including independence.

Step 3:establishing the overall audit strategy that sets the scope, timing and direction of the audit and guides the development of the audit plan:

- Idendify the characteristics of the engagement that define its scope;
- Ascertain the reporting objectives to plan the timing of the audit and nature of communications required;
- Consider significant factors in directing the team's efforts;
- Consider results of preliminary engagement activities;
- Ascertain nature, timing and extent of resources necessary to perform the engagement.

Step 4: Preparing the detailed audit approach

Step 5: Making administrative decision such as staffing and budgets.

7.1.2. Audit planning strategies

a) planning strategies

Audit strategy sets the scope, timing and the direction of the audit, and guides the development of the more detailed audit plan.The audit strategy is the key planning document. It considers general areas of planning such as:

- The timetable for reporting, key dates and statutory obligations;
- Reporting framework and scope of the audit;
- Initial materiality levels;
- Preliminary risk assessment.
- Audit team members and skills required;
- Arrangements for directing, supervising and reviewing the work of audit team members;
- Consider the need for the service of experts;
- Location of client premises and travel/accommodation requirements.

Any changes made during the audit engagement to the overall audit strategy or audit plan, and the reasons for such changes, shall be included in the audit documentation.

Audit needs to be planned to ensure that:

- Appropriate attention is devoted to the important areas of the audit;
- Potential problems are identified (and resolved) on a timely basis;
- Work is completed effectively and efficiently;
- Appropriate staff are engaged on the audit team and, the proper tasks are assigned to the members of the audit team;
- Assisting with the direction and supervision of the audit team and review their work;
- Assisting with the coordination of work done by experts.

The establishment of the audit strategy involves:

Identifying the characteristics of the engagement which define its scope.	– Financial reporting framework – Industry-specific reporting requirement – Location of components of the entity – Availability of internal audit work – Effect of information technology on audit procedures – Availability of client personnel and data

Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communication required.	– Deadlines for interim and final reporting – Key dates for expected communications with management and those charged with governance
Considering the important factors that will determine the focus of the engagement team's efforts.	– Materiality levels – High risk areas – Preliminary identification of material components and account balances – Possible reliance on internal control, and management's approach to internal control – Financial reporting/industry specific developments – Results of previous audits
Considering the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.	– Ensure auditor maintains necessary independence and ability to perform engagement – Management integrity issues that may affect auditor's willingness to continue the engagement
Ascertaining the nature, timing and extent of resources necessary to perform the engagement.	– Resources required – When and where the resources will be deployed – How the resources are managed, directed and supervised – Client's timetable for reporting to its members (and impact this has on audit timetable)

In many audit firms, the audit engagement partner would create the audit strategy, with the audit managers then being responsible for using the strategy and then produce the detailed audit plan. This division of roles does, however, vary from firm to firm and it is not unusual for an audit manager to contribute to the audit strategy document.

b) Changes to the overall audit strategy and audit plan

The auditor shall update and change the overall audit strategy and the audit plan where necessary during the course of the audit work.

An accurate record of changes to the audit strategy must be maintained in order to explain the general approach finally adopted for the audit. Any changes to the audit strategy or the audit plan and the reasons for them must be included in the audit documentation.

c) Audit programmes

The audit manager will typically use the audit plan as a basis for drawing up checklists or similar documents for audit staff to use in gathering audit evidence during the fieldwork stage of the audit. Audit programmes are schedules of audit procedures to be carried out by audit staff to obtain sufficient appropriate audit evidence.

Each account area (eg non-current assets, inventory, receivables etc) will have its own audit programme and each member of the team is likely to be assigned responsibility for carrying out the audit procedures for one or more account areas. Audit programmes may be designed with reference to specific audit objectives; this ensures that audit work is focused and that sufficient appropriate audit evidence is gathered and documented.

d) Audit matters

Audits should be carried out by staff with appropriate skills and experience.

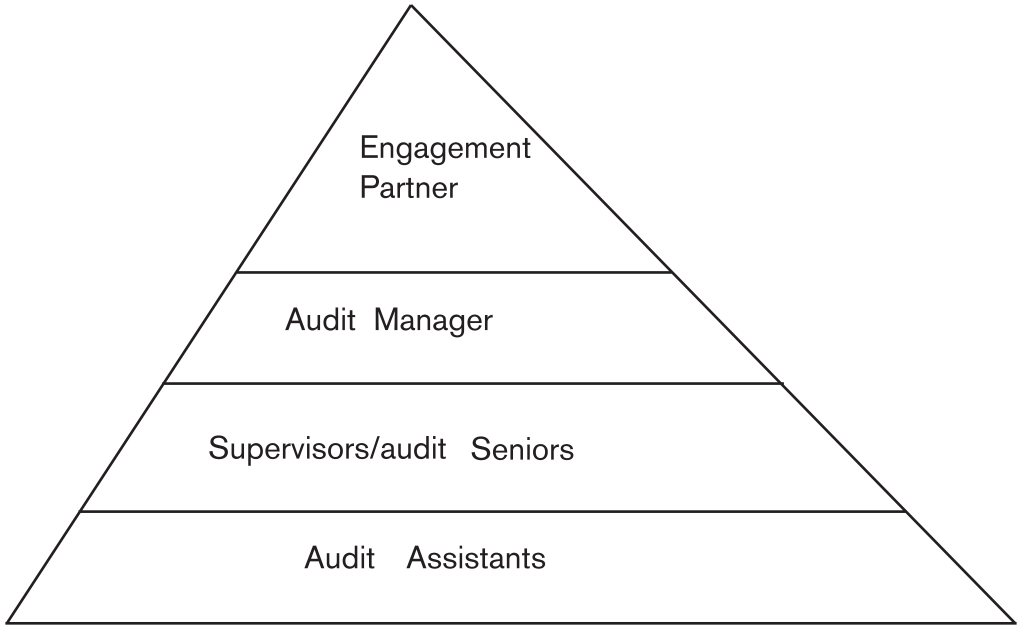
- **Audit team**

ISA 220 for Quality control for an audit of financial statements considers the issue of assignment of engagement teams. The audit engagement partner (sometimes called the reporting partner) must take responsibility for the quality of the audit to be carried out (ISA 220: para. 8). He/she should assign staff with necessary competencies to the audit team (ISA 220: para. 14).

Some audits are wholly carried out by a sole practitioner (an accountant who practises on his/her own) or a partner.

More commonly, however, the engagement partner will take overall responsibility for the conduct of the audit and will sign the auditor's report. The engagement partner will delegate aspects of the audit work such as the detailed testing to the staff of the firm. The usual hierarchy of staff on an audit assignment is:

Hierarchy of staff



The engagement partner is responsible for ensuring that:

- An appropriate level of professional scepticism is applied by audit staff in the conduct of the audit; and
- There is proper communication both within the audit team and with the audited entity.

Achieving these two objectives is likely to involve holding a planning meeting with the audit staff on the assignment to discuss the risks of material misstatement that could arise in the financial statements and making them aware of historical issues on the audit.

Ensuring communication between client staff and audit staff will be more difficult as the audit engagement partner is unlikely to visit the client site during the audit. However, given that the audit partner has a responsibility here, he/she must take appropriate steps. What these should be will depend on the individual circumstances of the audit. The audit engagement partner should consider the following:

- Keeping in regular contact with both audit and client staff during the audit to assess the level of communication between them;
- Attending the site during the audit to facilitate better communication if he/she feels that it is necessary.Fostering lines of communication between client staff and audit staff during the period between audits to ensure a good working relationship is built up between them;

- The availability of audit staff throughout the engagement (taking into account conflicting audit deadlines, holidays and study leave).

- **Dealing with client staff**

An important skill that all staff chosen for the audit assignment should have is the ability to deal with the client staff with whom they come into contact. Discussions with staff operating the system should be conducted in a manner which promotes professional relationships between auditing and operational client staff.

Relationships with the client will be enhanced if auditors aim to provide a high quality service that caters for the needs of the client. However, more specific people skills will also be needed. Negotiation skills and interviewing skills are particularly important.

Auditors should also be trying to understand what managers and staff want from the audit and how hostility to the time they have to spend dealing with auditors can be overcome. This does not mean agreeing with management and staff on every issue, but it does mean enabling the auditors to understand why difficulties have arisen and how those difficulties can be overcome.

7.1.3. Limitations of audit planning

Even though the audit plan has a number of advantages, it is not free from limitations. Some of the major disadvantages of audit plan are as follows:

- **Rigitity**

An audit plan follows a standard approach and set patterns. This may stifle flexibility and initiative, therefore dampening professional judgement of the parties involved. Rigidity also makes the process too mechanistic undermining the audit staffs'liabilities, creativity and talents. This will consequently leave them with less freedom in performing their task and also technically challenged.

- **Overlooking audit staffs'capabilities**

A plan will make the audit process automated and will loose the sense of responsibility for the audit staff. It can potentially decrease initiative and inventiveness, with less application of staff talents and abilities. They therefore do not reinforce the plan with any improvements, which will lower it future effectiveness. The automation also leaves the staff performing their task with normality, which can cause boredom.

The strategies and pocedures adopted from an audit may not be in accordance with a client's standards. An auditor will likely need to prepare a new procedural plan that meets the need of the client: in some cases, this backtracking may cause the client to loose faith and /or trust in the auditor. Staff may also feel manipulated since they will have to participate in the preparation of the new plan, which can varry significantly from the audit standards..

- **Constant update**

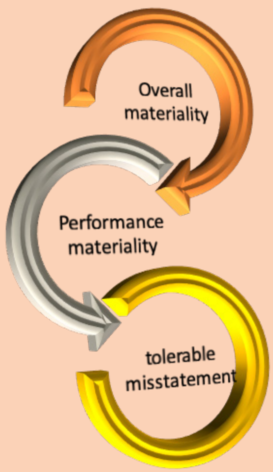
An audit plan needs to change regularly, usually each year to keep it current with the changing economic environment and business structures. If this change is not done, the plan may turn out to be too rigid in nature and its application in an audit process may be in-effective and out-dated. This updating requires more time and resource devotion to the plan, which would be better used in another productive activities.

Application activity 7.1

1. Explain the difference between the audit strategy and the audit plan
2. Identify seven key items of information likely to be contained in an audit strategy document.

7.2. Materiality in Auditing

Learning activity 7.2



Observe the above picture, then answer the following questons:

1. What do you mean by a material misstatement?
2. Explain the difference between the overall materiality and performance materiality.

7.2.1. Meaning and methods of calculating materiality inauditing

a) Meaning of materiality

Materiality in Auditing is defined as the benchmark used to obtain reasonableassurance that an audit does not detectany material misstatementthat can significantlyimpact the usability of financial statements.

The auditor is required to determine the materiality level for the financial statements as a whole, as well as performance materiality, at the planning stage. The calculation or estimation of materiality should be based on the auditor's experience and judgment. The materiality chosen should be reviewed throughout the audit.

Materiality relates to the level of misstatement that affects the decisions of users of the accounts.

Misstatements are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users.

Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size and nature of a misstatement or a combination of both. Judgments about matters that are material to users of financial statements are based on a consideration of the common financial information needed users as a group.

The practical implication of this is that the auditor must be concerned with identifying 'material' errors, omissions and misstatements of transactions, account balances and disclosures. Both the amount (quantity) and nature (quality) of misstatements need to be considered (e.g., lack of disclosure regarding ongoing litigation is likely to be considered material).

Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have to be useful.

E.g. If a company has a profit of FRW 100Millions, a misstatement of FRW1Million is unlikely to be significant. If a company has a profit of FRW 10Millions, a misstatement of FRW 1Million will have a more significant impact on the readers of the accounts.

During planning, the auditor must establish materiality for the financial statements as a whole, but must also set performance materiality levels.

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Materiality considerations during audit planning are extremely important. The assessment of materiality at this stage should be based on the most recent and reliable financial information and will help to determine an effective and efficient audit approach. Materiality assessment will help the auditors to decide:

- How many and what items to examine;
- Whether to use sampling techniques;
- What level of error is likely to lead to a modified audit opinion.

The resulting combination of audit procedures should help to reduce detection risk to an appropriately low level.

b) Determining materiality for the financial statements as a whole

Determining materiality for the financial statements as a whole involves the exercise of professional judgment. Because many users of financial statements are primarily interested in the profitability of the company, materiality is often thought in terms of a value associated with the level of profit before tax.

For example, if profit before tax was FRW 40,000,000, auditors might consider that all matters in the financial statements equal to 5% of FRW 40,000,000 (i.e. FRW 2,000,000) will be important to users.

However, auditors should avoid thinking of materiality solely in these terms. For example, some users might be more concerned with asset values or specific matters in the financial statements rather than 'value' at all. Consequently, auditors may have a monetary guide to what is important to users, but they should also use their professional judgment at all times to consider what is important to users.

In addition, certain types of errors should be investigated even if they are small in monetary terms, because, as stated above, they are important for other reasons.

- Recurring errors as these may indicate weaknesses in the accounting system
- Errors that would mean breaches of statutory requirements
- Critical point errors, for example, those that change a loss into profit
- Conceptual errors, errors that involve breaches in the accounting requirements

At the planning stage, auditors will set a 'value level' for planning materiality based on draft financial information available to them. However, this should be reviewed as the audit progresses and as any changes are made to the financial information.

Generally, a percentage is applied to a chosen benchmark as a starting point for determining materiality for the financial statements as a whole. The following factors may affect the identification of an appropriate benchmark:

- Elements of the financial statements (e.g. assets, liabilities, equity, revenue, expenses)
- Whether there are items on which users tend to focus
- Nature of the entity, industry and economic environment
- Entity's ownership structure and financing
- Relative volatility of the benchmark
- The following benchmarks and percentages may be appropriate in the calculation of materiality for the financial statements as a whole.

Value	%
Profit before tax	5
Gross profit	½ -1
Revenue	½ -1
Total assets	1-2
Net assets	2-5
Profit after tax	5-10

c) Determining performance materiality

Consider what would happen if this materiality for the financial statements as a whole was applied directly to, for example, different accounts balances (such as receivables, inventory etc.). It could be that a number of balances (or elements making up those balances) are untested or dismissed on the grounds they are immaterial. However, a number of errors or misstatements could exist in those untested balances, and these could aggregate to a material misstatement.

For this reason, the auditor is required to set performance materiality levels, which are lower than the materiality for the financial statements as a whole and this means a lower is applied during testing. The risk of misstatements which could add up to a material misstatement is therefore reduced. As we can see in the key terms below, performance materiality really has two definitions

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce an appropriately low level of the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

Performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

This indicates the auditor sets a level or levels of materiality lower than overall materiality for the purposes of performing procedures in general (for example on a low risk area) and this is just to account for aggregation.

However, an even lower level is set for certain balances, transactions or disclosures where there is an increased risk (for example, the auditor will set a lower performance materiality level for bank balances if he/she considers bank balances to be a sensitive area). Lower levels are also set if qualitative considerations (discussed below) necessitate it.

Determining performance materiality is very much dependent on the auditor's professional judgment. In summary it is affected by:

- The nature and extent of misstatements identified in prior audits;
- The auditor's understanding of the entity;
- Result of risk assessment procedures.

7.2.2. Difference between materiality in government and in private sector

Materiality in governmental audit is different from materiality in private sector auditing for several reasons.

Most importantly, due to the format of state and local government financial statements under GAAP (general accepted accounting principles), the AICPA (American institute of certified public accountant) audit guide for state and local governments requires auditors to consider materiality by "opinion unit" rather than for the financial statements taken as a whole. The guide defines opinion unit as follows:

Government-wide level

- Government activities;
- Business activity(nature of business);
- Discretely presented component units in the aggregate.

Fund levels:

- General fund (always a major fund)
- Other major funds determined for government funds or enterprise funds. Each major fund is an opinion unit. If there are no major funds, then there will be only two opinion units. The general fund and then remaining fund information; and

- Remaining fund information, consisting of all other non-major governmental and enterprise funds, internal service fund type, and fiduciary fund type. (this will generally always be present, although the individual components and size will change between governmental entities.)

This functionally decreases materiality for state and local government financial statements by an order of magnitude compared to materiality for private company financial statements. Due to the unique concept of materiality, the auditor's report expresses an opinion in relation to each opinion unit.

Moreover, the primary users of government financial statements are different: the citizens and the parliament in the public sector versus investors in the private sector. It is important to identify the primary users since materiality reflects the auditors judgment of the needs of users in relation to the information in the financial statements.

Finally, in government auditing, the political sensitivity to adverse media exposure often concerns the nature rather than the size of an amount, such as illegal acts, bribery, corruption and related-party transactions.

Qualitative considerations of materiality are therefore different in private sector auditing, in which qualitative consideration are focused on the effect on earnings per share, executive bonuses or other risks that are not applicable to governments.

Qualitative materiality refers to the nature of a transaction or amount and includes many financial and non financial items that, independent of the amount, may influence the decisions of users of the financial statements.

While rules of thumb mentioned in the section above are commonly applied to state and local government financial statements, government auditors may also use different means to quantify materiality such as total cost or net cost (expenses less revenues or expenditure less receipts). In a cash accounting environment, total expenditures is often used as a benchmark.

7.2.3. Roles of materiality of an error in auditing

The importance of materiality of an error in auditing is that:

- It influnces the auditor's time budget on specific items;
- It dictates the auditor's plan;
- It influences the auditor's plan;
- It determines the amount of audit evidence to be gathered;
- It is required by the professional body ICPAR (Institute of Certified Public Accountants of Rwanda) as an incidental objective.

Application activity 7.2

1. Which measures of a client's business is an auditor likely to use when setting a level of materiality:

   a) For a client that has a stable asset base and steady revenue over the last few years but has only made a small pre-tax profit this year owing to a large one-off expense?

   b) For a client where the outside shareholders have expressed concern over declining profits over the last few years?

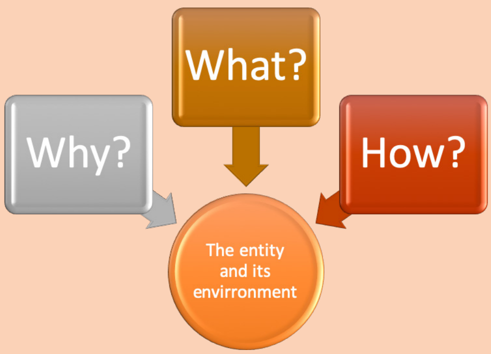
2. Profit before tax at Rilla Ltd is FRW10, 000,000.

   Which one of the following balances are the auditors unlikely to plan to test in detail?

   a) Receivable FRW 5, 000,000
   b) Bank FRW 450,000
   c) Dirctor's bonus of FRW 400,000
   d) Addition to non-current assets FRW 2,000,000

7.3. The entity and its environment

Learning activity 7.3



Observe the above image then answer the following questions:

1. What does the above image show?
2. What information do you think the auditor wants to know when he/she asks himself/herself the questions in the image?

7.3.1. The entity and its environment

The auditor is required to obtain an understanding of the entity and its environment in order to be able to assess the risks of material misstatement and direct his/her audit approach accordingly.

ISA 315 states that 'the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

a) Why?

The reasons the auditor is to obtain the understanding of the entity and its environment are very much bound up with assessing risks and exercising audit judgment. We shall look at these aspects more in the next two topics of this Unit.

b) What?

ISA 315 sets out a number of requirements about what the auditors must consider in relation to obtaining an understanding of the business.

c) How?

ISA 315 sets out the risk assessment procedures that the auditor must use to obtain the understanding. The auditor does not have to use all of these for each area, but the ISA requires that risk assessment procedures should, as a minimum,comprise a combination of these procedures.

- Inquiries of management and others within the entity
- Analytical procedures
- Observation and inspection

The audit team and the engagement partner are also required by ISA 315 to discuss the susceptibility of the financial statements to material misstatement. Judgment must be exercised in determining which members of the team should be involved in which parts of the discussion, but all team members should be involved in the discussion relevant to the parts of the audit they will be involved in.

Lastly, if it is a recurring audit, the auditors may have obtained a great deal of knowledge about the entity and the environment in the course of prior year audits. The auditor is entitled to use this information in the current year audit, but he/she must determine whether any changes in the year have affected the relevance of information obtained in previous years.

Inquiries of management and others within the entity

The auditors will usually obtain most of the information they require from staff in the accounts department, but may also need to make enquiries of other personnel, for example, internal audit, production staff or those charged with governance. Those charged with governance may give insight into the environment in which the financial statements are prepared. In-house legal counsel may help with understanding matters such as outstanding litigation, or compliance with laws and regulations. Sales and marketing personnel may give information about marketing strategies and sales trends.

Analytical procedures

Analytical procedures are a useful tool in risk assessment. ISA 315 and ISA 520 Analytical procedures provide guidance in this area. ISA 315 requires auditors to use analytical procedures during the risk assessment phase of the audit.

Analytical procedures consist of the evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information, or deviate significantly from predicted amounts.

There are many sources of information available to the auditor at this stage including interim financial information, budgets, management accounts, information for prior periods and industry information.

All of this information can be used by auditors to help them understand areas of risk. For example, ratios (such as the receivables days, inventory turnover and the current ratio) can be calculated using information from the financial statements. The financial statements can also be compared to prior years, or similar firms in the same industry.

Budgets are helpful in indicating the expectations of the organization, and management accounting information is useful for variance analysis. Variance analysis involves looking at actual income and expenditure against the expected figures and determining the reasons for any variances between the two.

Analytical procedures such as these can be extremely helpful at the risk assessment and planning stages of an audit and help the auditor to identify the areas of greatest risk, and therefore the areas where the risk of misstatement in the accounts is highest. These are the areas where the most work will be required during the audit.

Observation and inspection

These techniques are likely to confirm the answers made to inquiries made of management. They will include observing the normal operations of a company, reading documents or manuals relating to the client's operations or visiting premises and meeting staff.

The ISA gives guidance on performing these risk assessment procedures in order to obtain the required understanding of the business.

The table below summarizes some of the key points.

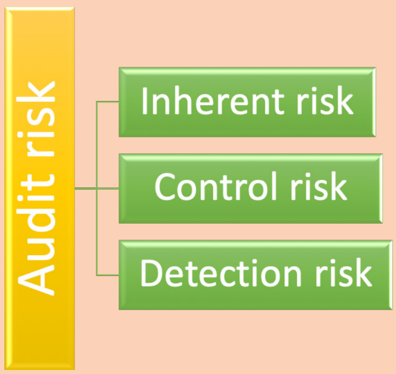
obtaining an understanding of the entity and its environment	
Why?	▪ To identify and assess the risks of material misstatement in the financial statements ▪ To enable the auditor to design and perform further audit procedures ▪ To provide a frame of reference for exercising audit judgment, for example when setting audit materiality.
What?	▪ Industry, regulatory and other external factors, including the applicable financial reporting framework ▪ Nature of the entity, including operations, ownership and governance, investments, structure and financing ▪ Entity's selection and application of accounting policies ▪ Objectives and strategies related to business risks that might cause material misstatement in the financial statements ▪ Measurement and review of the entity's financial performance ▪ Internal control framework.
How?	▪ Inquiries of management and others within the entity ▪ Analytical procedures ▪ Observation and inspection ▪ Prior period knowledge ▪ Client acceptance or continuance process ▪ Discussion by the audit team of the susceptibility of the financial statements to material misstatement ▪ Information from other engagements undertaken for the entity

Application activity 7.3

1. What auditors need to know in understanding the entity and its environment?
2. Why do auditors needs to be familiar with the organization business model?
3. What are the factors the auditor must valuate to understand the entity and its environment?
4. What is the most important thing that an auditor does when understanding the entity?

7.4. Audit risk

Learning activity 7.4



Observe the above picture then answer the following questions:

1. Is it possible that an auditor can give an inappropriate audit opinion on financial statements?
2. How do we call the case in which an auditor can give an inappropriate audit opinion on financial statements ?

7.4.1. Meaning and types of audit risks

a) Meaning of audit risk

In anaudit of financial statements, audit risk is **the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated**, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework.

b) Types of audit risk

Audit risk

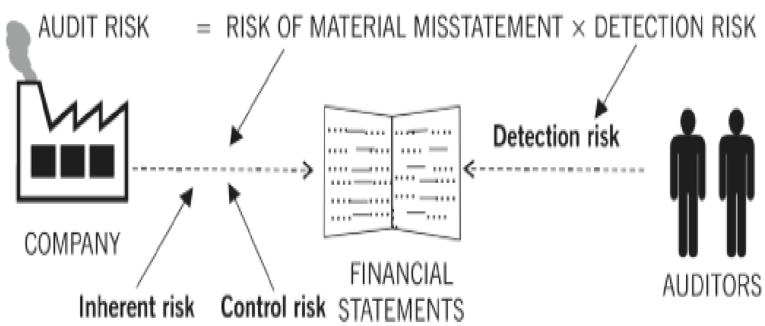
Audit risk is the risk that the auditors give an inappropriate audit opinion when the financial statements are materially misstated. It has two elements: the risk that the financial statements contain a material misstatement (inherent risk and control risk) and the risk that the auditors will fail to detect any material misstatements (detection risk).

In order to obtain assurance about whether the financial statements are free from material misstatement, the auditor needs to consider how and where misstatements are most likely to arise.

Carrying out a financial statement risk assessment helps the auditor ensure that the key areas more susceptible to material misstatement are adequately investigated and tested during the audit. It also helps the auditor identify low risk areas where reduced testing may be appropriate, ensuring time is not wasted by over-testing these areas.

In this way, auditors follow a risk-based approach to auditing. In the risk-based approach, auditors analyze the risks associated with the client's business, transactions and systems, which could lead to misstatements in the financial statements, and direct their testing to risky areas. Audits conducted in accordance with ISAs must follow the risk-based approach.

Auditors are therefore not concerned with individual routine transactions, although they will still be concerned with material, non-routine transactions.



As you can see from the above diagram, audit risk has two major components:

- The **risk of material misstatement arising** in the financial statements is dependent on the entity, and cannot be influenced by the auditors. It is a product of inherent risk and control risk. (ISA 200: para. 13(n))

Detection risk

Detection risk is dependent on the auditor, and is the risk that the auditor will not detect material misstatements in the financial statements. (ISA 200: para. 13(e))

Inherent risk

Inherent risk is the risk that items will be misstated due to characteristics of those items, such as the fact they are estimates or that they are important items in the accounts. The auditors must use their professional judgment and all available knowledge to assess inherent risk. If no such information or knowledge is available, then the inherent risk is high.

Inherent risk is affected by many factors, including:

- The nature of the entity, for example, the industry it is in and the regulations it falls under
- The attitudes and experience of management
- The geographic spread of the operations
- The future business strategy of the entity
- The presence of complex wage structures, for example, a bonus- or commission-based salary structure

The information system, for example, computer-based accounting systems

Inherent risk can also vary from account to account. Balances made up of complex items, such as inventory in a manufacturing company, portable assets in an engineering company and cash balances are generally more prone to high levels of inherent risk.

Control risk

Control risk is the risk that a misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control.

7.4.2. Model and calculation of audit risk

This aspect of audit risk is known as detection risk.

Detection risk is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements. (ISA 200)

Detection risk is the component of audit risk that the auditors have a degree of control over, because, if risk is too high to be tolerated, the auditors can carry out more work to reduce this aspect of audit risk, and therefore audit risk as a whole.

ISA 200 Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing (ISA 200) states that 'the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion', that is, giving reasonable assurance on the truth and fairness of the financial statements.

Looking at audit risk as a whole, we can see that it can be represented by the audit risk model as follows:

Audit risk (AR) = Inherent risk (IR) * Control risk (CR) * Detection risk (DR)

The implication of this for the auditor is that if inherent risk and control risk are relatively high, then the amount of work carried out to reduce detection risk will have to increase to reduce audit risk as a whole to an acceptably low level.

For example, let us assume that an auditor is prepared to accept a 5% chance that he may give an inappropriate audit opinion on the financial statements. In other words, the auditor sets the acceptable level of audit risk at 5%.

From his assessment of the client's risk environment, the auditor has determined the inherent risk factor to be 80% and the control risk factor for a given area of the financial statements to be 25%.

By re-arranging the audit risk model [Audit risk (AR) = Inherent risk (IR) * Control risk (CR) * Detection risk (DR)] we can find the level of detection risk required:

DR= AR/ IR*CR

DR = 0.05/ 0.8*0.25

DR= 0.05/0.2

DR= 0.25*100= 25%

So, the level of detection risk would need to be set at 25%.

However, let us now assume that for a different area of the client's financial statements, the auditor has assessed control risk at 12½%. How does this affect the level of detection risk?

AR= 0.05

DR= AR/ IR*CR

DR= 0.05/ 0.8*0.125

DR= 0.05/ 0.1

DR= 0.5 *100= 50%

Now the level of detection risk should be set at 50%.

These examples illustrate a very important point: that detection risk has an inverse relationship with risk of material misstatement (inherent risk u control risk). The lower the risk of material misstatement, the higher the level of detection risk which can be accepted, and therefore the lower the level of detailed testing required.

Conversely, if the auditor feels a company has a high risk of material misstatement, then the acceptable level of detection risk will need to be reduced to compensate for this, and consequently the auditor will need to increase the level of detailed testing required.

Remember that the level of detection risk represents the risk that the auditors will not find a material misstatement. Consequently, there is also an inverse relationship between the level of detection risk and the level of substantive testing required: the higher the acceptable level of detection risk, the lower the amount of substantive testing required, and vice versa.

7.4.3. Assessing the risk of material misstatement and responding to risk assessment

a) Assessing the risk of material misstatement

The ISA 315) says that the auditor shall identify and assess the risks of material mistatement at the financial statement level and assertion level. It requires the auditor to take the following steps:

- Identify risks throughout the process of obtaining an understanding of the entity'
- Relate the risks to what can go wrong at the assertion level;

- Consider whether the risks are of a magnitude that could result in a material misstatement;
- Consider the likelihood of the risks causing a material misstatement.

b) responding to risk assessment

The auditors must formulate an approach to the identified risks of material misstatement. They must formulate overall responses and detailed further audit procedures, which will comprise tests of controls and substantive procedures or substantive procedures only.

The objective of ISA 330 The auditor's responses to assessed risks is 'to obtain sufficient appropriate audit evidence regarding to the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks'.

In other words, having assessed the risks of material misstatements in the financial statements, the auditor has to plan the work that will be carried out to ensure that he/she can give an opinion that the financial statements give a true and fair view, that is, that any material misstatements have been identified and amended if necessary.

Overall responses

Overall responses to risks of material misstatement will be changes to the general audit strategy or re-affirmations to staff of the general audit strategy. For example (ISA 330):

- Emphasizing to audit staff the need to maintain professional scepticism;
- Assigning additional or more experienced staff to the audit team;
- Using experts;
- Providing more supervision on the audit;
- Incorporating more unpredictability into the audit procedures;
- Making general changes to the nature, timing and extent of audit procedures.

Responses to the risks of material misstatement at the assertion level

The ISA says that 'the auditor shall design and perform further audit procedures whose nature, timing and extent are based upon and are responsive to the assessed risks of material misstatement at the assertion level. Nature refers to the purpose and the type of test that is carried out. ISA 330 requires that auditors should carry out tests of controls and substantive procedures.

Test of controls is an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level.

Substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details and substantive analytical procedures.

Application activity 7.4

You are involved with the audit of Kigali Solutions Ltd, a small company. You have been carrying out procedures to gain an understanding of the entity. The following matters came to your attention:

The company offers standard credit terms to its customers of 60 days from the date of invoice. Statements are sent to customers on a monthly basis. However, Kigali Solutions Ltd does not employ a credit controller, the company sends statements to clients on a monthly basis, it does not communicate with them on a systematic basis (regular basis). On certain days, the receivables ledger clerk may call a customer if the company has not received a payment. Some clients pay regularly according to the credit terms offered to them, but others pay on a very haphazard basis and do not provide a remittance advice. Receivables ledger receipts are entered into the receivables ledger but not matched to invoices remitted. The company does not produce an aged list of balances.

Required

From the above information, assess the risks of material misstatement arising in the financial statements. Outline the potential materiality of the risks and discuss factors in the likelihood of the risks arising.

Skills lab activity 7

Under the guidance of the teacher, the students can visit the school accountant, headteacher and other school staffs, to ask them different questions about organization policy, management framework and financial informations that can help them to obtain useful information that can be used in the audit work.

End unit 7 assessment

1. Which of the following would not increae inherent risk

   A. Revenue is derived from sales of high-tech products

   B. Sales order are not authorised prior to sales being executed

   C. A number of customers have significatly old debt

   D. Some recent sales have resulted in legal claims against the company

2. Which of the following statement does not illustrate an inherent risk?

   A. The organization is seeking to rise finance to diversity

   B. The auditor uses samples when carrying out audit testing

   C. Directors participate in a profit-related bonus scheme

   D. The financial statements contain complex transactions

3. Can an audit partner delegate responsibility for the audit opinion to his staff?

4. What procedures might an auditor use in gaining an understanding of the entity?

5. What information does an audit plan usually contain?

6. The audit partner has set the overall level of audit risk for a client as 10%.

   Your risk assessment of the client has indicated that inherent risk is 60% and control risk is 60%.

   What level of detection risk should be prescribed for this client?

UNIT 8 AUDIT EVIDENCE AND SAMPLING

Key unit competence: To be able to explain the audit procedures in sampling and gathering audit evidence

Introductory activity

Observe the above picture then answer the following questions:

1. What do you think this auditor is looking for?
2. Is it necessary that this auditor can check all of these documents? If yes or no explain.
3. What this auditor can use to find what he/she is looking for?
4. Is it possible that this auditor can do his/her auditing activities by using the computer? If yes or no explain.

8.1. Audit execution and procedures

Learning activity 8.1

Observe the picture above then answer the following questions:

1. How do we call the terms in small circles surrounding the big circle?
2. Why these terms surround the big circle named audit execution?

8.1.1. Meaning and steps of audit execution

a) Meaning of audit execution

The audit execution consists mainly on the assessment and valuation of the questions based on the replies in the audit, the determination of the audit result and the degree of fulfilment, and the rating of the audit. In audit execution, the auditor has to perform audit procedures i.e. test of controls and substantive tests. The tests are perfomerd on class of tranactions and balances sampled.

b) Steps of audit execution

The conduct of an audit execution involves various procedures and techniques. These are various steps, which are taken by the auditor to complete an audit. These steps are illustrated with the help of the following figure:

Step1	Appointment of the auditor
Step2	Communication with previous auditor (if any)
Step 3	Letter of engagement sent to the client
Step 4	Investigate relevant internal control and accounting systems
Step 5	Evaluate operations of internal control and accounting systems by applying relevant tests
Step 6	Ensure the correctness of accounting records and final accounts
Step 7	Carry out final review
Step 8	Prepare and submit report

The steps involved in the conduct of audit execution are further explained as under:

- The auditor is appointed by the members or shareholders of a company. The auditor should make it sure that his/her appointment is in accordance with provisions of companies Act;
- If the auditor has been appointed in place of another auditor, he/she should enquire from the retiring auditor, the reasons for his/her removal as an auditor. If the retiring auditor discloses some information due to which the new auditor would not be able to work independently or in accordance with the professional ethics, then he/she should not accept the appointment;
- When the auditor accepts the appointment then he/she should obtain definite instructions from his/her client about the nature and scope of his/her work and duties, for this purpose, the auditor writes an engagement letter to the client;
- The next step is to investigate relevant internal control and accounting systems of the company. In this case, he/she obtains a list of the books maintained and the details of internal systems established in the respective organization. He/she opens an audit file and draws up internal control questionnaires (I.C.Q). At this stage, he/she also prepares an audit programme;

- The auditor carries out audit work to evaluate the operation of internal control and accounting systems of the concerned company. For this purpose, he/she applies various compliance and substantive tests;
- The auditor obtains audit evidence to ensure that all accounting records have been maintained accurately and the financial statements prepared from these records are also correct;
- The auditor reviews his/her findings critically in order to form his/her opinion.
- Finally, the auditor prepares his/her audit report and submits this report to the members of the company or to the concerned parties.

8.1.2. Audit procedures

a) Meaning of audit procedures

Audit procedures are the techniques, processes, and methods that auditors use to obtain reliable audit evidence, which enable them to gain a sound judgment about an organization's financial status. Audit procedures are conducted to help determine whether or not a company's financial statement is credible and factual.

The regular implementation of these procedures helps establish a business's financial reputation and strengthen its trustworthiness in the eye of its customers, the market, and potential investors.

There is no definitive structure when it comes to auditing; its whole process would depend on the auditor, the company to be audited, and the purpose of the audit. Learn more about the three main methods of audit procedures below.

- **Tests of controls**

Tests of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level.

Tests of controls are performed only on those controls that the auditor has determined and suitably designed to prevent, or detect and correct a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each control is considered separately.

Testing the operating effectiveness of controls is different from obtaining an understanding and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

- **Substantive procedures**

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level.

- **Analytical procedures**

Analytical procedures pair financial data with non-financial data determine the correlation between them. Comparison of previous trends versus current trends, as well as evaluation of the difference between the client's record and the substantive evidence, are also considered analytical procedures.

Application activity 8.1

1. Audit execution is said when :

    a. audit is done

    b. Audit start

    c. Audit take place

    d. Audit is concluded

    e. a and c are correct answers

    f. All of the above

2. Differentiate substantive procedures from analytical procedures

8.2. Audit evidence

Learning activity 8.2

Mr. GAKIRE is an external auditor in XYZ company. During his audit activities, he has discovered some fictious transactions and other frauds in their books of accounts and financial statement. At first, Mr. GAKIRE thought that the frauds were committeded by some of the staff at managerial level, especially the managing director, and other staff working in sensitive areas like the cashier and the storekeeper but he did not have the information appropriate information to support it. He started by looking at the information within the company that can help him to confirm who were responsible for frauds and failed to get them. Leter, he decided to visit some of the company's third parties like banks, suppliers, creditors and debtors with the aim of identifying the persons who were involved in the frauds. At the end, Mr. GAKIRE discovered that the frauds were committed by the managing director, accountant, and cashier.

After reading the above scenario answer the following questions:

1. What is the technical term used for the information found by Mr. GAKIRE?
2. How do we call the means used by Mr. GAKIRE when he was searching information? And which one has he used?
3. Is Mr. GAKIRE allowed to accept any kind of information received from XYZ's third parties? If yes or no, explain.

8.2.1. Meaning of audit evidence

Audit evidence is all the information, whether obtained from audit procedures or other sources that is used by the auditor in arriving at the conclusion on which the auditor's opinion is based on.The auditor obtains evidence from several sources. Some of significant source of audit evidence are from:

- Accounting records;
- Audit procedures performed to test accounting records;
- Information obtained during the audit of previous years;
- Audit firm's quality control procedures for acceptance of audit;
- Work of management's expert;
- Confirmation from third parties;
- Comparable data of other companies engaged in the same industry;

- Written representations from management to support other evidences obtained during the audit.

8.2.2. Qualities of audit evidence

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the relevance of audit evidence. These can be summarized as follows:

a) Sufficiency

It means that audit evidence should be complete and adequate to prove any material fact. For example, complete physical counting of items of stock is sufficient to verify the value of stock.

The auditor must assess whether the evidence is sufficient to allow him/her to reach the opinion that the financial statements give a true and fair view. If the auditor decides that the evidence obtained is insufficient to reach this opinion (or any other opinion), he/she may take any other action depending on the circumstances that can allow him/her to obtain more evidence by means of tests of controls and substantive procedures.

b) Relevance

Audit evidence should be relevant to the purpose for which it is required. For example, checking of physical existence of assets in accordance with the schedule of assets is relevant for audit purposes.

c) Reliability

Evidence is reliable if it is considered correct and accurate. For example, if the auditor receives a certificate of stock valuation from an outsider expert instead of an official of the company then it is more reliable. Similarly, documentary evidence instead of oral evidence is more reliable. A physical inspection by the auditor himself/herself is more reliable than evidence obtained from others.

8.2.3. Types of Audit evidence

There are four main types/groups of audit evidences are:

a) Primary audit evidence

This is the type of evidence which the auditor gathers from within the company, basically from accounting records and source documents. This type of audit evidence is usually biased or may fall-short of some fact, which renders it less reliable.

b) Secondary audit evidence

This is the type of audit evidence which the auditor collaborates outside the company, i.e. which gathers from such sources as third parties ‘confirmation, e.g. debtors, creditors, bankers, trustees, etc. and this evidence is gathered by writing to these parties and requesting them to send replies directly to the auditor. This evidence is usually more reliable except where these parties have other special relationships with the company in which case they may collude to give biased information.

c) Circumstantial Audit evidence

This evidence is gathered from circumstances prevailing in a given business at the time of the audit, e.g. orderliness of the business which is an indication of strong internal control system, qualification and ability of the staff to co-operate with the auditor, etc. This evidence may prove to be biased in particular if the auditor’s visit was known by the client in advance.

d) Hearsay evidence

This is gathered from such sources as: interviews, conversation, posing intelligent questions to the client’s senior staff and other parties related to the client in their day-to-day deals.

8.2.4. Techiniques of gathering audit evidence

A number of audit testing procedures are available to the auditor as a means of gathering audit evidence. More than one procedure may be used in collecting evidence in a particular area.

Not all procedures may be appropriate to a given objective of the audit. The auditor should select the most appropriate procedure in each situation. ISA 500 identifies seven (7) main testing procedures for gathering audit evidence:

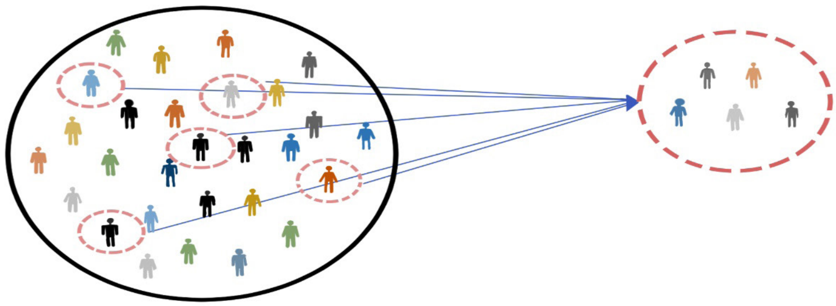
- Inspection (of an item)
- Observation (of a procedure)
- Inquiry
- External confirmation
- Recalculation
- Reperformance
- Analytical procedures

Application activity 8.2

1. Primary audit evidence is an evidence the auditor gathers from:
   a. Inside the company
   b. Source documents
   c. Accounting records
   d. A and C are correct answers
   e. All of the above
2. The following audit procedures are used for gathering audit evidence except:
   a. Staff confirmation
   b. Recalculation
   c. Inquiry
   d. Checking procedure
   e. A and D are correct answers
   f. No one of the above
3. Hearsay evidence is an audit evidence obtained from the followings except:
   A. Interviews
   b. Written conversations
   c. Questioning
   d. Oral presentations
   e. No one of the above
4. Enumerate sources of audit evidence.

8.3. Audit sampling

Learning activity 8.3



Observe the above image, answer the questions below:

1. What auditing term can be used for these people in the big circle?
2. What is the term used in auditing for the people who are selected in the big circle then move in the small circle?
3. What do you think can be based on when selecting these people in the small circle?

8.3.1. Meaning of audit sampling

a) Meaning

Audit sampling is the application of audit procedures to less than 100% of items with a population of audit relevance such that all sampling units have a chance of being selected. This will enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to provide the auditor with reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.

Auditors do not normally examine all the information available to them as it would be impractical to do so and using audit sampling will produce valid conclusion. ISA 530 Audit sampling provides guidance to auditors.

Notes: Some testing procedures do not involve sampling, such as:

- Testing 100% of items in a population
- Testing all items with certain characteristics as selection is not representative

Auditors are unlikely to test 100% of items when carrying out test of controls, but 100% testing may be appropriate for certain substantive procedure. For example, if the population is made up of a small number of high value items, there is a high risk of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100% examination may be appropriate.

The auditor may alternatively select certain items from population because of specific characteristics they possess. The results of items selected in this way cannot be projected onto the whole population but may be used in conjunction with other audit evidences concerning the rest of the population.

- **High value or key items.** The auditor may select high value items or items that are suspicious. Unusual or phone error.
- **All items over a certain amount**. Selecting items, this way may mean a large proportion of the population can be verified by testing a few items.
- **Items to obtain information** about the client's business, the nature of transactions, or the client's accounting and control systems.
- **Items to test procedures**, to see whether particular procedures are being performed.

In designing the audit sampling, the auditor applies judgment in considering:

- Audit objective
- Population
- Sampling unit
- Risk and assurance
- Tolerable error
- Expected error in the population, and
- Stratification

Audit objective: the auditor should first consider the specific audit objectives to be achieved to enable him/her to determine the audit procedure or combination of procedures which is likely to best achieve those objectives. In addition, when audit sampling is appropriate, the nature of the audit evidence sought and possible error conditions or other characteristics relating to that evidence will assist the auditor in defining what constitutes an error and what population should be used for sampling.

The population: the population is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. The auditor should determine that the population from which he/she draws the sample is appropriate for the specific audit objective. For example, if the auditor's objective was to test for overstatement of accounts receivable, his/her population could be defined as the accounts received trial balance.

Sampling unit is the individual items constituting a population. It may be a physical item (e.g. credit entries on bank statements, sales invoices, receivables' balances) or a monetary unit.

Risk and assurance: in planning the audit, the auditor uses professional judgment to assess the level of audit risk that is appropriate. Audit risk means the chance of damage to the audit firm as result of giving an audit opinion that is wrong in some particular.

Tolerable error: tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved his/her audit objective. Tolerable error is considered during the planning stage and is related to the auditor's preliminary judgment about materiality. The smaller the tolerable error, the larger the sample size the auditor will require.

Expected error in the population: if the auditor expects error to be present, he/she will normally have to examine a larger sample to conclude either that the population values are fairly stated to within the planned tolerable error or that the planned reliance on a relevant control is justified. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor should consider such matters as error levels identified in previous audits changes in client procedures and evidence available from his/her evaluation of the system of internal control and from results of analytical review procedures.

Stratification: stratification is the process of dividing population into sub-populations, which is a group of sampling units, which have similar characteristics (often in monetary value). The strata must be explicitly defined so that each sampling unit can belong to only one stratum. This procedure reduces the variability of the items within each stratum. Stratification enables the auditor to direct his/her efforts towards the items he/she considers potentially contain the greater monetary error. For example, the auditor might direct his/her attention to larger value items for accounts receivable to detect material overstatement errors. In addition, stratification may result in a smaller sample size.

8.3.2. Sample size

The auditor shall determine a sufficient sample size to reduce sampling risk to an acceptably low level.

a) Sampling risk

Sampling risk is the risk that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population weas subjected to the same audit procedure.

Non-sampling risk is the risk that the auditor might reach an erroneous conclusion for any reason not related to sampling risk. For example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognize a misstatement or deviation.

Remember: Detection risk is the risk that auditors will not detect a material misstatement in the financial statements. Sampling risk is a subset of detection risk, being the risk that the sample is not representative of the population. This means that the auditor's sample may not include an item, which contains a material error, and so the material misstatement would not be detected.

The auditors are faced with sampling risk in both tests of controls and substantive procedures, as follows.

The risk the auditor will conclude, in the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details that a material misstatement does not exist when in fact it does. This type of risk affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

The risk the auditor will conclude, in the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of risk affects audit efficiency, as it would usually lead to additional work to establish that initial conclusions were incorrect.

Auditors need to ensure that risk is managed, so the greater their reliance on the results of the procedure in question, the lower the sampling risk auditors will be willing to accept and the larger the sample size will be. The sample size needed to give acceptable level of audit risk will depend on the assessed levels of inherent risk and control risk. The higher these risks are, the greater the sample size needed to offset this.

If both inherent risk and control risk are low, then a smaller sample size will be necessary than for situations where inherent or control risks are considered to be high.

For both tests of controls and substantive tests of details, sampling risk can be reduced by increasing sample size while non-sampling risk can be reduced by proper engagement planning, supervision and review.

b) Risk and sample size

If you recall, in the previous unit we illustrated how the prescribed level of detection risk is affected by inherent risk and control risk, given a desired level of audit risk. This relationship is described by the audit risk model: AR = IR*CR*DR.

This formula is very important, so we will look at another example of it here, to reinforce your understanding.

An audit firm sets its acceptable level of risk as 5%. The risk assessment activities at the firm's client have indicated that the level of inherent risk is 75% and control risk is 40%. What is the level of detection risk the auditor can accept?

Applying the audit risk formula:

AR= IR*CR*DR

DR = AR / IR*DR

DR= 0.05 / 0.75*0.4

DR= 0.05 / 0.3

DR= 0.16666667= 0.167*100= 16.7%

AR= 0.75*0.4*0.167

AR= 0.0501*100= 5%

So, the level of detection risk would need to be set at 16.7% to achieve the prescribed level of audit risk (5%).

However, we have now also seen that detection risk comprises both sampling risk and non-sampling risk.

To reflect this, the audit risk model can be rewritten:

Audit risk = Inherent risk * Control risk * Sampling risk (SR) * Non-sampling risk (NSR)

As above, the audit firm sets its acceptable level of risk as 5%, the level of inherent risk is 75% and control risk is 40%. However, in addition, the firm has identified that non-sampling risk is 50%. What is the prescribed level of sampling risk?

Applying the amended audit risk formula, we find that:

AR= IR*CR*SR*NSR

SR= AR / IR*CR*NSR

SR= 0.05 / 0.75*0.4*0.5

SR= 0.05/0.15

SR= 0.33333333*100= 33%

AR= 0.75*0.4*0.5*0.33

AR= 0.05*100= 5%

So, the level of sampling risk would now need to be set at 33%.

Calculating the actual sample size to be used for an audit test is a complex exercise involving mathematical tables, and is outside the scope of this paper. You will not have to perform such a calculation in your exam.

However, you need to appreciate, in general terms, the relationship between the level of sampling risk and the size of the sample an auditor will need to choose. That is, the lower the sampling risk the auditor is prepared to accept, the larger the sample size he/she will have to select. Or conversely, the higher the sampling risk the auditor is prepared to accept, the smaller the sample size he/she will have to select.

8.3.3. Techniques of audit sampling

Audit sampling can be done using either **statistical sampling** or **non-statistical sampling** methods.

Statistical sampling is sampling method involving random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk.

Non-statistical sampling is another sampling method that does not have these characteristics.

There are a number of methods available to an auditor to help him/her select a sample (ISA 530).

a. **Random selection** uses random number tables or computerized generator to select the sample.
b. For example, the auditors might tell a computer program there are 450 receivables numbered 1–450 and they want a sample of 30. The computer would randomly select 30 numbers between 1 and 450 to be the sampled items.
c. **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. So using the above example of 1–450 again, the sampling interval would be 15, as 15*30 is 450. The computer could randomly choose a number between 1 and 15 to be the 1st sampled item and every 15th item after that (for example, 13, 28, 43 etc.) would be sampled. When using systematic selection auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds to a particular pattern in the population.
d. **Haphazard selection** is where an auditor himself/herself selects items 'at random'. It may be an alternative to random selection provided that the auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased, for example towards items which are easily located, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.
e. **Sequence or block selection.** Sequence sampling may be used to establish whether certain items have particular characteristics. For example: an auditor may use a sample of 50 consecutive cheques to verify whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year. Sequence sampling may however produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.
f. **Monetary unit sampling** is a type of value-weighted selection in which sample size, selection and evaluation result in a conclusion in monetary amounts.

The auditor shall perform audit procedure, appropriate to the purpose, on each item selection.

If the particular item is not appropriate, tests can be performed on alternative items

If however, evidence about the item is not available, the auditor should normally treat it as an error. For example, if an auditor has chosen a selection of receivables balances to confirm whether they have subsequently been paid and one sampled item was actually in credit due to a previous double payment, it would not be appropriate to test for a subsequent payment and another balance should be selected.

8.3.4. Factors affecting the sample size

Examples of some factors affecting sample size are given in ISA 530, and summarized here:

Examples of factors influencing sample size for tests of controls:

Factors	Effects on sample size	Explanations
An increase in the extent to which the auditor's risk assessment takes into account relevant controls.	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's risk assessment of material misstatement will be and the larger the sample size will need to be.
An increase in the tolerable rate of deviation.	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.
An increase in the expected rate of deviation of the population to be tested.	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation.
An increase in the auditor's desired level of assurance	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
An increase in the number of sampling units in the population	Negligible effect	For small populations however, sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Examples of factors influencing sample size for tests of details

Factors	Effects on sample size	Explanations
An increase in the auditor's risk assessment of material misstatement	Increase	In order to reduce audit risk to an acceptably low level, the auditor needs low detection risk and will rely more on substantive procedures. This results in increased sample sizes.
An increase in the use of other	Decrease	The more the auditor is relying on other substantive procedures, the less assurance the auditor will require from sampling.
An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires, the larger the sample size needs to be.
An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size need to be.
An increase in the amount of misstatement the auditor expects to find in the population	Increase	Factors relevant to the auditor's consideration of the expected misstatement include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of controls and the results of other substantive procedures.
Stratification of the population when appropriate	Decrease	Useful when there is a wide range in the monetary size of items in the population.
The number of sampling units in the population	Negligible effect	For small populations though, sampling may not be the most efficient approach.

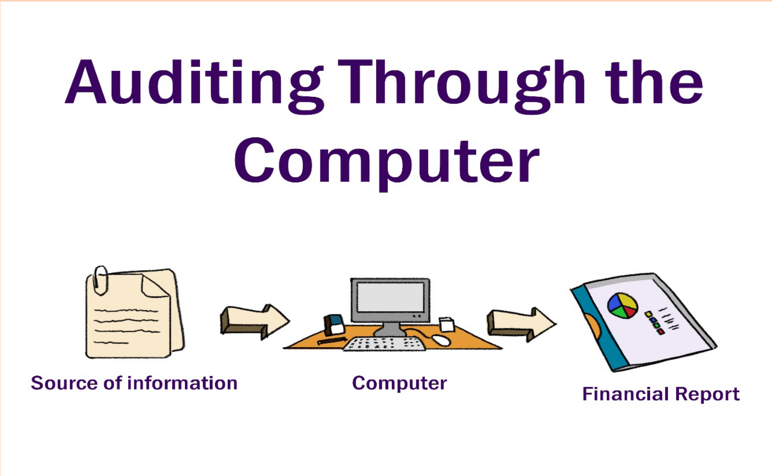
An important thing to note is that although the auditor can manage/influence the level of audit risk by increased sampling, this should always be balanced against the amount of time and resource available.

Application activity 8.3

1. Give three examples of sample selection methods that can be used in audit sampling.
2. Differentiate sampling risk from non-sampling risk.
3. Explain the importance of audit sampling during the audit execution.
4. What are the testing procedures that do not involve sampling?
5. State the elements that the auditor may depend upon when designing the audit sampling before applying judgement.

8.4. Audit in IT environment

Learning activity 8.4



Observe the above picture then answer the following questions:

1. How do we call applications of auditing procedures that can be performed with the use of a computer as an audit tool?
2. What are those applications?

8.4.1. Computer Assisted Audit Techniques(CAATs)

a) Meaning of CAATs

Computer-assisted audit techniques (CAATs) are commonly used by auditors. They consist of audit software and test data.

Computer-assisted audit techniques (CAATs) are applications of auditing procedures to be applied using the computer as an audit tool.

It is by no means unusual to use a computer to help with auditing. You probably use common CAATs all the time in your daily work without realizing it.

Most modern accounting systems allow data to be manipulated in various ways and extracted into a report.

Even if reporting capabilities are limited, the data can often be exported directly into a spreadsheet package (sometimes using simple Windows-type cut and paste facilities in very modern systems) and then analyzed.

Most systems have searching facilities that are much quicker to use than searching through print-outs by hand.

There is a variety of packages specially designed either to ease the auditing task itself, or to carry out audit interrogations of computerized data automatically. There is also a variety of ways of testing the processing that is carried out. Much of this work can now be done using computers that are independent of the organization's systems.

These uses of the computer for audit work are known as computer-assisted audit techniques (CAATs). CAATs may be used in performing various auditing procedures, including the following:

- Tests of details of transactions and balances
- Analytical review procedures
- Tests of computer information system controls

The overall objectives and scope of an audit do not change when an audit is conducted in a computerized environment. Auditing can be carried out around, through or with the computer.

b) Auditing around the computer

To audit around the computer, the auditor does not look at the specific workings of the system itself. A sample of inputs will be traced to outputs, and vice versa. If they prove to be accurate and valid, it is assumed that the system of controls is effective and that the system is operating properly.

The main advantage of this method of auditing is that it can be carried out with very little technical expertise. However, this method is only suitable if there is a clear audit trail within the system, the system is relatively simple, and up to date documentation exists about how the system works.

c) Auditing through the computer

Auditing through the computer requires more specific IT audit skills than those required to audit around the computer as this method directly tests the controls within the system itself.

Auditors customarily audit 'through the computer'. This involves an examination of the detailed processing routines of the computer to determine whether the controls in the system are adequate to ensure complete and correct processing of all data. In these situations, it will often be necessary to employ CAATs.

d) Auditing with the computer

Auditing with the computer refers to the use of CAATs to assist in auditing work. CAATs consist of audit software and test data which we will look at in detail below.

8.4.2 .Advantages and disadvantages of CAATs

a) The advantages of using CAATs

- Audit testing capability is increased – large volumes, up to 100%, of information can be tested, thereby reducing or even eliminating sampling risk.
- Tasks which are manually impossible can be carried out – using the computer to trace key controls and processes where there is no visible audit trail.
- Cost-effectiveness – although up-front costs may be considerable, CAATs can often be used again in subsequent audits.
- Repetitive work is eliminated – this can increase job satisfaction for auditors and for them up to apply professional judgment to key areas.
- Knowledge of client's systems is improved – this is an important by-product that enhances the auditor's knowledge of the client and aids future audit planning.
- Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased.

b) The challenges or disadvantages associated with using CAATs

- Setting up the software needed for CAATs can be time consuming and expensive.

- Audit staff will need to be trained so they have a sufficient level of IT knowledge to apply CAATs.
- Not all client's systems will be compatible with the software used with CAATs.
- There is a risk that the client's data is corrupted and lost during the use of CAATs.
- Information in real-time systems is constantly changing.
- Testing can be limited by the data held on the system.
- There is a risk of over-reliance on 'infallible' computerization of audit procedures.
- Auditor judgment must still be applied throughout the testing process.

8.4.3. Audit software

a) Meaning of audit software

Audit software is computer programs used by the auditor to interrogate a client's computer files. Audit software consists of computer programs used by the auditors as part of their auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of generalized audit software or custom audit software. Audit software is used for substantive procedures.

Generalized audit software allows auditors to perform tests on computer files and databases, such as reading and extracting data from a client's systems for further testing, selecting data that meets certain criteria, performing arithmetic calculations on data, facilitating audit sampling and producing documents and reports quickly.

Customized audit software is written by auditors for specific tasks when generalized audit software cannot be used.

Using audit software, the auditor can scrutinize large volumes of data, and identify results or anomalies which need further investigation.

Audit software performs the sort of tests on data that auditors might otherwise have to perform by hand. The following are some examples of the use of audit software in the course of an audit work.

b) Audit software: Examples of its use

- Access the client's data files and obtain information without the need to ask the client for information.
- Perform calculations and comparisons in analytical procedures.

- Sampling programs to extract data for audit testing, e.g. select a sample of receivables for confirmation.
- Scan a file to ensure that all documents in a series have been accounted for or to search for large and unusual items.
- Compare data elements in different files for agreement (e.g. prices on sales invoices to authorized prices in master file).
- Re-perform calculations, e.g. totaling receivables ledger.
- Prepare documents and reports, e.g. Produce receivables' confirmation letters and monthly statements.

The use of audit software is particularly appropriate during substantive testing of transactions and especially balances. Interrogation software in particular can help auditors prepare tests, by for example selecting a sample of balances or dividing populations according to set criteria such as amounts owed (this is called stratification and is discussed further later in this unit).

Interrogation software can also help auditors scrutinize large volumes of data, and concentrate resources on the investigation of results.

Earlier we looked at the advantages and disadvantages of CAATs in general and, although some may be similar, we will now look specifically at the benefits of audit software along with the potential difficulties of using audit software.

c) Benefits and difficulties of using audit software

- **Benefits of using audit software**
  - Audit software can perform calculations and comparisons more quickly than those done manually.
  - Audit software makes it possible to test more transactions than when simply manually scanning print outs. For example: audit software may facilitate searches for exceptions, such as negative or very high quantities when auditing inventory listings. The additional information will give the auditor increased comfort that the figure being audited is reasonably stated.
  - Audit software may allow the actual computer files (the source files) to be tested from the originating program, rather than print outs from spool or previewed files which are dependent on other software (and therefore could contain errors or could have been tampered with following export).
  - Using audit software is likely to be cost-effective in the long-term if the client does not change its systems.

- **Difficulties of using audit software**
  - The costs of designing tests using audit software can be substantial as a great deal of planning time will be needed in order to gain an in-depth understanding of the client's systems so that appropriate software can be produced.
  - The audit costs in general may increase because experienced and specially trained staff will be required to design the software, perform the testing and review the results of the testing.
  - If errors are made in the design of the audit software, audit time, and hence costs, can be wasted in investigating anomalies that have arisen because of flaws in how the software was put together rather than by errors in the client's processing.
  - If audit software has been designed to carry out procedures during live running of the client's system, there is a risk that this disrupts the client's systems. If the procedures are to be run when the system is not live, extra costs will be incurred by carrying out procedures to verify that the version of the system being tested is identical to that used by the client in live situations.

8.4.4. Test data

a) Meaning of test data

Test data is data submitted by the auditor for processing by the client's computer system, to test that the system processes the data as expected.

Test data techniques are used in conducting audit procedures by entering data (e.g. a sample of transactions) into an entity's computer system, and comparing the results obtained with pre-determined results. Test data is used for tests of controls.

An obvious way of seeing whether a system is processing data in the way that it should be is to input some example, or test data and see what happens. The expected results can be calculated in advance and then compared with the results that actually arise. Test data has two aspects:

- Data representing **valid transactions**. Here the auditor is looking for confirming that the system produces the required documentation such as sales invoices and updates the accounting records.
- Data that is **invalid** for any reason. Here the auditors are reviewing controls that prevent processing of data that is clearly wrong, negative amounts or non-existent customers for example, or which breaches limits set down by the company (for example transactions which take credit customers over their credit limit). Auditors are interested in seeing not only that the system rejects the transaction, but also that breaches are reported (by means of exception reports).

uses of test data

- Test data used to test specific controls in computer programs such as on-line password and data access controls.
- Test transactions selected from previously processed transactions or created by the auditors to test specific processing characteristics of an entity's computer system. Such transactions are generally processed separately from the entity's normal processing. Test data can, for example, be used to confirm whether the controls that prevent the processing of invalid data are operating effectively, for example by entering data with say a non-existent customer code or worth an unreasonable amount, or a transaction which may if processed break customer credit limits.
- Test transactions used in an integrated test facility. This is where a 'dummy' unit (e.g. a department or employee) is established, and to which test transactions are posted during the normal processing cycle.

b) Benefits and problems of using test data

Bearing the examples above in mind, we can see the main benefits of using test data techniques as follows:

- Test data provides evidence that the software or computer system used by the client is working effectively by testing the program controls and in some cases there may be no other way to test some program controls.
- Once the basic test data have been designed, the level of ongoing time needed and costs incurred is likely to be relatively low until the client's systems change.

However, there are some problems with using test data as shown below:

- A significant problem with test data is that any resulting corruption of data files has to be corrected. This is difficult with modern real-time systems, which often have built-in (and highly desirable) controls to ensure that data entered cannot be easily removed without leaving a mark.
- Test data only tests the operation of the system at a single point of time and therefore the results do not prove that the program was in use throughout the period under review.
- Initial computer time and costs can be high and the client may change their programs in subsequent years.

Application activity 8.4

1. Name two types of CAATs that are commonly used.
2. How CAATS may be used in audit execution?
3. Explain the use of audit software
4. Explain the benefits of using test data
5. Diferentiate the aspects of test data
6. State the main audit procedure used for gathering audit evidence

Skills lab activity 8

Accounting records/transactions from the school's bursar, share with students the following:

1. Let students apply sampling techeniques to obtains samples
2. Guide students on how some sampling techeniques can increase or deacrese the sample size.

End unit 8 assessment

1. Explain the challenges associated with using CAATs
2. Differentiate audit software from test data
3. Explain the qualities of an audit evidence
4. Differentiate statistical sampling from non-statistical sampling

UNIT 9 | AUDIT DOCUMENTATION

Key unit competence: To be able to evaluate the form, content and extent of audit documentation

Introductory activity

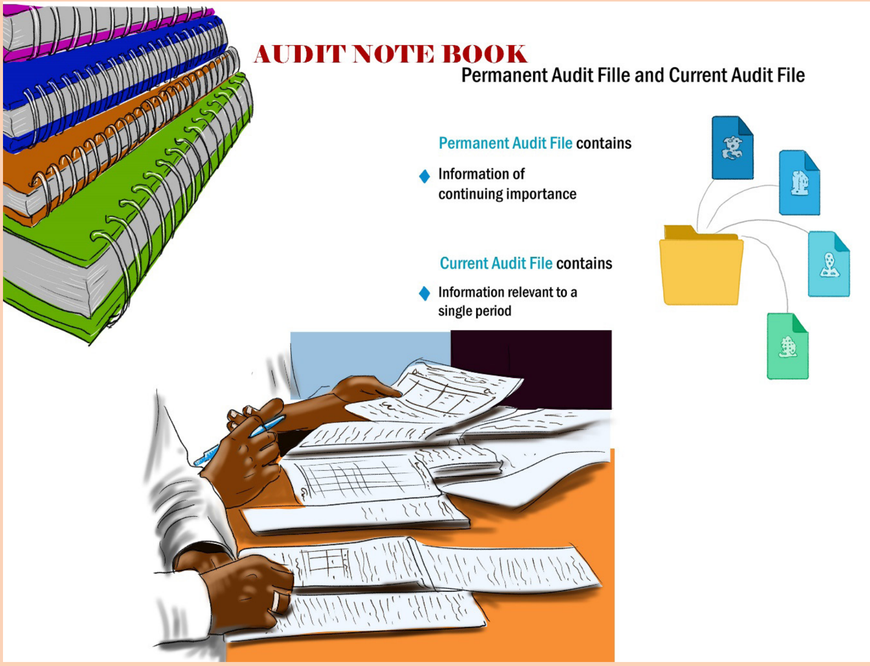
KAYIJUKA has been recently appointed as the auditor of ITERAMBERERYACU Ltd Company located in GATSIBO DISTRICT. The company is operating in beverage business industry. On his arrival, he was received by the managing director of the company. They had discussions and later proceeded with auditing work. He was given various documents from the accountant, manager, cashier and storekeeper. During his work of audit, the auditor was collecting some documents that could help him to prepare his audit report.

Question

1. How do you call the documents gathered by the auditor during audit?
2. What do you think could be the purpose of gathering the documents?

9.1. Components of audit documentations

Learning activity 9.1



Observe carefully the pictures above and answer the following questions:

1. Which documents do you observe on the pictures?
2. In few words how do you call the documents observed?

9.1.1. Meaning and objectives of audit documentation

a) Meaning of audit documentation

Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise.

Audit documentation refers to the records or documentation of procedures that auditors performed, the audit evidence that they obtained and the conclusions made by them based on the evidence obtained from the field. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment.

b) Objectives of audit documentation

Before the auditor could make a conclusion on financial statements whether those financial statements are free from material misstatement or they contain the misstatement, the auditor needs to make sure that they have enough(sufficient and appropriate) audit evidence to support his/her conclusions. Therefore, audit documentation is important for the success of audit works. The following are the objectives of audit documentation:

- It provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective;
- It provides evidence that the audit was planned and performed in accordance with ISAs and other legal and regulatory requirements;
- It assists the engagement team to plan and perform the audit;
- It assists team members responsible for supervision to direct, supervise and review audit work;
- It enables the team to be accountable for its work;
- It allows a record of matters of continuing significance to be retained;
- It enables the conduct of quality control reviews and inspections (both internal and external).

Audit documentation is sometimes called audit working papers.

9.1.2. Audit working papers

a) Definition of audit working papers

Audit working papers are documents which contain all information gathered from the company audited and show all evidences to help the auditor to prepare the final report and to form his/her opinion. Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement

Working papers are the record of various audit procedures performed, audit evidence collected and obtained, allocation of work between audit team members etc. Audit working papers are the documents and evidence that an auditor collects and retains with himself/herself during the audit work.

b) The form and contents of working papers

The form and content of working papers are affected by matters such as:

- The size and complexity of the entity;
- The nature of the audit procedures to be performed;
- The identified risks of material misstatement;

- The significance of the audit evidence obtained;
- The nature and extent of exceptions identified;
- The audit methodology and tools used.

c) Features of good working papers

- They should be properly headed.
- They should indicate the period covered by them or when they were collected or recorded.
- They should be as complete as possible so that they do not call for further explanation.
- They should be sufficiently detailed.
- They should be kept safely as a safeguard from misuse or destruction.
- Symbols used should be explained.

d) Advantages/benefits of collecting working papers

- They are used as a basis for planning the current year's audit.
- They are used as a means of controlling the current year's audit through their review.
- They enable the auditor to form an opinion.
- They are used to assist in investigations in company's financial affairs.
- These working papers can be used as evidence of work done in particular if the auditor has been sued for negligence.
- They are collected as evidence of work done by each audit clerk who can be questioned if any work was omitted.

e) How Audit working Papers are gathered

- By taking photocopies of the client's statements.
- By taking notes relating to areas of weak internal control system, material errors and frauds.
- By filing up evidence from third parties.
- Auditor's own judgment which is put on record and filed.
- Important documents from the company.

f) Ownership of working papers

Working papers are the property of the auditor. The auditor may, at his/her discretion, make portions of or extracts from his/her working papers available to his/her client. They should not, however, be a substitute for the client's accounting records.

9.1.3. Audit files

The auditor maintains two audit files for each client. These two files are known as permanent audit file and current audit file and they are explained as follows:

a) Permanent audit file

Permanent audit file is a file which containst all documents that are required by the auditor as long as he/she remains the auditor of this particular company. Permanent audit file is a file which contains informations of continuing importance / nature to the auditor i.e.that informations which the auditor will use beyond one financial period.

A permanent audit file contains information which is of continuous interest and is relevant in future audits. In preparing this file, the auditor should bear in mind the following points:

- The objective of the file is to maintain a permanent record of information of permanent importance to the auditor.
- The file must be updated at each annual audit.

The documents kept in the parmanent file include:

- Statutory or legal documents like Memorandum of association and Articles of association;
- Details relating to the nature of the business, its operations;
- Organization plan and chart showing the duties and authorities of various officials of the company;
- Details of accountig systems and internal control in operation;
- Copies of important agreements and minutes of important meetings of board of Directors;
- List of accounting books or records maintained by the company;
- Copies of previous years financial statement.

b) Current audit file

Current audit file is that file which contains information which related primarily to the set of accounts being audited i.e. It contains informations which will be used by the auditor for the current year under audit only. A current audit file contains information regarding audit conducted for the current period. This file contains documents in respect of one specific year.

The current file contains the following documents:

- A copy of the final accounts of the respective year.
- Completed internal control questionnaires.

- Audit programme
- Audit time table
- All relevant list e.g. list of fixed asset, a list of debtors, a list of creditors etc.
- Correspondence with the client in respect of the current audit.

9.1.4. Audit note book

a) Definition and purpose of audit note book

An audit notebook is a register kept by an audit team to record crucial/important points observed during the audit.

The purpose of an audit notebook is to note down various points, which need to be either clarified with the client or the chief auditor. Audit notebook is also used for recording important points to be included in the Auditor's Report. It is a complete record of doubts and their clarification.

b) Importance of Audit Note Book

- Audit notebook shall be taken as reliable evidence even by the Court of law in case of dispute or if the auditor is charged with negligence.
- It is useful for drawing the audit program.

c) Advantages of audit notebook

- Audit note book enables the auditor to record important points, which arise during the course of his/her audit; otherwise he/she might forget these points.
- An auditor can produce this book as a documentary evidence in a suit filed against him/her for negligence or misfeasance.
- It facilitates the preparation of the audit report.
- If the assistant in charge is changed before the completion of a particular work, it acts as a guide and makes the completion of balance work easier.
- It can help in making an assessment of the work of audit clerks.
- It provides a key to evaluate the efficiency of the audit staff.

d) Disadvantages of Audit NoteBook

- Very often, it creates misunderstanding between the client staff and the audit staff.
- If it is not properly and carefully prepared, it cannot be used as evidence against the auditor for negligence.
- Audit staff has to depend too much upon the client's staff for its preparation.

e) Contents of an audit notebook

- A list of books of accounts maitained by the client.
- The technical terms used in the business.
- The names of the principal officers, their powers, duties and responsibilities.
- The points which require further explanations and clarification.
- The mistakes and errors discovered .
- The total or balance of certain books of accounts, bank reconciliation statemant.
- Accounting methods followed in the business.
- The points which have to be incorporated in the audit report.
- Any matters which require discussions with the senior or with the auditor.
- Date of commencement and completion of the audit.

Application activity 9.1

1. Define the following concepts:

   a. Audit documentation

   b. Audit notebook

2. What are the types of audit files?

Skills lab activity 9

Under the guidance of a teacher, the students in their learning groups are facilitated to design appropriate working papers showing all the required information as required per International Standards on Auditing.

End unit 9 assessment

1. Identify the objectives of audit documentation.
2. What is the definition and the purpose of audit notebook?
3. Differentiate Permanent audit file from Current audit file
4. Give the features of good audit working papers
5. Complete the following definitions:
   a. …...documents which contain all information gathered from the company audited and show all evidences to help the auditor to prepare the final report and to form his/her opinion.
   b. …...the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise.

UNIT 10 INTERNAL CONTROL SYSTEM

Key unit competence: To be able to evaluate internal control system

Introductory activity

A case study

IHAHIRORYACU Ltd Company is located in Kigali city. Due to the lack of sufficient staff at both managerial and operational levels staff , the management of the company requested its staff to perform any tasks assigned to them. This implies that there were no specific duties and responsibilities assigned to each staff.

Procurement of goods and services are planned and executed by Head of Finance (HoF). The Head of the Finance is the one who receives the goods and services and later makes payments for them. Suppliers are paid with the use of cheques. As part of practice, the issued must bear the signatures of the Hod and accountant. The accountant is the brother in law to the HoF.

In accordance with company's human resources policy, the recruitment of staff is done by a team of staff appointed by the Head of the Human Resources (HRM).

It is the responsibility of the Human Resources unit to conduct the recruitment process and recommend to Managing Director (MD) the competent candidates for appointment. This is not done as per the policy; recruitment of staff is conducted by the Head of Finance and recommend the competent candidates to the MD for appointment. The Human Resources unit does only preparare monthly payrolls and ensure that the employees are paid timely.

The management of petty cash is done by the accountant. No one makes follow up of money spent through petty cash. No records regarding petty cash managment. IHAHIRORYACU Ltd Company maintains three bank accounts. The signatories to the bank accountants are the accountant and HoF. Bank reconciliation for the bank accounts are prepared at the end of financial year.

Question

What are weaknesses that exist in management of IHAHIRORYACU Ltd Company?

10.1. Features of internal control system

Learning activity 10.1

A manager of a company would like to build an overall system, which will allow the management of the organisation to govern, control of organisational activities, examine financial information and review operating activities.

1. What do you think this manager can do in order to provide the company with an effective internal control system?
2. What are main elements of internal control system?

10.1.1. Meaning and features of internal control system

a) Meaning of internal control system

Internal control is the process designed and affected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

b) Features of internal control system

Effective internal control depends on good organization. Reducing the level of errors and irregularities helps to ensure that the objectives of the control system are effectively achieved.

Organization plan

The first feature of an internal control system is the organization plan. In order for it to be effective, it must be simple and flexible. This plan should clearly outline the functions of each unit and its staff members.

- **Segregation of functions**

Structural independence of an organization means separating the functions of each area of the company. This is essential for an effective internal control system, as it ensures that one person is not responsible for all stages of an operation. In this sense, all processes must go through different phases, and each of them must be under the responsibility of different persons. Thus, the execution, authorization or registration of a transaction is performed independently by different employees.

- **Control of access to assets**

Effective internal control depends on a large extent on the security of the processes. An organization achieves an adequate degree of security when access to assets or accounting records is limited. This involves restricting physical or remote access to assets or the preparation of documents for authorizing access to them.

- **Authorization system and procedure**

Effective internal control includes methods to monitor the records of operations and transactions. The procedures involved in an activity must include periodic audits and reviews, as well as obtaining control information and authorisation.

10.1.2. Elements of internal control system

Internal control has five elements:

a) The control environment

The control environment is the framework within which controls operate. The control environment is determined by the management of the business. The control environment includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

Communication and enforcement of integrity and ethical values: Essential elements which influence the effectiveness of the design, administration and monitoring of controls.

Commitment to competence: Management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

Organisational structure: The framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed.

Assignment of authority and responsibility: How authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

Human resource policies and practices: Recruitment, orientation, training, evaluating, counselling, promoting, compensation and remedial actions. The auditor shall assess whether these elements of the control environment have been implemented using a combination of inquiries of management and observation and inspection.

Entity risk assessment process: An auditor must obtain an understanding of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives;
- Estimating the significance of the risks;
- Assessing the likelihood of risks occurrence;
- Deciding upon actions to address those risks.

b) Information system relevant to financial reporting

The information system relevant to financial reporting is a component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity's transactions and to maintain accountability for the related assets, liabilities and equity.

The auditor shall obtain an understanding of the information system relevant to financial reporting objectives, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements;
- The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected, transferred to the general ledger and reported in the financial statements;
- The related accounting records, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions;
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures;
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

c) Control activities

Control activities are those policies and procedures that help ensure that management directives are carried out. This means that the auditor shall obtain an understanding of control activities relevant to the audit and how the entity has responded to risks arising from IT. Control activities include those activities designed to prevent or to detect and correct errors.

Those include activities relating to authorisation, performance reviews, information processing, physical controls and segregation of duties. Examples of control activities include:

- Activities relating to authorisation;
- Performance reviews;
- Information processing;
- Physical controls and segregation of duties.

Components of control activities

- Approval and control of documents
- Controls over computerised applications
- Checking the arithmetical accuracy of records
- Maintaining and reviewing control accounts and trial balance
- Reconciliations of accounts balances such as bank account.
- Comparing the results of cash, security and inventory accounts with accounting records
- Comparing internal data with external sources of information
- Limiting physical access to assets and records
- Segregation of duties

In brief, control activities are those policies and procedures that ensure management's directives are carried out. This means that the auditor shall obtain an understanding of control activities relevant to the audit and how the entity has responded to risks arising from IT.

Table illustrating control objectives and control activities

Examples of control objectives	Examples of control activities
(Sales and receivables) To ensure that goods and services supplied on credit are only supplied to customers with good credit ratings.	Referring any new credit customer to the credit control department which performs credit checks on the customer before their order is accepted. Only accepting orders from customers who have no credit problems.

(Purchases and payables) To ensure that goods and services purchased are ordered under proper authority and using proper procedures.	Authorising purchase orders at the correct level of authority before the orders are placed. Verifying that all orders are authorised by a responsible official whose authority limits are pre-defined. Recording all orders on official documents, showing the names of the supplier used, the quantity ordered and the price of the goods or services ordered.
(Wages and salaries) To ensure that employees are only paid for work they have done.	Using clock cards to record the hours worked by staff who are paid on an hourly rate. Ensure overtime worked is authorised by a manager or supervisor.
(Inventories) To ensure that inventory records are up to date and accurately maintained, and are supported by regular physical inventory counts/checking.	Recording and confirming all movements of inventory inwards and outwards. Ensure inventory issues are supported by appropriate documentation. Arranging for inventory levels to be periodically reconciled to the records by a person independent of the stores or warehouse personnel.
(Non-current assets) To ensure that all non-current assets are correctly recorded, adequately secured and properly maintained.	Maintaining a register of non-current assets for all non-current assets, and containing details of the cost of the each asset. Giving each asset acquired a unique asset number. Recording this asset number on the asset register. Carrying out a physical inspection of non-current assets periodically, and agreeing to the asset register. Investigating any discrepancies noted.

d) Entity risk assessment process

An auditor must obtain an understanding of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives;
- Estimating the significance of the risks;
- Assessing the likelihood of risks occurrence;
- Deciding upon actions to address those risks.

As part of managing business risk generally, the directors should have a system for identifying and dealing with risks affecting the financial statements. If they have such a system, and it works effectively, the chance of having an error in the financial statements (control risk) is lower and so audit risk is lower. The entity's risk assessment process is an element of the control environment which encompasses the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to take to address those risks.

If the entity has established such a process, the auditor would obtain an understanding of it. If there is not a process, the auditor shall discuss with management whether relevant business risks have been identified and how they have been addressed.

e) Monitoring of controls

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions/measures.

Small companies - the problem of control

Many of the controls which would be relevant to a large entity are neither practical nor appropriate for a small company. For a small company, the most important form of internal control is generally the close involvement of the directors or proprietors. However, that very involvement will enable them to override controls and, if they wish, to exclude transactions from the records.

Auditors can have difficulties not because there is a general lack of controls but because the evidence available as to their operation and the completeness of the records is insufficient.

Segregation of duties will often appear inadequate in enterprises having a small number of staff.

Similarly, because of the scale of the operation, organisation and management controls are likely to be rudimentary at best.

The onus is on the proprietor, by virtue of their day-to-day involvement to compensate for this lack. This involvement should encompass physical, authorisation, arithmetical and accounting controls as well as supervision.

However, it is important to stress that in a well-run small company, there will be a system of internal control. In any case, all companies must comply with any relevant legislation concerning the maintenance of a proper accounting system.

Where the manager of a small business is not himself/herself the owner, he/she may not possess the same degree of commitment to the running of it as an owner-manager would. In such cases, the auditors will have to consider the adequacy of controls exercised by the shareholders over the manager in assessing internal control.

Controls in a computer environment

Auditors must be able to cope with the special problems that arise when auditing in a computer environment and keep abreast of technical innovation. There are two types of controls such as: application controls and general IT controls.

Application controls are 'manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

General IT controls are 'policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the proper continuity of operations of information systems. General IT controls commonly include controls over data centre and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development and maintenance.

Application controls and general IT controls are inter-related. Strong general IT controls contribute to the assurance which may be obtained by an auditor in relation to application controls.

On the other hand, unsatisfactory general IT controls may undermine strong application controls or exacerbate unsatisfactory application controls.

The following points will particularly influence the auditors' approach:

- Before auditors placing reliance on application controls which involve computer programs, they need to obtain reasonable assurance that the programs have operated properly, by evaluating and testing the effect of relevant general IT controls or by other tests on specific parts of the programs;
- Sometimes, a programmed accounting procedure may not be subject to effective application controls. In such circumstances, in order to put themselves in a position to limit the extent of substantive procedures, the auditors may choose to perform tests of controls by testing the relevant general IT controls either manually or by using CAATs, to gain assurance of the continuity and proper operation of the programmed accounting procedure;

- In a computer environment, there is the possibility of systematic errors. This may take place because of program faults or hardware malfunction in computer operations. However, many such potential recurrent errors should be prevented or detected by general controls over the development and implementation of applications, the integrity of the program and data files, and of computer operations;
- The extent to which the auditors can rely on general IT controls may be limited because many of these controls might not be evidenced, or because they could have been performed inconsistently.

Table illustrating application controls

Application controls	
Controls over input: completeness	▪ Manual or programmed agreement of control totals Document counts ▪ One for one reconciliation of processed output to source documents Programmed matching of input to an expected input control file ▪ Procedures over resubmission of rejected inputs
Controls over input: accuracy	▪ Programmes to review data fields (for example value, reference number, date) on input transactions for plausibility: ▪ Digit verification (eg reference numbers are as expected) ▪ Reasonableness test (eg sales tax to total value) ▪ Existence confirmations (eg customer name) ▪ Character confirmations (no unexpected characters used in reference) Necessary information (no transaction passed with gaps) Permitted range (no transaction processed over a certain value) ▪ Manual scrutiny of output and reconciliation to source ▪ Agreement of control totals (manual/programmed)
Controls over input: authorization	▪ Manual verifications to ensure information input was: – Authorised – Input by authorised personnel
Controls over processing	▪ Similar controls to input must be completed when input is completed, for example, batch reconciliations ▪ Screen warnings can prevent people logging out before processing is complete

Controls over master files and standing data	▪ One-for-one confirmation (verifying that specific elements between two or more sources of data are consistent, for example by verifying that the staff listed in the company's HR records are the same as those listed on the payroll) Cyclical or regular reviews of all master files and standing data by internal auditors ▪ Record counts (number of documents processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions ▪ Controls over the deletion of accounts that have no current balance

Table illustrating general IT controls, controls and where they are needed

General IT controls	
Development of computer applications	▪ Standards over systems design, programming and documentation Full testing procedures using test data Approval by computer users and management ▪ Segregation of duties so that those responsible for design are not responsible for testing ▪ Installation procedures so that data is not corrupted in transition ▪ Training of staff in new procedures and availability of adequate documentation
Prevention of unauthorised changes to programs	▪ Segregation of duties ▪ Full records of program changes ▪ Password protection of programs so that access is limited to computer operations staff Restricted access to central computer Maintenance of programs logs Virus checks on software ▪ Back-up copies of programs being taken and stored in other locations Control copies of programs being preserved and regularly compared with actual programs ▪ Stricter controls over certain programs (utility programs)
Testing and documentation of program changes	▪ Complete testing procedures ▪ Documentation standards ▪ Approval of changes by computer users and management ▪ Training of staff using programs

Prevention of use of wrong programs or files	▪ Operation controls over programs ▪ Libraries of programs Proper job scheduling
Prevention of unauthorised changes to data files	▪ Password protection ▪ Access restricted to authorised users only
Controls to ensure continuity of operation	▪ Storing extra copies of programs and data files off-site Protection of equipment against fire and other hazards ▪ Back-up power sources Emergency procedures ▪ Disaster recovery procedures eg availability of back-up computer facilities ▪ Maintenance agreements and insurance

Application activity 10.1

1. Find out the requirements to achieve the overall objectives of application controls.
2. Explain the various ways through which the segregation of duties should be carried out.

10.2. Assessment and recording of information systems

Learning activity 10.2

BUGIRIMANA is an entrant or beginner in the auditing profession. The association of accountants where he is a member has offered him an opportunity to audit TUZAMURANE Ltd Company, one of the medium business category in the country. He was required to assess its recording of information system and the entire internal control system.

1. What should the auditor do to assess the accounting system?
2. Explain how an auditor can test controls of the internal control system of a business organisation.
3. What are several techniques for the assessment of control risk?

10.2.1. Assessment of information systems and internal control

Auditors should assume control risk is high, unless it is assessed as low, and the assessment confirmed by tests of controls.

In order to assess the information system and internal control, the auditor may do the following:

- Assess the adequacy of the accounting system as a basis for preparing the financial statements;
- Identify the types of potential misstatements that could occur in the financial statements;
- Consider factors that affect the risk of misstatements;
- Design appropriate audit procedures.

a) Accounting systems and the control environment

Auditors perform procedures to give them an understanding of the accounting systems at a client and comprise what procedures are carried out, how many and when depend on the size and complexity of the entity (more procedures are likely to be required if the system is big and complicated), whether their systems are documented or not (if so, reading this will give some understanding of the system).

It will also depend on the auditors' assessment of the risk of material misstatement in the financial statements. If the risk is low, fewer procedures will be carried out.

A client is unlikely to change its system substantially on too regular basis, so normally, auditors simply have to update their understanding of the system from the previous year (that is, for changes that have occurred during the year). They do this by:

- Asking staff (inquiry)
- Watching staff operate the system (observation)
- Looking at documents produced by the system (inspection)

The auditor shall design and perform tests of controls to obtain sufficient appropriate evidence as to the operating effectiveness of relevant controls if:

- The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures);or

- Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

b) Tests of controls

Tests of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing, detecting and correcting material misstatements at the assertion level and must cover the whole accounting period.

- They are performed to obtain audit evidence about the effectiveness of the:
  - Design of the accounting and internal control systems, ie whether they are suitably designed to prevent or detect and correct material misstatements.
  - Operation of the internal controls throughout the period.

The auditor will use inquiry in combination with other procedures (in particular reperformance and inspection) to obtain evidence about the operating effectiveness of controls and should consider:

- How controls were applied
- The consistency with which they were applied during the period
- By whom they were applied

Tests of controls
Inspection of documents supporting controls or events to gain audit evidence that internal controls have operated properly, eg verifying that a transaction has been authorized.
Inquiries about internal controls which leave no audit trail, eg determining who actually performs each function not merely who is supposed to perform it.
Reperformance of control procedures, eg reconciliation of bank accounts, to ensure they were correctly performed by the entity.
Examination of evidence of management views, eg minutes of management meetings.
Testing of internal controls operating on computerised systems over the overall information technology function, eg access controls.
Observation of controls. Auditors will consider the manner in which the control is being operated.

Deviations in the operation of controls (caused by change of staff etc) may increase control risk and tests of controls may need to be modified to confirm effective operation during and after any change.

c) Questionnaires

Internal Control Questionnaires (ICQs): are used to ask whether controls exist which meet specific control objectives.

Internal Control Evaluation Questionnaires (ICEQs): are used to determine whether there are controls which prevent or detect specified errors or omissions.

The specific controls for major transaction systems (sales, purchases, inventory, payroll etc) are examined in detail in later Units. Here we will look at the overall objectives of the questionnaires, although we have included examples from specific transaction systems to illustrate how ICQs and ICEQs are used.

Internal Control Questionnaires (ICQs)

The major question which internal control questionnaires are designed to answer is 'How good is the system of controls?'

Where strengths are identified, the auditors will perform work in the relevant areas. If, however, deficiencies are discovered they should then ask:

a) What errors or irregularities could be made possible by these deficiencies?
b) Could such errors or irregularities be material to the financial statements?
c) What substantive procedures will enable such errors or irregularities to be discovered and quantified?

Although there are many different forms of ICQ in practice, they all conform to the following basic principles:

- They comprise a list of questions designed to determine whether desirable controls are present.
- They are formulated so that there is one to cover each of the major transaction cycles.

Since it is the primary purpose of an ICQ to evaluate the system rather than describe it, one of the most effective ways of designing the questionnaire is to phrase the questions so that all the answers can be given as 'yes' or 'no' and a 'no' answer indicates a deficiency in the system. An example would be:

Are purchase invoices matched to goods received notes before being passed for payment?

A 'no' answer to that question clearly indicates a deficiency in the company's payment procedures. The ICQ questions below dealing with goods inward provide additional illustrations of the ICQ approach.

Goods inward

- Are supplies examined on arrival as to quantity and quality?
- Is such an examination evidenced in some way?
- Is the receipt of supplies recorded, perhaps by means of goods inwards notes?
- Are receipt records prepared by a person independent of those responsible for :
  - Ordering functions?
  - The processing and recording of invoices?
- Are goods inwards record controlled to ensure that invoices are obtained for all goods received and to enable the liability for unbilled goods to be determined (by pre-numbering the record and accounting for all serial numbers)?
  - Are goods inward record regularly reviewed for items for which no invoices have been received?
  - Are any such items investigated?
- Are these record reviewed by a person independent of those responsible for the receipt and control of goods?

However, note that while ICQs are used primarily for evaluating a system, they can still be used to record a system. If they are used to record a system, then the questions will be constructed in such a way that they require answers in the form of descriptive notes on the system.

Internal Control Evaluation Questionnaires (ICEQs)

In recent years, many auditing firms have developed and implemented an evaluation technique more concerned with assessing whether specific errors (or frauds) are possible rather than establishing whether certain desirable controls are present. This is achieved by reducing the control criteria for each transaction stream down to a handful of key questions (or control questions). The characteristic of these questions is that they concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are weak.

Internal control evaluation questionnaire: control questions

The sales (revenue) cycle

Is there reasonable assurance that:

- Sales are properly authorised?
- Sales are made to reliable payers?
- All goods despatched are invoiced?
- All invoices are properly prepared?
- All invoices are recorded?
- Invoices are properly supported?
- All credits to customers' accounts are valid?
- Cash and cheques received are properly recorded and deposited?
- Slow payers will be chased and that bad and doubtful debts will be provided against?
- All transactions are properly accounted for?
- Cash sales are properly dealt with?
- Sundry sales are controlled?
- At the period end the system will neither overstate nor understate receivables?

The purchases (expenditure) cycle

Is there reasonable assurance that :

- Goods or services could not be received without a liability being recorded?
- Receipt of goods or services is required in order to establish a liability?
- A liability will be recorded:
    - Only for authorised items?
    - At the proper amount?
- All payments are properly authorised?
- All credits due from suppliers are received?
- All transactions are properly accounted for?
- At the period end liabilities are neither overstated nor understated by the system?
- The balance at the bank is properly recorded at all times?
- Unauthorised cash payments could not be made and that the balance of petty cash is correctly stated at all times?

Wages and salaries

Is there reasonable assurance that:

- Employees are only paid for work done?
- Employees are paid the correct amount (gross and net)?
- The right employees actually receive the right amount?
- Accounting for payroll costs and deductions is accurate?

Inventories

Is there reasonable assurance that :

- Inventory is safeguarded from physical loss (eg fire, theft, deterioration)?
- Inventory record are accurate and up to date?
- The recorded inventory exists?
- The recorded inventory is owned by the company?
- The cut-off is reliable?
- The costing system is reliable?
- The inventory sheets are accurately compiled?
- The inventory valuation is fair?

Non-current assets

Is there reasonable assurance that:

- Recorded assets actually exist and belong to the company?
- Capital expenditure is authorised and reported?
- Disposals of non-current assets are authorised and reported?
- Depreciation is realistic?
- Non-current assets are correctly accounted for?
- Income derived from non-current assets is accounted for?

Management information and general controls

Is the nominal ledger satisfactorily controlled?

- Are journal entries adequately controlled?
- Does the organisation structure provide a clear definition of the extent and limitation of authority?
- Are the systems operated by competent employees, who are adequately supported?
- If there is an internal audit function, is it adequate?
- Are financial planning procedures adequate?
- Are periodic internal reporting procedures adequate?

Each key control question is supported by detailed control points to be considered.

For example, the detailed control points to be considered in relation to key control question (b) for the expenditure cycle (Is there reasonable assurance that receipt of goods or services is required to establish a liability?) are as follows:

- Is segregation of duties satisfactory?
- Are controls over relevant master files satisfactory?
- Is there a record showing that all goods received have been reviewed :
  - Weight or number?
  - Quality and damage?
  - Are all goods received taken on charge in the detailed inventory ledgers?
    - By means of the goods received note?
    - Or by means of purchase invoices?
    - Are there, in a computerised system, sensible control totals (hash totals, money values and so on) to reconcile the inventory system input with the payables system?
  - Are all invoices initialled to show that,
    - Receipt of goods has been matched to the goods received record?
    - Receipt of services has been verified by the person using it?
    - Quality of goods has been reviewed against the inspection?

In a computerised invoice approval system, are there printouts (examined by a responsible person) of:

- Where order, GRN and invoice are present but they are not equal (equal within predetermined tolerances of minor discrepancies)?
- Cases where invoices have been input but there is no corresponding GRN?
  - Is there adequate control over direct purchases?
  - Are receiving documents effectively cancelled (for example cross-referenced) to prevent their supporting two invoices?

10.2.2. Recording the information system and internal control

The auditor must keep a record of client's systems, which must be updated each year. This can be done with narrative notes, flowcharts, questionnaires or checklists.

There are several techniques for recording the assessment of control risk and one or more of the following techniques may be used depending on the complexity of the system:

- Narrative notes
- Questionnaires
- Flowcharts
- Checklists

Whatever method of recording is used, the record will usually be retained on the permanent file and updated each year. We will look at the use of questionnaires in a little more detail here. There are two types, each with a different purpose.

- Internal Control Questionnaires (ICQs) are used to ask whether controls exist which meet specific control objectives.
- Internal Control Evaluation Questionnaires (ICEQs) are used to determine whether there are controls which prevent or detect specified errors or omissions.

In most cases, specific controls are applied on major transactions relating to sales, purchases, inventory, cash, payroll, revenue and capital expenditure.

Confirming understanding

In order to confirm their understanding of the control systems, auditors will often carry out walk-through tests. This is where they pick up a transaction and follow it through the system to see whether all the controls they anticipate should be in existence were in operation with regard to that transaction.

Application activity 10.2

1. what are major questions which internal control questionnaires are designed to answer?
2. What auditor should do in order to obtain the audit evidence about the effectiveness of the internal control system?

10.3. Communication and control activities

Learning activity 10.3

MUTUNZI is an auditor who has finished to examine the internal control of TURWUBAKE Ltd. Company wants to communicate for the first time the findings of the audit examination to the management.

1. How does the auditor communicate the findings on the internal control system to the organisation?
2. Give five statements reflecting the deficiencies in the internal control system of an organisation.

10.3.1. Communication with the management

a) Commucation with managment

The auditor's communication with the management is about communicating significant deficiencies in internal controls and shall be communicated in writing to those charged with governance in a report to management.

b) The deficiency in the internal control of the organisation

A deficiency in internal control exists when a control is designed, implemented or operated in a way that is unable to prevent, or detect and correct misstatements in the financial statements on a timely basis, or if a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely is missing.

The likelihood of a misstatement occurring and its potential magnitude. Examples of matters to consider when determining whether a deficiency in internal control is a significant deficiency:

- The likelihood of the deficiencies resulting in material misstatements in the financial statements in the future
- The susceptibility to loss or fraud of the related asset or liability
- The subjectivity and complexity of determining estimated amounts
- The amounts exposed to the deficiencies
- The volume of activity that has occurred or could occur
- The importance of the controls to the financial reporting process
- The cause and frequency of the exceptions identified as a result of the deficiencies
- The interaction of the deficiency with other deficiencies in internal control

- Evidence of ineffective aspects of the control environment
- Absence of a risk assessment process
- Evidence of an ineffective entity risk assessment process
- Evidence of an ineffective response to identified significant risks
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control
- Restatement of previously issued financial statements that were corrected for a material misstatement due to fraud or error

c) Necessary information the auditor should communicate to the management

- Evidence of management's inability to oversee the preparation of the financial statements.
- The auditor shall communicate any significant deficiencies in internal control to those charged with governance on a timely basis.
- The auditor shall also communicate in writing to management on a timely basis significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance.
- Deficiencies in internal control that have not been communicated to management by other parties and that the auditor considers are of sufficient importance to warrant management's attention.

The auditor shall include the following in the written communication:

- A description of the deficiencies and an explanation of their potential effects

Sufficient information to enable those charged with governance and management to understand the context of the communication, in particular that:

- The purpose of the audit was for the auditor to express an opinion on the financial statements.
- The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures appropriate in the circumstances, but not to express an opinion on the effectiveness of internal control.
- The matters being reported are limited to those deficiencies identified during the audit and which the auditor has concluded are sufficiently important to merit being reported to those charged with governance.
- The auditor may also include suggestions for remedial actions on the deficiencies.

Note: The communication to management of less important deficiencies in internal control can be done orally.

10.3.2. Control activities of internal control system

a) Meaning of control activities

Control activities are those policies and procedures that help ensure that management directives are carried out.

- The auditor should obtain an understanding of control activities relevant to the audit and how the entity has responded to risks arising from IT.
- Control activities include those activities designed to prevent or to detect and correct errors. Examples include activities relating to authorisation, performance reviews, information processing, physical controls and segregation of duties.

b) Examples of control activities

Approval and control of documents: Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers.

Controls over computerised applications: These are controls that assess the overall system of the computerised operations.

Checking the arithmetical accuracy of records: For example, checking to see if individual invoices have been added up correctly.

Maintaining and reviewing control accounts and trial balances: Control accounts bring together transactions in individual ledgers. Trial balances bring together unusual transactions for the organisation as a whole. Preparing these can highlight unusual transactions or accounts.

Reconciliations: Reconciliations involve comparison of a specific balance in the accounting records with what another source says the balance should be, for example, a bank reconciliation. Differences between the two figures should only be reconciling items.

Comparing the results of cash, security and inventory counts with accounting records: For example, in a physical count of petty cash, the balance shown in the cashbook should be the same as the amount held.

Comparing internal data with external sources of information: For example, comparing records of goods despatched to customers with customers' acknowledgement of goods that have been received.

Limiting physical access to assets and records: Only authorised personnel should have access to certain assets (particularly valuable or portable ones). For example, ensuring that the inventory store is only open when store personnel are there and is otherwise locked.

Segregation of duties

Segregation of duties should take place in various ways:

Segregation implies a number of people being involved in the accounting process. This makes it more difficult for fraudulent transactions to be processed (since a number of people would have to collude in the fraud), and it is also more difficult for accidental errors to be processed (since the more people are involved, the more checking there can be). Segregation should take place in various ways:

- Segregation of function. The key functions that should be segregated are the carrying out of a transaction, recording that transaction in the accounting record and maintaining custody of assets that arise from the transaction;
- The various steps in carrying out the transaction should also be segregated;
- The carrying out of various accounting operations should be segregated. For example: the same staff should not record transactions and carry out the reconciliations at the period-end.

10.3.3. Benefits and limitations of internal control system

a) Benefits

The auditors shall assess the adequacy of the systems as a basis for the financial statements and shall identify risks of material misstatements to provide a basis for designing and performing further audit procedures.

Auditors are only concerned with assessing policies and procedures which are relevant to the financial statements. Auditors shall:

- Assess the adequacy of the accounting system as a basis for preparing the accounts
- Identify the types of potential misstatements that could occur in the accounts
- Consider factors that affect the risk of misstatements
- Design appropriate audit procedures

The assessment of the controls of an entity will have an impact on that risk assessment.

Risks arising from poor control environments are unlikely to be confined to particular assertions in the financial statements, and, if severe, may even raise questions about whether the financial statements are capable of being audited, that is, if control risk is so high that audit risk cannot be reduced to an acceptable level.

On the other hand, some control procedures may be closely connected to an assertion in financial statements, for example, controls over the inventory counts are closely connected with the existence and completeness of inventory in the financial statements.

There may be occasions where substantive procedures alone are not sufficient to address the risks arising. Where such risks exist, auditors shall evaluate the design and determine the implementation of the controls, which is by controls testing. This is most likely to be the case in a system which is highly computerised and which does not require much manual intervention.

b) Limitations

There are always inherent limitations to internal controls, including cost-benefit requirements and the possibility of controls being by-passed and over-ridden.

Management of an entity will set up internal controls in the accounting system to assess the following:

- Transactions are executed in accordance with proper authorisation.
- All transactions and other events are promptly recorded at the correct amouns, in the appropriate accounts and in the proper accounting period.
- Access to assets is permitted only in accordance with proper authorisation.
- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

However, any internal control system can only provide the directors with reasonable assurance that their objectives are reached, because of inherent limitations, such as the following:

The potential for human error

These include the fact that human judgement in decision-making can be faulty or produce simple errors and mistakes. For example: if an entity's information system personnel do not completely understand how the company's order entry system operates, they may incorrectly design changes to this system.

On the other hand, they may design the changes correctly but these may be misunderstood by the personnel responsible for translating them into program code. Errors may also occur in the use of information produced by IT. For example: automated controls may be designed to report transactions over a specified amount for management review, but individuals responsible for conducting the review may not understand the purpose of these reports, and fail to review them or investigate unusual items.

The possibility of controls being by-passed or over-ridden

Controls can be circumvented by the collusion of two or more people or management may inappropriately override controls. For example: management could enter into a side agreement with customers that alter the terms and conditions of sales contracts, which could result in improper revenue recognition.

Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

Collusion among employees

In any organisation collusion exist among employees due to different conflicting circumstances.

The costs of controls outweighing their benefits

This is a particular problem faced by smaller entities. For example: smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. It would not make commercial sense to employ additional staff purely for the purposes of achieving greater segregation of duties. However, this lack of formal control might be compensated for by a responsible and ethical owner-manager, who closely monitors his/her company's business and accounting processes.

Controls tending to be designed to cope with routine and not non-routine transactions

Non-routine transactions are by their very nature unusual. As a result, it will be difficult to predict what these might be and therefore is less likely that a system will have been devised to deal with these effectively. Take a shipping company that leases cargo ships to transport goods as an example. It may have effective controls over leasing transactions, but if and when the company acquires a vessel of its own, the controls around authorising and recording the acquisition may be much less effective.

These factors show why auditors cannot obtain all their evidence from tests of the systems of internal control.

The key factors in the limitations of controls system are human error and potential for fraud. The safeguard of segregation of duties can help deter fraud. However, if employees decide to perpetrate frauds by collusion, or management commit fraud by overriding systems, the accounting system will not be able to prevent such frauds.

Application activity 10.3

1. How do auditors assess policies and procedures which are relevant to the financial statements?
2. What does the management of an entity assess when it sets up internal controls in the accounting system?

Skills lab activity 10

Under the supervision of teacher, students in their learning teams' role playing the communications with management, where one group play as management another as auditor.

End unit 10 assessment

1. Define the term internal control system
2. What are the features of the internal control system?
3. Explain briefly the elements of internal control system.
4. What are different ways in which segregation ofduties should be carried out to ensure that there is an effective internal control system within the organisation?
5. After defining control activities, give some examples which explain the application of control activities within an organisation.
6. In order to reflect a clear distinction between control objectives and control activities, draw a table which illustrates the difference between the two parts using examples.
7. Describe problems relating to internal control system and application of controls in small companies.
8. After defining tests of controls, draw a table which demonstrates how tests of controls are applied in the internal control system of an organisation.
9. Find examples of matters to consider when determining whether a deficiency in internal control is a significant deficiency.
10. What are the limitations of internal control system?
11. what are the benefits of internal control

UNIT 11 TEST OF CONTROL

Key unit competence: To be able to describe the characteristics of effective accounting systems

Introductory activity

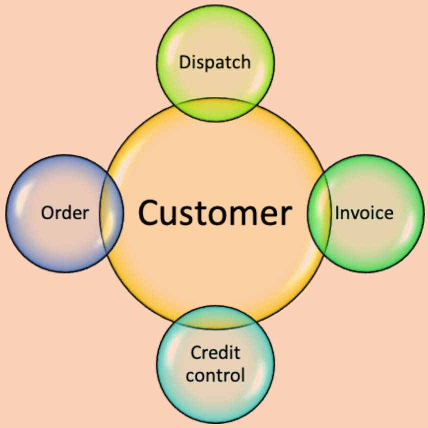
1. Explain the relationship between small circles and big circle

In the last Unit we talked about controls and evaluating internal controls. We have stated that in all audits, auditors must ascertain the accounting system and internal control system used. If auditors decide to rely on controls, they must test them. The next Unit describes the controls that may operate and the tests auditors may carry out.

It is best to examine controls in terms of the various components of the accounting system. Most commonly, these will be: **sales, purchases, wages and other systems such as inventory, non-current assets and management information.**

11.1. Sales system

Learning activity 11.1



Analyze the picture above, and answer the following questions:

1. What do you see in this picture?
2. Which elements do you see can be used in sales system?

The tests of controls of the sales system will be based around:

- **Selling** (authorisation)
- **Goods outwards** (custody)
- **Accounting** (recording and valuation)

11.1.1. Control objectives

The most important objectives of internal control relating to receivables and sales are as follows.

Features	Objectives
Ordering and granting of credit	To ensure that: ▪ Goods and services are only supplied to customers with good credit ratings ▪ Customers pay promptly ▪ Orders are recorded correctly ▪ Orders are fulfilled

Invoicing and dispatch	To ensure that: ▪ All dispatches of goods are recorded ▪ All goods and services sold are correctly invoiced ▪ All invoices raised relate to goods and services that have been supplied by the business ▪ Credit notes are only given for valid reasons
Recording, accounting and credit control	To ensure that: ▪ All sales that have been invoiced are recorded in the general and sales ledgers ▪ All credit notes that have been issued are recorded in the general and sales ledgers ▪ All entries in the sales ledger are made to the correct sales ledger accounts ▪ Cut-off is applied correctly to the sales ledger ▪ Potentially irrecoverable debts are identified

11.1.2. Control activities

The following control activities relate to the **ordering** and **credit control** process; note the importance of controls over credit terms, ensuring that goods are only sent to customers who are likely to pay promptly.

- **Segregation** of duties : credit control, invoicing and inventory despatch
- **Authorisation** of **credit terms** to customers involves:
  - References/credit checks obtained
  - Authorisation by senior staff
  - Regular review
- **Authorisation** for changes in **other customer data**
  - Change of address supported by letterhead
  - Requests for deletion supported by evidence balances cleared/ customer in liquidation
- **Credit limits confirmed** before new orders are accepted
- **Sequential numbering** of blank **order documents**
- **Matching of customer orders** with production orders and despatch notes

The following procedures relate to invoice preparation and despatches:

- **Authorisation of despatch of goods**
  - Despatch only on sales order
  - Despatch only to authorised customers
  - Special authorisation of despatches of goods free of charge or on special terms
- **Examination of goods outwards** as to quantity, quality and condition
- **Recording** of **goods outwards on goods despatched notes**
- **Agreement** of **goods outwards records** to **customer orders, despatch notes** and **invoices**
- **Pre-numbering** of despatch notes and delivery notes and regular checks on sequence
- **Condition** of **returns reviewed**
- Recording of goods returned on **goods returned notes**
- **Signature of delivery notes** by customers

Procedures for the preparation of invoices and credit notes including the following:

  - Authorisation of selling prices/use of price lists
  - Authorisation of credit notes
  - Verification of prices, quantities, extensions and totals on invoices and credit notes
  - Sequential numbering of blank invoices and credit notes, and regular tests on sequence

- **Inventory record updated** on a timely basis
- **Matching of sales invoices** with despatch and delivery notes and sales orders
- Regular **review for orders** which have not yet been delivered

The following control activities relate to accounting and recording.

- **Segregation of duties**: recording sales, maintaining customer accounts and preparing statements
- **Recording** of **sales invoices** sequence and **control** over **spoilt invoices**
- **Matching** of **cash receipts** with **invoices**
- **Retention** of **customer remittance advices**
- **Separate recording** of **sales returns, price adjustments** etc.

- **Cut-off procedures** to ensure goods despatched and not invoiced (or vice versa) are properly dealt with in the correct period
- Regular **preparation** of **receivables statements**
- **Review** of **receivables' statements** to ensure they have been prepared correctly
- **Safeguarding** of **receivables statements** so that they cannot be altered before despatch
- **Review** and **follow-up of overdue accounts**
- **Authorisation** of **writing off of irrecoverable debts** (bad debts)
- **Reconciliation** of **receivables ledger** (sales ledger) **control account**
- **Analytical review** of **receivables ledger** (sales ledger) and **profit margins**

Control objectives	Control activities
Goods and services are only supplied to customers with good credit ratings and who are within approved credit limits.	▪ Segregation of duties; credit control, invoicing and inventory dispatch ▪ Authorization of credit terms to customers – References/credit checks obtained – Authorization by senior staff – Regular review ▪ Credit limits confirmed before new orders are accepted.
Customers pay promptly	▪ Authorization of credit terms to customers – References/credit checks obtained – Authorization by senior staff – Regular review ▪ Credit limits confirmed before new orders are accepted. ▪ Balance statements sent regularly to customers
Orders are recorded correctly	▪ Sequential numbering of blank order documents. ▪ The sequence of orders processed is accounted for

Orders are fulfilled	▪ Matching of customer orders with production orders and dispatch notes ▪ Regular review for orders which have not yet been delivered
All dispatches of goods are recorded.	▪ Authorization of dispatch of goods – Dispatch only on sales order – Dispatch only to authorized customers – Special authorization of dispatches of goods free of charge or on special terms ▪ Examination of goods outwards as to quantity, quality and condition ▪ Recording of goods outwards on a timely basis ▪ Pre-numbering of dispatch notes and delivery notes and regular checks on sequence
All goods and services sold are correctly invoiced.	▪ Agreement of goods outwards records to customer orders, dispatch notes and invoices ▪ Preparation of invoices – Authorization of selling prices/use of price lists – Verification of prices, quantities, extensions and totals on invoices
All invoices raised relate to goods and services that have been supplied by the business.	▪ Agreement of goods outwards records to customer orders, dispatch notes and invoices ▪ Signature of delivery notes by customers ▪ Matching of sales invoices with dispatch and delivery notes and sales orders
Credit notes are only given for valid reasons.	▪ Condition of returns reviewed ▪ Recording of goods returned on goods returned notes ▪ Management approves credit notes issued
All sales that have been invoiced are recorded in the general and receivables ledgers.	▪ Segregation of duties: recording sales, maintaining customer accounts and preparing statements ▪ Regular reconciliation of receivables ledger control account

All credit notes that have been issued are recorded in the general and receivables ledgers.	▪ Segregation of duties: recording sales, maintaining customer accounts and preparing statements ▪ Separate recording of sales returns, price adjustments etc.
All entries in the receivables ledger are made to the correct receivables ledger accounts.	▪ Retention of customer remittance advices ▪ Regular preparation of receivables' statements ▪ Review of receivables' statements
Cut-off is applied correctly to the receivables ledger.	▪ Cut-off procedures to ensure goods dispatched and not invoiced (or vice versa) are properly dealt with in the correct period
Potentially irrecoverable debts are identified.	▪ Timely review and follow-up of overdue accounts ▪ Authorization of writing off of irrecoverable debts

11.1.3. Tests of controls

The precise nature of the tests of controls performed by the auditor would depend on the way in which the control is being operated by the audit client. Procedures however would typically include the following.

- **Review the organisation chart** and allocation of responsibilities and assess whether **segregation of duties** is operating.
- **Verify** that **references** are being **obtained** for a sample of new customers by reviewing customer files.
- **Verify** that a **sample of new accounts** on the sales ledger have been authorised by senior staff.
- Examine **computer application controls for credit limits.**
- For a sample of **customer orders** obtain evidence that they have been **matched with production orders** and **despatch notes**.
- Verify that price lists and terms of trade are **properly documented, authorised and communicated.**
- Obtain evidence of **authorisation** of goods despatched e.g. signature of despatch note.
- Review and test the entity's procedures for **accounting for numerical sequences** of despatch notes and inspect despatch notes to confirm that they are sequentially numbered.

- Examine delivery notes for **evidence of confirmation of receipt** of goods by customers e.g. customer signature.
- Obtain evidence that **procedures relating to the accuracy of invoices** have been performed e.g. evidence that prices have been matched to the price list, evidence that calculations have been reperformed, evidence that discounts have been authorised.
- Review and test the entity's procedures for **accounting for numerical sequences of invoices** and inspect invoices to confirm that they are sequentially numbered.
- Review and observe procedures for **matching of invoices to despatch notes and reperform a sample.**
- Obtain evidence of **authorisation of credit notes**.
- Evaluate procedures for **the preparation of customer statements.**
- Review **supplier statement reconciliations** produced by the audit client.
- **Reperform** a sample of **supplier statement reconciliations** produced by the audit client to determine whether they have been performed accurately.
- Review **control account reconciliations to the receivables ledger** produced by the client.
- **Reperform** a sample of **control account reconciliations to the receivables ledger** to determine whether they have been performed accurately.
- Confirm **authorisation** of irrecoverable receivables allowances/write offs.

Application activity 11.1

1. What should auditors consider when reviewing sales invoices?
2. Which of the following controls identified when evaluating a sales system would provide positive assurance to an auditor in respect of the key question 'can goods and services be supplied to a bad credit risk?'

a) References are obtained for new customers
b) Goods are verified to sales order prior to dispatch
c) Invoice prices prepared from authorized selling prices
d) Receivables statements are prepared

11.2. The purchases system

Learning activity 11.2

Analyse the image above and answer the following questions:

1. Identify the elements can be used in purchase system

The tests of controls of the purchases system will be around:

- **Buying** (authorisation)
- **Goods inwards** (custody)
- **Accounting** (recording and valuation)

11.2.1. Control objectives

The most important objectives of internal control relating to suppliers and purchases are:

- **Ordering**

To ensure that:

- All orders for, and expenditure on, goods and services are properly authorised, and are for goods and services that are actually received and are for the company.
- Orders are only made to authorised suppliers.
- Orders are made at competitive prices.

- **Receipt and invoices**

To ensure that:

- Goods and services received are used for the organisation's purposes and not private purposes.

- Goods and services are only accepted if they have been ordered, and the order has been authorised.
- All goods and services received are accurately recorded.
- Liabilities are recognised for all goods and services that have been received.
- All credits to which the organisation is due are claimed.
- Receipt of goods and services is necessary to establish a liability.

▪ **Accounting**

To ensure that:

- All expenditure is authorised and is for goods that are actually received.
- All expenditure that is made is recorded correctly in the general (nominal) and payables (purchase) ledgers.
- All credit notes that are received are recorded in the general and payables ledgers.
- All entries in the payables ledger are made to the correct payables ledger accounts.
- Cut-off is applied correctly to the payables ledger.

11.2.2. Control activities

The following control activities should be in place over ordering.

- Central policy for choice of suppliers
- Evidence required of requirements for purchase before purchase authorised (re-order quantities and re-order levels)
- Order forms prepared only when a purchase requisition has been received
- Authorisation of order forms by appropriate authorised personnel
- Prenumbered order forms
- Safeguarding of blank order forms
- Review of orders not received
- Monitoring of supplier terms and taking advantage of favourable conditions (bulk order, discount)

The client should carry out the following procedures on goods received and invoices from suppliers.

- Examination of goods inwards
  - Quality
  - Quantity
  - Condition
- Recording arrival and acceptance of goods (pre-numbered goods received notes)
- Comparison of goods received notes with purchase orders
- Referencing of supplier invoices; numerical sequence and supplier reference
- Verification of suppliers' invoices
  - Prices, quantities, accuracy of calculation
  - Comparison with order and goods received note
- Recording return of goods (pre-numbered goods returned notes)
- Procedures for obtaining credit notes from suppliers

The following control activities should be in place over accounting procedures.

- Segregation of duties: accounting and verification functions
- Prompt recording of purchases and purchase returns in day books and ledgers
- Regular maintenance of payables ledger
- Comparison of supplier statements with payables ledger balances on a regular basis
- Authorisation of payments
  - Authority limits
  - Confirmation that goods have been received, accord with purchase order, and are properly priced and invoiced
- Review of allocation of expenditure
- Reconciliation of payables ledger control account to total of payables ledger balances on a regular basis
- Cut-off accrual of unmatched goods received notes at year end

Control objectives	Control activities
All orders for, and expenditure on, goods and services are properly authorized, and are for goods and services that are actually received and are for the company.	▪ Order forms prepared only when a purchase requisition has been received ▪ Authorization of order forms (in accordance with pre-defined authority levels) ▪ All orders made on official company documents, and showing suppliers' name, quantity order and price ▪ Review of orders not received
Orders are only made to authorized suppliers.	▪ Central policy for choice of suppliers, and list of approved suppliers maintained ▪ Supplier master file data periodically reviewed by management to ensure approved suppliers remain suitable/appropriate
Orders are made at competitive prices.	▪ Monitoring of supplier prices in relation to other potential alternative suppliers ▪ Monitoring of supplier terms and taking advantage of favorable conditions (bulk order, discount)
Goods and services received are used for the organization's purposes and not private purposes.	▪ Evidence required of requirements for purchase before purchase authorized (re-order quantities and re-order levels)
Goods and services are only accepted if they have been ordered, and the order has been authorized.	▪ Authorization of order forms (in accordance with pre-defined authority levels) ▪ Safeguarding of blank order forms
All goods and services received are accurately recorded.	▪ Examination of goods inwards – Quality – Quantity – Condition ▪ Recording arrival and acceptance of goods (pre-numbered goods received notes, signed by a responsible company official) ▪ Comparison of goods received notes with purchase orders

Liabilities are recognized for all goods and services that have been received.	▪ Recording arrival and acceptance of goods (pre-numbered goods received notes) ▪ Comparison of goods received notes with purchase orders ▪ Prompt recording of purchases and purchase returns in day books and ledgers ▪ Referencing of supplier invoices ; numerical sequence and supplier reference
All credits to which the organization is due are claimed.	▪ Recording return of goods (pre-numbered goods returned notes) ▪ Procedures for obtaining credit notes from suppliers
Receipt of goods and services is necessary to establish a liability.	▪ Recording arrival and acceptance of goods (pre-numbered goods received notes) ▪ Comparison of goods received notes with purchase orders ▪ Referencing of supplier invoices; numerical sequence and supplier reference ▪ Confirmation of suppliers' invoices – Prices, quantities, accuracy of calculation – Comparison with order and goods received note
All expenditure is authorized and is for goods that are actually received.	▪ Authorization of payments, in accordance with: – Authority limits – Confirmation that goods have been received, accord with purchase order, and are properly priced and invoiced

All expenditure that is made is recorded correctly in the general and payables ledgers.	▪ Segregation of duties: accounting and verification functions ▪ Prompt recording of purchases and purchase returns in day books and ledgers ▪ Regular maintenance of payables ledger ▪ Comparison of supplier statements with payables ledger balances on a regular basis ▪ Reconciliation of payables ledger control account to total of payables ledger balances ▪ Invoices properly allocated to general ledger accounts ; invoices coded with expenditure codes, signed off by responsible company official
All credit notes that are received are recorded in the general and payables ledgers.	▪ Comparison of supplier statements with payables ledger balances
All entries in the payables ledger are made to the correct payables ledger accounts.	▪ Comparison of supplier statements with payables ledger balances ▪ Regular maintenance of payables ledger
Cut-off is applied correctly to the payables ledger.	▪ Cut-off accrual of unmatched goods received notes at year end

11.2.3. Tests of controls

A most important test of controls is for auditors to confirm that all purchases have been authorised. The officials who approve the invoices should be operating within laid-down authority limits. The precise nature of the tests of controls performed by the auditor would depend on the way in which the control is being operated by the audit client. Procedures however would typically include the following.

- Observe the processing of purchase orders throughout the purchasing cycle and evaluate whether proper segregation of duties is operating.
- Examine application controls for re-order levels.
- Verify that authorised supplier lists exist and have been communicated.
- Obtain evidence of regular management reviews of supplier terms.
- Examine a sample of purchase orders for evidence that they have been authorised.

- Observe procedures for receipt of goods to verify that the goods actually received are matched to the purchase order.
- Review entity's procedures for accounting for pre-numbered documents and inspect a sample of goods received notes for evidence of sequential numbering.
- Review a sample of goods received notes for evidence of matching to purchase orders.
- Examine supporting documentation for evidence that purchase invoices are matched to goods received notes and orders.
- Review a sample of purchase invoices for evidence that their accuracy has been verified (e.g. signature or initials) and reperform the procedures.
- Review evidence of approval of invoice coding to relevant expenditure account by responsible staff member.
- Test application controls relating to the input of purchase invoices and credit notes. For example, perform a batch reconciliation to determine whether purchase invoices have been entered accurately and a sequence check to determine whether all credit notes have been recorded.
- Review procedures for reconciling supplier statements to payables ledger accounts and reperform a sample of reconciliations.
- Review reconciliations of the payables ledger accounts and payables ledger control account.
- Reperform a sample of reconciliations of the payables ledger accounts and the payables ledger to ensure that they have been performed accurately.

Application activity 11.2

1. Which of the following controls undertaken when evaluating a purchases system would provide positive assurance to the auditor in respect of the key question 'Are goods only bought for business purposes?'
   a) Orders should only be raised in response to an authorized purchase requisition
   b) Goods inwards are examined for quality
   c) Goods inwards are verified to purchase orders
   d) Review of allocation of expenditure
2. What are the important objectives of internal control relating to suppliers and purchases

11.3. The payroll system

Learning activity 11.3

Analyse the image above and answer the following questions:

1. Explain the relationship between small circles and big circle

Key controls over payroll cover:

- Documentation and authorisation of staff changes
- Calculation of wages and salaries
- Payment of wages and salaries
- Authorisation of deductions

11.3.1. Control objectives

The most important objectives of internal control relating to wages and salaries are:

Setting of wages and salaries

To ensure that:

- Employees are only paid for work that they have done.
- Gross pay has been calculated correctly and authorised.

  Recording of wages and salaries

To ensure that:

- Gross and net pay and deductions are accurately recorded on the payroll.
- Wages and salaries paid are recorded correctly in the bank and cash records.

- Wages and salaries are correctly recorded in the general ledger.
- Payment of wages and salaries

To ensure that:

- The correct employees are paid.
- Wages and salaries are only paid to valid employees.

Deductions

To ensure that:

- Statutory and non-statutory deductions have been calculated correctly and are authorised.
- The correct amounts paid to the taxation authorities.

11.3.2. Control activities

While in practice separate arrangements are generally made for dealing with wages and salaries, the considerations involved are broadly similar and for convenience the two aspects are here treated together

General arrangements

Responsibility for the preparation of pay sheets should be delegated to a suitable person, and adequate staff appointed to assist him/her. The extent to which the staff responsible for preparing wages and salaries may perform other duties should be clearly defined. In this connection full advantage should be taken where possible of the division of duties, and controls available where automatic wage-accounting systems are in use.

Setting of wages and salaries

- Staffing and segregation of duties
- Maintenance of personnel records and regular reconciliation of wages and salaries to details in personnel records
- Authorisation
  - Engagement and discharge of employees (new staff are added to the payroll system correctly, and leavers are removed)
  - Changes in pay rates
  - Overtime
  - Non-statutory deductions (for example pension contributions)
  - Advances of pay
- Recording of changes in personnel and pay rates
- Recording of hours worked by timesheets, clocking in and out arrangements

- Review of hours worked
- Recording of advances of pay
- Holiday pay arrangements
- Answering queries
- Review of wages against budget

Recording of wages and salaries

- Bases for compilation of payroll
- Preparation, review and approval of payroll
- Dealing with non-routine matters

Payment of cash wages

- Segregation of duties
  - Cash sheet preparation
  - Filling of pay packets
  - Distribution of wages
- Authorisation of wage cheque
- Custody of cash
  - Encashment of cheque
  - Security of pay packets
  - Security of transit arrangements
  - Security and prompt banking of unclaimed wages
- Verification of identity
- Recording of distribution

Payment of salaries

- Preparation and signing of cheques and bank transfer lists
- Comparison of cheques and bank transfer list with payroll
- Maintenance and reconciliation of wages and salaries bank account

Deductions from pay

- Maintenance of separate employees' records, with which pay lists may be compared as necessary
- Reconciliation of total pay and deductions between one pay day and the next
- Surprise cash counts
- Comparison of actual pay totals with budget estimates or standard costs and the investigation of variances

- Agreement of gross earnings and total tax deducted with the returns submitted to the taxation authorities

Appropriate arrangements should be made for dealing with statutory and other authorised deductions from pay, such as social insurance, tax, pension fund contributions, and savings held in trust. A primary consideration is the establishment of adequate controls over the records and authorising deductions.

For the payroll system, as with other systems, it is important that you appreciate how the control activities we have identified relate to the control objectives.

Control objectives	Control activities
Employees are only paid for work that they have done.	▪ Staffing and segregation of duties ▪ Authorization – Engagement and discharge of employees (new staff are correctly added to the payroll system, and leavers are removed) ▪ Recording of hours worked by timesheets, clocking in and out arrangements ▪ Review of hours worked ▪ Salary and hourly payroll reports are reviewed and approved for payment by management
Gross pay has been calculated correctly and authorized.	▪ Maintenance of personnel records and regular comparison of wages and salaries to details in personnel records ▪ Authorization for: – Changes in pay rates – Overtime – Non-statutory deductions (for example pension contributions) – Advances of pay ▪ Recording of changes in personnel and pay rates ▪ Recording of hours worked by timesheets, clocking in and out arrangements ▪ Review of hours worked ▪ Recording of advances of pay ▪ Holiday pay arrangements ▪ Review of wages against budget

Gross and net pay and deductions are accurately recorded on the payroll.	▪ Bases for compilation of payroll ▪ Preparation, review and approval of payroll
Wages and salaries paid are recorded correctly in the bank and cash records.	▪ Bases for compilation of payroll ▪ Preparation, review and approval of payroll
Wages and salaries are correctly recorded in the general ledger.	▪ Preparation, review and approval of payroll ▪ Review of wages against budget
The correct employees are paid.	▪ Segregation of duties – Cash sheet preparation – Filling of pay packets – Distribution of wages ▪ Authorization of wage cheque ▪ Verification of identity ▪ Recording of distribution; employees sign for cash wages received ▪ Preparation and signing of cheques and bank transfer lists ▪ Comparison of cheques and bank transfer list with payroll ▪ Maintenance and reconciliation of wages and salaries bank account
Wages and salaries are only paid to valid employees.	▪ Payroll master file is periodically reviewed for accuracy (e.g. to confirm leavers have been removed) ▪ Preparation and signing of cheques and bank transfer lists ▪ Maintenance and reconciliation of wages and salaries bank account

Statutory and non-statutory deductions have been calculated correctly and are authorised.	▪ Maintenance of separate employees' records, with which pay lists may be compared as necessary ▪ Reconciliation of total pay and deductions between one pay day and the next ▪ Payroll deductions table data is periodically reviewed by management for accuracy and compliance with current taxation rates ▪ Comparison of actual pay totals with budget estimates or standard costs and the investigation of variances
The correct amounts are paid to the taxation authorities.	▪ Comparison of actual pay totals with budget estimates or standard costs and the investigation of variances ▪ Agreement of gross earnings and total tax deducted with the returns submitted to the taxation authorities

11.3.3. Tests of controls

Setting of wages and salaries

Auditors should confirm that the wages and salaries summary is approved for payment. They should confirm that procedures are operating for authorising changes in rates of pay, overtime, and holiday pay.

A particular concern will be joiners/new employees and leavers. Auditors will need to obtain evidence that staff only start being paid when they join the company, and are removed from the payroll when they leave the company. They should test that the engagement of new employees and discharges have been confirmed in writing.

Auditors will also wish to verify that the calculation of wages and salaries is accurate. Tests of controls should be designed to obtain evidence that the client is carrying out adequate checks on the calculations.

The precise nature of the tests of controls performed by the auditor would depend on the specific control activities operated by the entity. However, they would typically include the following:

- Review payroll and HR job descriptions and company policies on the payroll process, to evaluate whether proper segregation of duties is in place.

- Review a sample of starters/new employees and leavers in the year and verify that the correct documentation is in place e.g. personnel files.
- Review the entity's procedures for reporting changes (e.g. wage increases) to the payroll department.
- Obtain evidence of authorisation of standing data in payroll system.
- Review and test authorisation procedures for hiring staff, wage rates, overtime etc.
- Observe employees' use of clocking-in and out procedures.
- Inspect a sample of clock-cards/timesheets for evidence of approval by the appropriate level of management.
- Review documentary evidence that a sample of payroll calculations have been independently reperformed by entity staff e.g. review of spreadsheet printout.
- Test operation of computerised controls e.g. range checks.
- Inspect documentary evidence of management's review of agreement of gross earnings and total tax deducted to taxation returns.
- Examine paid cheques or a certified copy of the bank list for evidence of proper authorisation.
- Where wages are paid in cash attend the pay-out and observe procedures.
- Review payroll budgeting procedures adopted by the client.
- Review reconciliation of the payroll master file to the wages and salaries account in the general ledger.
- Review procedures for classifying payroll costs to ensure that costs are not incorrectly capitalised.

Application activity 11.3

1. Which of the following controls would not provide assurance that the correct amounts are paid to employees, in a system where employees are paid by the hour?

   a) Recording of hours worked

   b) Reperformance of payroll calculations

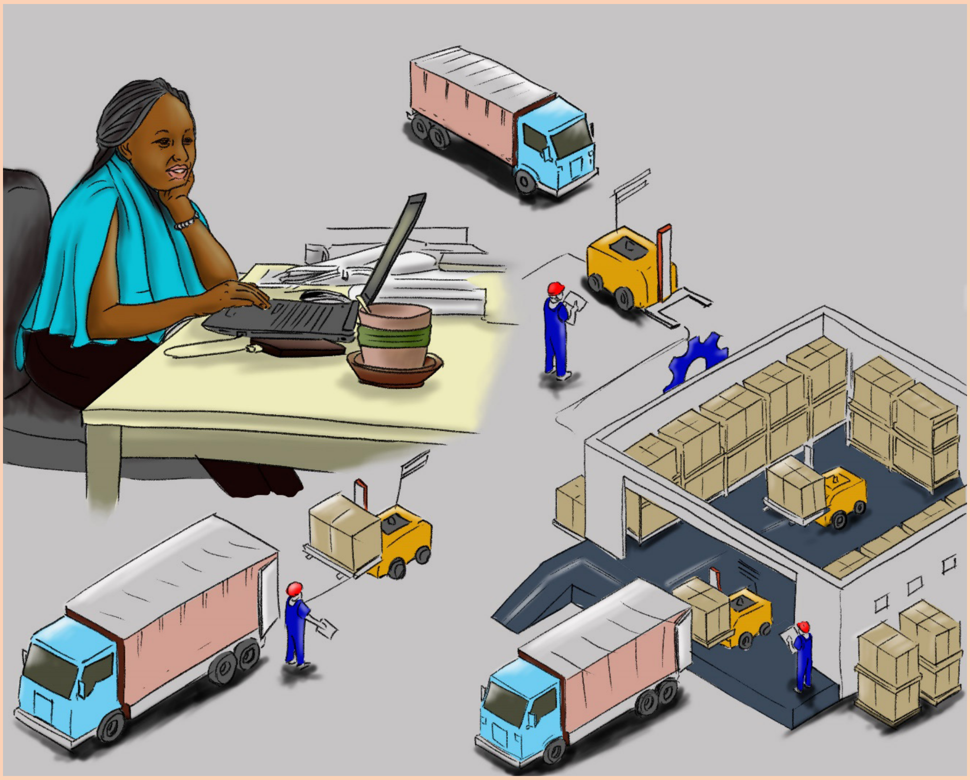
   c) Comparing bank transfer list with payroll

   d) Comparing payroll and income tax returns

2. How should auditors confirm that wages have been paid at the correct rate to individual employees?

11.4. The inventory system

Learning activity 11.4



Analyse the picture above and answer the following questions:

1. Which activities are carried out there?
2. What elements do you see on the picture can be used in inventory system?

Inventory controls are designed to ensure safe custody, and appropriate valuation. These include:

- Restriction of access to inventory
- Documentation and authorisation of movements
- Regular inventory counting/checking and review of inventory condition

11.4.1. Control objectives

The most important objectives of internal control relating to inventory are:

Recording

To ensure that:

- All inventory movements are authorised and recorded.
- Inventory records only include items that belong to the client.
- Inventory records include inventory that exists and is held by the client.
- Inventory quantities have been recorded correctly.
- Cut-off procedures are properly applied to inventory.

Protection of inventory

To ensure that:

- Inventory is safeguarded against loss, pilferage/theft or damage.

Valuation of inventory

To ensure that:

- The costing system values inventory correctly.
- Allowance is made for slow-moving, obsolete or damaged inventory.

Inventory-holding

To ensure that:

- Levels of inventory held are reasonable.

11.4.2. Control activities

Key control activities are as follows.

Recording of inventory:

- Segregation of duties : custody and recording of inventories
- Receipt, review and recording of goods inwards
- Inventory issues supported by appropriate documentation
- Maintenance of inventory records:
  - Inventory ledgers
  - Bin cards
  - Transfer records

Protection of inventory:

- Precautions against theft, misuse and deterioration by:
  - Restriction of access to stores
  - Controls on stores environment (right temperature, precautions against damp etc.)
- Security over inventory held by third parties, and third party inventory held by entity
- Inventory counting:
  - Regular inventory counting/checking
  - Fair coverage so that all inventory is counted at least once a year
  - Counts by independent persons
  - Recording
  - Cut-off for goods in transit and time differences
  - Reconciliation of inventory counting to book records and control accounts

Valuation of inventory:

- Computation of inventory valuation
  - Accords with IAS 2 Inventories
  - Review of calculations
- Review of condition of inventory
  - Treatment of slow-moving, damaged and obsolete inventory
  - Authorisation of write-offs

Inventory holding:

- Control of inventory levels by:
  - Maximum inventory limits
  - Minimum inventory limits
  - Re-order quantities and levels
- Arrangements for dealing with returnable containers

Control objectives	Control activities
All inventory movements are authorized and recorded.	▪ Segregation of duties : custody and recording of inventories ▪ Receipt, review and recording of goods inwards (all deliveries of goods from suppliers should pass through a goods inwards section to the stores, and be recorded and confirmed as received) ▪ Issues of inventory supported by appropriate documentation ▪ Issues of inventory should only be made on basis of properly authorized requisitions ▪ Maintenance of inventory records through use of: – Inventory ledgers – Bin cards – Transfer records
Inventory records only include items that belong to the entity.	▪ Receipt, review and recording of goods inwards (all deliveries of goods from suppliers should pass through a goods inwards section to the stores, and be recorded and confirmed as received) ▪ Procedures in place to include inventory held at third parties and to exclude inventory held on consignment for third parties ▪ Inventories received should be compared to purchase orders to confirm ownership

Inventory records include inventory that exists and is held by the entity.	▪ Segregation of duties : custody and recording of inventories ▪ Receipt, review and recording of goods inwards (all deliveries of goods from suppliers should pass through a goods inwards section to the stores, and be recorded and confirmed as received) ▪ Maintenance of inventory records through use of: – Inventory ledgers – Bin cards – Transfer records ▪ Physical safeguards in place to ensure inventory is not stolen ▪ Inventory counted regularly
Inventory quantities have been recorded correctly.	▪ Segregation of duties : custody and recording of inventories ▪ Receipt, review and recording of goods inwards ▪ Inventory issues supported by appropriate documentation ▪ Maintenance of inventory records through use of: – Inventory ledgers Bin cards – Transfer records ▪ Reconciliations of accounting records with physical inventory levels (inventory counts)
Cut-off procedures are properly applied to inventory.	▪ All dispatch documents processed daily to record the dispatch of finished goods ▪ All goods inwards reports processed daily to record the receipt of inventory ▪ Reconciliation of inventory counts to book records and control accounts

Inventory is safeguarded against loss, pilferage or damage.	▪ Precautions against theft, misuse and deterioration – Physical safeguards in place to ensure inventory is not stolen or damaged – Restriction of access to stores – Controls on stores environment (right temperature, precautions against damp etc.) ▪ Security over inventory held by third parties, and third party inventory held by entity ▪ Inventory counts
The costing system values inventory correctly.	▪ Computation of inventory valuation – Accords with IAS 2 (i.e. lower of cost and net realizable value) – Reviewing of calculations ▪ Review of condition of inventory – Treatment of slow-moving, damaged and obsolete inventory – Authorization of write-offs
Allowance is made for slow-moving, obsolete or damaged inventory.	▪ Computation of inventory valuation – Accords with IAS 2 (i.e. lower of cost and net realizable value) – Reviewing of calculations ▪ Inventory managers regularly review condition of inventory – Treatment of slow-moving, damaged and obsolete inventory – Authorization of write-offs
	▪ Control of inventory levels – Maximum inventory limits – Minimum inventory limits – Re-order quantities and levels ▪ Arrangements for dealing with returnable containers

11.4.3. Tests of controls

Most of the testing relating to inventory has been covered in the purchase and sales testing outlined.

Auditors will primarily be concerned at this stage with ensuring that the business keeps track of inventory. To confirm this, tests must be carried out on how inventory movements are recorded and how inventory is secured.

- Select a sample of inventory movement's records and reperform matching to goods received and goods despatched notes.
- Confirm that movements have been authorised as appropriate.
- Select a sample of goods received and goods despatched notes and agree to inventory movement records.
- Reperform a sample of reconciliations of inventory records with the general ledger to confirm that they are performed and reviewed.
- Examine evidence of sequence of inventory records.
- If the company uses perpetual inventory counting (i.e. it counts inventory on a regular basis throughout the year, rather than at the year-end alone), reperform a sample of the inventory counts and review evidence to confirm that:
    - All discrepancies between book and actual figures have been fully investigated All discrepancies have been signed off by a senior manager
    - Obsolete, damaged or slow-moving goods have been marked accordingly and written down to net realisable value
- Observe security arrangements for inventories.
- Consider environment in which inventories are held.
- Review procedures for counting inventory and attend the count.

Application activity 11.4

1. What controls should businesses exercise over inventory levels?
2. Which of the following would be appropriate test of controls in the audit of inventory :
    a) Agree a sample of inventory items to purchase invoices
    b) Obtain details of last goods out at the inventory count
    c) Review the system for safeguarding inventory
    d) Review the overhead allocation system

11.5. Non-current assets

Learning activity 11.5

Analyse the image above and answer the following questions:

1. Which kind of an assets observed on the picture?

Important controls over tangible non-current assets include physical custody and authorisation of purchases and disposals.

These systems tend to be of lesser importance, although this depends on the nature of the business.

11.5.1. Control objectives

The most important objectives of internal control relating to non-current assets are to ensure that:

- Non-current assets are properly accounted for and recorded.
- Security arrangements over non-current assets are sufficient.
- Non-current assets are maintained properly.
- Non-current assets acquisitions are authorised.
- Non-current assets disposals are authorised and proceeds of disposals are accounted for.
- Depreciation rates are reasonable.
- All income from income-yielding non-current assets is collected.

11.5.2 Control activities

Key control activities are as follows.

- Segregation of duties : authorisation, custody and recording
- Maintenance of appropriate accounting records (including distinction between capital and revenue expenditure)

Security and maintenance:

- Maintenance of plant and property registers which are regularly reviewed for:
  - Agreement with general ledger
  - Inspection of assets recorded
- Inspection of non-current assets to ensure properly maintaining and using

Acquisition and disposal:

- Authorisation of capital expenditure
- Authorisation of sales, scrapping or transfer of non-current assets

Depreciation:

- Authorisation of depreciation rates:
  - Calculation and confirmation of depreciation rates
  - Arithmetical accuracy Assessment of asset lives

Income from non-current assets:

- Identification of income-producing assets
- Monitoring of income
- Receipt of cash
- Adequate insurance cover

Asset register

Maintenance of a non-current asset register is a key control activity. The register should contain details of all the company's tangible non-current assets. It is an important control over the completeness of recording and safe custody of those assets. To preserve segregation of duties, it should be maintained by someone who does not use, and is not responsible for the custody of non-current assets.

The non-current asset register acts as a point of comparison against which the non-current assets that physically exist can be compared, and also the non-current asset accounts in the general ledger. It is of most use for assets that can easily be stolen. Information that should be included within the register for individual assets includes the following.

- Cost
- Additions or alterations to the assets
- Total depreciation charged over the asset's life
- The serial number or other means of identification
- Description of the asset
- The location of the asset
- The manufacturer and supplier
- Insurance details
- Maintenance record

As well as knowing the control objectives and control activities that could be used in relation to non-current assets, it is important that you appreciate how the different control activities relate to the control objectives.

Control objectives	Control activities
Non-current assets are properly accounted for and recorded.	▪ Segregation of duties: authorization, custody and recording of assets ▪ Maintenance of appropriate accounting records (including distinction between capital and revenue expenditure) ▪ Maintenance of non-current asset register
Security arrangements over non-current assets are sufficient.	▪ Maintenance of non-current asset register ▪ Physical inspection of non – current assets – Asset details agree to register – Assets are properly maintained and used ▪ Precautions against theft or misuse Physical safeguards in place to ensure assets are not stolen or damaged Where necessary, access is restricted to non authorized personnel only ▪ Portable assets (e.g. laptops) should be tagged and movements in and out of the entity's properties recorded

Non-current assets are maintained properly.	▪ Physical inspection of non-current assets – Assets are properly maintained and used ▪ Precautions against theft or misuse – Physical safeguards in place to ensure assets are not stolen or damaged ▪ Assets should be regularly inspected and maintained (e.g. annual maintenance service) and adequately insured
Non-current asset acquisitions are authorized.	▪ Authorization of capital expenditure – Applications for capital expenditure should be submitted to the board for approval ▪ Annual capital expenditure budgets should be approved by the board
Non-current asset disposals are authorized and proceeds of disposals are accounted for.	▪ Authorization of sales, scrapping or transfer of non-current assets ▪ Proceeds from disposal recorded, and related to disposal
Depreciation rates are reasonable.	▪ Authorization of depreciation rates – Calculation and confirmation of depreciation rates Arithmetical accuracy of assessment of asset lives Review of profit/loss on disposal of assets to assess any needs for depreciation rates
All income from incomeyielding non-current assets is collected.	▪ Identification of income-producing assets – Monitoring of income – Receipt of cash

11.5.3. Tests of controls

The precise nature of the tests of controls performed by the auditor would depend on the way in which the control is being operated by the audit client. Procedures, however, would typically include those listed below.

A key concern of auditors will be proper controls over movements (acquisitions and disposals) during the year.

- Confirm maintenance of a non-current asset register
- Review annual capital budgets produced by the board and confirm that they are authorised
- For a sample of acquisitions and disposals recorded in the non-current asset register confirm authorisation (and board approval if necessary).
- Inspect invoices to confirm that they have been appropriately approved.
- Review reconciliations of the non-current assets register to the general ledger accounts and confirm that discrepancies are followed up.
- Reperform a sample of reconciliations.
- Verify that depreciation rates are authorised and are in line with company policy.
- Review evidence of arithmetical accuracy of depreciation and reperform a sample of calculations.
- Review evidence of calculations of profits or losses on disposal and reperform a sample of calculations.
- Review adequacy of physical security measures.

Auditors should also carry out some testing on security and maintenance of non-current assets.

For a sample of non-current assets from the non-current asset register:

- Review procedures used to ensure assets are in good condition eg inspection procedures.
- Ascertain for a sample of assets when they were last reviewed for maintenance and whether this is in line with company's policy.
- Observe for a sample of newly acquired assets the procedures for ensuring they are labelled and stored.
- Review procedures for insuring new assets and renewal of insurance for existing assets.

Application activity 11.5

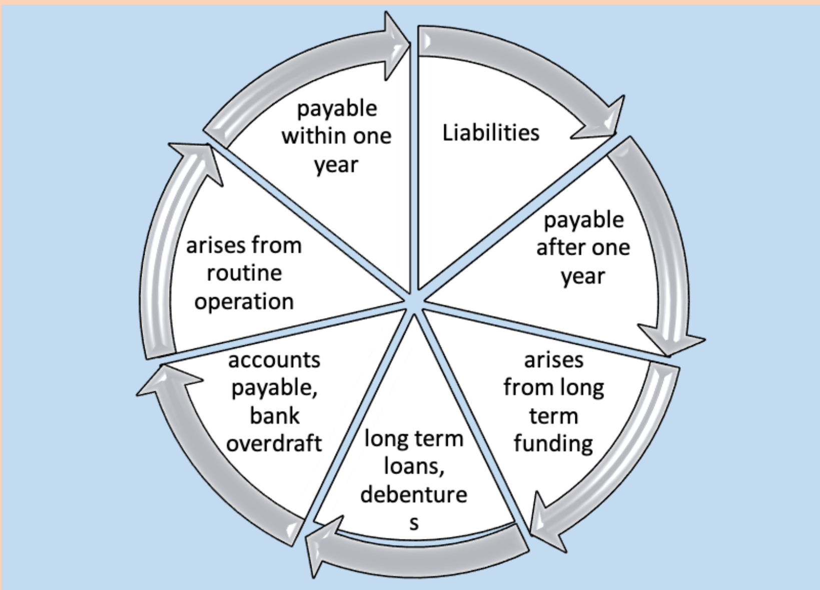
1. What tests would auditors normally carry out on controls over non-current asset purchases?

2. Which of the following is not a test of controls over non-current assets?

   a) Review the system of authorizing capital expenditure
   b) Review whether a non-current asset register exists
   c) Review the system of authorizing non-current asset disposal
   d) Review the condition of non-current assets in use

11.6. Non-current liabilities

Learning activity 11.6



Analyse the picture above and answer the following question:

1. Among the elements above, which ones are non- current liabilities?

2. Why for the auditor, is auditing the liabilities of the client very important?

Non-current liabilities may comprise payables due more than one year after the year end, as well as capital lease obligations, mortgages, debentures, and other loans repayable at a date more than one year after the year end.

The most important objectives of internal control relating to non-current liabilities are to ensure:

- **Authorisation:** that loans and any other long-term borrowings are properly authorised
- **Completeness:** that all non-current liabilities have been recognised and disclosed
- **Accuracy:** that the value of the liability has been correctly recorded, and that interest payable has been calculated correctly and included in the correct accounting period
- Classification and understandability: that long-term loans and interest on loans have been correctly disclosed in the financial statements

A major complication for the auditors is that debenture and loan agreements frequently contain conditions with which the company must comply. These may include restrictions on the company's total borrowings, and requirements to adhere to specific borrowing ratios.

In this respect, it is important that internal controls ensure that borrowing limits imposed by agreements are not exceeded.

New loans should be approved by the Board, and documented in signed Board minutes.

In the financial statements themselves, it will also be important to ensure non-current liabilities are correctly disclosed, in accordance with accounting standards. In particular, the capital element of any loans repayable within one year should be classified under current liabilities, rather than under non-current liabilities.

Control objectives	Control activities
Non-current liabilities have been properly accounted for and recorded.	▪ **Maintenance of appropriate accounting records** (including distinction between current and non-current liabilities) – Sample of postings reviewed independently by a senior member of staff to confirm allocations between current and non-current liabilities ▪ **Statements** from loan or lease providers should be reconciled with the relevant ledger accounts on a regular basis

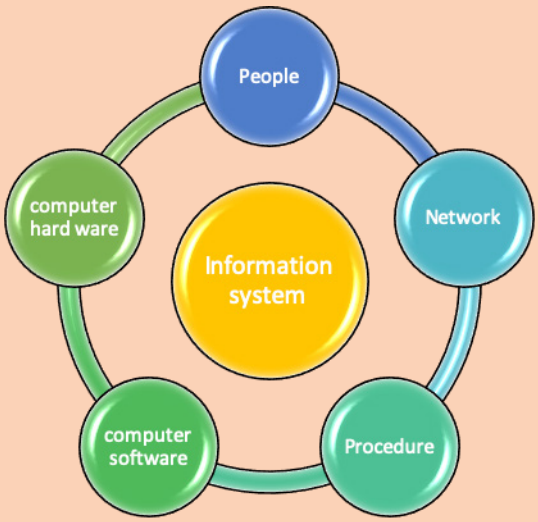
Non-current liabilities are authorized.	▪ Authorization of new loans, mortgages etc. – Applications for new loans, mortgages etc. should be submitted to the **board for approval**
Interest charges are reasonable.	▪ The calculation of interest charges should be checked for accuracy

Application activity 11.6

What will be the control activities if non-current liabilities have been properly recorded?

11.7. Management information

Learning activity 11.7



Analyse the image above and answer the following questions:

1. Explain the relationship between small circles and big circle

The management information system is an important aspect of the control environment, since timely and accurate information helps management supervise operations. There should be controls in place to ensure budgets are regularly set, and reports and information are provided on time to the specified degree of accuracy and detail.

As well as the control aspects, auditors will be concerned with the management information system's ability to provide useful data for analytical procedures.

Auditors will also be particularly concerned of course with the accounting records, with the procedures that ensure transactions are completely posted, and journal adjustments are authorised and backed up by appropriate documentation.

11.7.1. Management information procedures

Auditors will review the contents of internal management accounting reports, and confirm in particular that budgets are being set and that actual results are being compared with budgeted figures.

As well as testing based on individual components of the accounting system, the auditor will also perform some general tests, including the following.

- **Test postings** from books of prime entry to the general ledger.
- **Confirm** that the general ledger is regularly balanced.
- **Test vouch** a sample of journal entries to original documentation.

Application activity 11.7

What test of control of management information helps the management operations?

Skills lab activity 11

Under guidance of the teacher, students in their learning teams act as auditor of school and test how purchase system, payroll system, inventory system are recorded, maintained and reported in accounting systems.

End unit 11assessment

1. How can a company ensure that quantities of goods ordered do not exceed those that are required?
2. What are the important verification procedures that should be made on invoices received from suppliers?
3. Which of the following controls helps to ensure that non-current assets are depreciated in line with company policy?

a) Limiting access to non-current assets

b) Periodically verifying that assets listed in the non-current asset register exist

c) Review of records that show significant profits on disposal

d) Obtaining authorization for capital purchases

4. Mpundu Ltd, a limited liability company, manufactures high fashion jeans for distribution to wholesalers and retailers.

   You have been assigned to the audit of inventory in the company's financial statements for the year ended 31 July 2019.

   The following points are relevant to the audit.

   i. The company has raw materials, consumables and work in progress inventory at its factory base. Finished goods are stored in a separate warehouse located five miles away. The company does not hold inventory owned by third parties.

   ii. On 31 July 2019 employees of the company will physically count the inventory at both of the company's sites and members of your audit team will attend.

   iii. The company has significant quantities of finished goods inventory held by independent retail stores under its sale or return system. Under this system, inventory is displayed for sale at retail shop premises but remains the property of Mpundu until it is sold by retailers. Any garments not sold within three months are returned to Mpundu for bulk sale at heavily discounted prices.

   iv. Some quantities of finished goods inventory were stated at net realisable value in the financial statements of the company for the previous year.

Required

a) With explanations, discuss why the inherent risk associated with inventory in the financial statements of Mpundu would be assessed as 'high'.

b) Identify five tasks that members of your audit team should carry out when attending the company's physical inventory count on 31 July 2019.

UNIT 12 PROCEDURES IN AUDIT OF FINANCIAL STATEMENTS

Key unit competence: To be able to demonstrate working knowledge in respect of performance of audit procedures

Introductory activity

UMURAVA Ltd Company is a textile industry with the purpose of selling its products in Rwanda and outside. As part of corporate governance, shareholders are supposed to make follow up of the performance of their company. They often appoint the management and auditor. The auditor is appointed by the shareholders during the annual meeting.

The main responsibility of the auditor is to audit the financial statements of the company and ascertain whether the financial statements are prepared in all material respects and free from material misstatement due to errors and fraud. The auditor should also review/ carry out an assessment on the internal control. Thereafter, the auditor should issue the audit report on financial statements and on internal controls (Management letter).

1. What do you think could be the purpose of the audit?
2. What are the auditable elements of the financial statements?

12.1. Substantive procedures

Learning activity 12.1

1. What do you think the person in picture above could be doing?
2. What do you think would be roles/tasks of the auditor during the audit of a financial statement?

12.1.1. The nature of substantive procedures

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. They consist of tests of details (i.e. testing classes of transactions, accounts balances and disclosures) and as well substantive analytical procedures (i.e. where the auditor develops his/her expectations and reconcile it with balances shown in the financial statements.

a) Substantive procedures

Substantive audit procedures (tests of details), the auditor inspects transactions and balances taken on sample basis. The auditor is required to establish the audit procedures and carryout audit. Detailed audit tests are performed to detect any material misstatement due to errors or fraud.

b) Analytical procedures

Analytical procedures are also another form of substantive procedures.

- The analytical procedures involve comparison with:
  - **Similar information** for prior periods;
  - **Anticipated results** of the entity, from budgets or forecasts;
  - **Predictions** prepared by the auditor's Industry information.

- The consideration of the relationship between financial information and **relevant non-financial information.**
- The consideration also of the relationship between elements of **financial information** that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales.
- **Ratio analysis** can be a useful technique when carrying out analytical procedures.

12.1.2. Financial statement assertions

Financial statement assertions are the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur. Audit tests are therefore designed and performed to obtain the appropriate and sufficient audit evidences about the financial statements assertions. Assertions relate to:

- Classes of transactions,
- Accounts balances
- Disclosures

a) Assertions about classes of transactions and events and disclosures (related to Income statement)

- **Occurrence**: transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.
- **Completeness**: all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy: a**mounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
- **Cut-off**: transactions and events have been recorded in the correct reporting period.
- **Classification**: transactions and events have been recorded in the proper accounts.
- **Presentation**: transactions and events are appropriately aggregated or disaggregated and are clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

b) Assertions about account balances and related disclosures (related financial position)

- **Existence**: assets, liabilities and equity interests exist.
- **Rights and obligations**: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- **Completeness**: all assets,aliabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy, valuation and allocation**: assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
- **Classification**: assets, liabilities and equity interests have been recorded in the proper accounts.
- **Presentation**: assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

12.1. Methods of obtaining audit evidences

During the audit, the auditor has to collect sufficient and appropriate evidences to support his or her conclusion. The audit evidences are collected in the following ways;

- **Inspection**: inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.
- **Observation**: observation consists of looking at a process or procedure being performed by others. For example: is where an auditor can attend inventory counts.
- **External confirmation**: an external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party.
- **Recalculation**: recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.
- **Reperformance**: reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

- **Analytical procedures**: analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also look at identified fluctuations or relationships that are inconsistent with from the expected values.
- **Inquiry**: inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries.

Exercise on analytical procedures

The audit XY Company is a company that is involved in sale of its agricultural produces. The company planned to obtain sales revenue amounting to **FRW 300,000,000** for sales during the year. The table below indicates different agricultural produces, quantities produced and their respective prices. You are required to audit the above revenue amount disclosed in XY Company's financial statements for the period ended 31 Dec 2021.

Agricultural produces	Approved in price per Kg	Quantities produced during the year
Banana	1,000	100,000
Rice	2,000	50,0000
Beans	950	300,000

As an auditor of XY Company, establish how can carry out your substantive audit procedures and conclude on the revenue amount indicated above.

Following the considering the information shared to the auditor, it easy for the audit to conclude on revenue amount by conducting substantive analytical procedures. The auditor can perform the following:

Step 1

Identify the quantities sold and their approved/ market prices

Step 2

Develop the expectation(s)

Agricultural produces during the year	Approved in price per kg in FRW (A)	Quantitties produced in Kg (B)	Expected revenue C=B*A
Banana	1,000	100,000	100,000,000
Rice	2,000	50,000	100,000,000
Beans	950	300,000	285,000,000
Total			485,000,000

Step 3

Asses the relationship between computed amount and the amount reported in the financial statements

Agricultural produce per activity	Approved in price per kg during the year(A)	Quantities produced during the year (B	Expected revenue(Frw) C= (B*A)
Banana	**1,000**	100,000	100,000,000
Rice	**2,000**	50,000	100,000,000
Beans	**950**	300,000	285,000,000
Total (A)			**485,000,000**
Amount per financial statement(B)			300,000,000
Difference C=(A-B)			**185,000,000**

Step 4 seek explanations from the management for the above difference of **185,000,000FRW** obtained.

Note

In case it is justified/supported, conclude it by ignoring the difference

If not justified, consider it as a reportable issue and include in the audit report.

Application activity 12.1

1. You have been tasked by your Auditor Manager to carry out the audit of expense amounting **FRW 100,000,000** included in the financial statements of AB Ltd for the period ended 31 December 2020. Demonstrate how you will collect the audit evidences during the audit of this expenditure of AB Ltd.

2. MK Ltd is a company that buys milk from the Milk collectors for the consumption of its staff. Every month, the company collects **50,000** litres at a price of **FRW 500** per Littre. MK reported the expense of **FRW 45,000,000**. You are assigned by your audit partners to quickly audit the expense related to milk consumed during the year. Establish the three audit procedures you will perform to conclude on milk expense included in MK Ltd for the period ended 31 December 2020.

12.2. Analytical procedures

Learning activity 12.2

1. What are the materials/ items shown in the above picture?
2. What do you think could be their purposes?
3. What are the activities being done by the people shown in the above picture?

12.2.1. Using analytical procedures

One of the objectives of ISA 520 is that relevant and reliable audit evidence are obtained when using substantive analytical procedures. The primary purpose of substantive analytical procedures is to obtain assurance, in combination with other audit testing (such as tests of controls and substantive tests of details), with respect to financial statements assertions for one or more auditable areas.

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be more predictable over time.

The application of substantive analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

To derive the most benefit from substantive analytical procedures, the auditor should perform substantive analytical procedures before other substantive tests because results of substantive analytical procedures often impact the nature and extent of detailed testing. Substantive analytical procedures might direct attention to areas of increased risk, and the assurance obtained from effective substantive analytical procedures will reduce the amount of assurance needed from other tests.

12.2.2.The nature of analytical procedures

Analytical procedures involve the analysis of the relationships such as between items of financial data to identify consistency and predicted patterns or significant fluctuations, unexpected relationships and results of investigations thereof. Analytical procedures are used throughout the audit process as follows:

a) Preliminary analytical review-risk assessment (Compliance with ISA 315)

Preliminary analytical reviews are performed to obtain an understanding of the business and its environment (e.g. financial performance relative to prior years and relevant industry and comparison groups), to help assess the risk of material misstatement in order to determine the nature, timing and extent of audit procedures, i.e to help the auditor develop the audit strategy and programme.

b) Substantive analytical procedures

Analytical procedures are used as substantive procedures when the auditor considers that the use of analytical procedures can be more effective or efficient than tests of details in reducing the risk of material misstatements at the assertion level to an acceptably low level.

c) Final analytical review (Compliance with ISA 520)

Analytical procedures are performed as an overall review of the financial statements at the end of the audit to assess whether they are consistent with the auditor's understanding of the entity. Final analytical procedures are not conducted to obtain additional substantive assurance. If irregularities are found, risk assessment should be performed again to consider any additional audit procedures deemed necessary.

12.2.3. Analytical procedures in substantive testing

Performing analytical procedures involve the following four steps:

- Develop an expectation of account balance or ratio
- To determine the amount of difference from expectation that can be accepted without investigation.
- Comparison of company's account balance or ratio with the expected.
- Investigate and evaluate significant ratio or difference from the expectation

Substantive analytical procedures are used for accounts balances or classes of transactions where it is possible to develop an expected value for the recorded amount or ratio. It should be however, noted that analytical procedures tend to be appropriate for large volumes of predictable transactions (for example, wages and salaries).

Analytical procedures can be designed to test several assertions at the same time. Some examples are shown in the table below:

Classes of transactions and related disclosures	
Analytical procedure	**Financial statement assertion to be tested**
Compare the current year gross profit margin with the prior year gross profit margin and with industry trends	▪ Occurrence and completeness of revenue ▪ Cut-off of revenue ▪ Accuracy of revenue ▪ Occurrence and completeness of cost of sales and its accuracy ▪ Classification of cost of sales
Compare the current year effective tax charge with the applicable rate of corporation tax for the period	▪ Accuracy of tax expense ▪ Completeness of tax expense and disclosures

Perform a proof-in-total of payroll (based on number of employees multiplied by average wage)	▪ Occurrence and completeness of payroll expenses ▪ Accuracy of payroll expenses ▪ Cut-off of payroll expenses
Accounts balances and related disclosures	
Analytical procedures	**Financial statement assertion to be tested**
Compare the current year receivables collection period to that of the prior year	▪ Existence and completeness of trade receivables ▪ Accuracy, valuation and allocation of trade receivables ▪ Accuracy, valuation and allocation of provision for irrecoverable receivables
Calculate the current year current ratio and compare with that of the prior year	▪ Existence and completeness of current assets ▪ Accuracy, valuation and allocation of current assets ▪ Existence and completeness of current liabilities ▪ Accuracy, valuation and allocation of current assets ▪ Presentation of going concern disclosures

Gasaka secondary school has 331 students. As per the schools' standards procedures, each student is required to consume **FRW 4750**. The school calendar of 2022 had 37 weeks/the year. The financial statement for the year ended 31December indicated expenditure of **FRW 325,000,000** on students' consumptions. Use analytical procedures to audit the above expenditure reported in Gasaka secondary school for the period ended 30 June2022.

Details of number of students are shown below:

Classes as per school records	No of students per class
Senior one	60
Senior two	55
Senior three	42
Senior four	34
Senior four	40

Senior five	45
Senor Six	55

Answer:

Step 1

- Obtain the school register and confirm whether the number of students existed throughout the academic year
- Obtain the approved school standards operating procedures/ guidelines determining amount to be consumed by each student on daily basis.

Step 2

- Develop the expectations

Classes	No of students per class (A)	amount to be consumed by each student per day in FRW (B)	No of days per during the academic year C	Expected cosy/ Expenditure per each class during at the year end in FRW D= (A*B*C)
Senior one	60	4,750	259	73,815,000
Senior two	55	4,750	259	67,663,750
Senior three	42	4,750	259	51,670,500
Senior four	34	4,750	259	41,828,500
Senior four	40	4,750	259	49,210,000
Senior five	45	4,750	259	55,361,250
Senior six	55	4,750	259	67,663,750
Total (A)	331	4,750	259	**407,212,750**
Amount disclosed in the financial statements (B)				**325,000,000**
C= (A-B)				**82,212,750**

Step 3

- Obtain explanation(s) on the difference of **FRW 82,212,750**
- Asses/analyze the reasons or justifications provided

In response to the difference, the management reviewed their records and noted that 67 were not available at some of days, hence form the basis for the difference above (67*4750* 259).

Step 4

Conclusion, the auditor concludes that the amount repported is appropriate (completeness and accurate and cut off)

1. Investigation of fluctuations and relationships

In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific accounts balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.

The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation, the inquiry of management may assist the auditor in this regard.

Management responses should ordinarily be agreed with other evidential matter. In those cases, when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself/herself as to whether the difference is a likely misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement.

Application activity 12.2

BC ltd company employs staff of different levels. The table below shows their levels and salaries per month. You have been appointed by audit supervisor to audit the expense related to salary disclosed in the financial statements for BC Ltd company. Note that the financial statements for BC Ltd company for the year ended 31 Dec 2019 under audit show the expense of FRW 115,000,000.

Staff category	**No of staff**	**Monthly pay in FRW**
Ordinary staff(officers)	275	650,000
Middle managers	30	1,450,000
Senior manager	15	3,000,000

Demonstrate the audit procedure you should perform during the audit of the salary expense included in BC Ltd company financial statements for the period ended 30 December 2019.

12.3. Audit procedures for some elements of financial statements

Learning activity 12.3

1. What do you think the person in the picture doing?
2. What is the purpose of the tool he has?

12.3.1. Inventory

The valuation and disclosure rules for inventory are laid down in IAS 2. Inventory should be valued at the lower of cost and net realisable value.

Cost is defined by IAS 2 as comprising all costs of purchase and other costs incurred in bringing inventory to its present location and condition. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale.

a) Audit procedures of inventory

The following procedures should be performed during the audit of inventory balance disclosed in the financial statements.

Audit assertions	Audit procedures
Completeness	▪ Complete the disclosure checklist to ensure that all the disclosures relevant to inventory have been made. ▪ Trace test counts to the detailed inventory listing. ▪ Where inventory is held in third-party locations, physically inspect this inventory or review confirmations received from the third party and match to the general ledger. ▪ Compare the gross profit percentage to the previous year or industry data.
Existence	▪ Observe the physical inventory count
Rights and obligations	▪ Verify that any inventory held for third parties is not included in the year-end inventory figure by being appropriately segregated during the inventory count. ▪ For any bill and hold inventory (ie where the inventory has been sold but is being held by the entity until the customer requires it), identify such inventory and ensure that it is segregated during the inventory count so that it is not included in the year-end inventory figure. ▪ Confirm that any inventory held at third-party locations is included in the year-end inventory figure by reviewing the inventory listing.

Accuracy, valuation and allocation	▪ Obtain a copy of the inventory listing and agree the totals to the general ledger. ▪ Cast the inventory listing to ensure it is mathematically correct. ▪ Vouch a sample of inventory items to suppliers' invoices to ensure it is correctly valued. ▪ Where standard costing is used, test a sample of inventory to ensure it is correctly valued. ▪ For materials, agree the valuation of raw materials to invoices and price lists. ▪ Confirm that an appropriate basis of valuation (eg FIFO) is being used by discussing with management. ▪ For labour costs, agree costs to wage records. ▪ Review standard labour costs in the light of actual costs and production. ▪ Reconcile labour hours to time summaries. ▪ Make enquiries of management to ascertain any slow-moving or obsolete inventory that should be written down. ▪ Examine prices at which finished goods have been sold after the year end to ascertain whether any finished goods need to be written down. ▪ If significant levels of finished goods remain unsold for an unusual period of time, discuss with management and consider the need to make allowance. ▪ Compare the gross profit percentage to the previous year or industry data. ▪ Compare raw material, finished goods and total inventory turnover to the previous year and industry averages. ▪ Compare inventory days to the previous year and industry average.

Accuracy, valuation and allocation	▪ Compare the current year standard costs to the previous year after considering current conditions. ▪ Compare actual manufacturing overhead costs with budgeted or standard manufacturing overhead costs. ▪ Obtain a copy of the inventory listing and cast it, and test the mathematical extensions of quantity multiplied by price. ▪ Trace test counts back to the inventory listing. ▪ If the entity has adjusted the general ledger to agree with the physical inventory count amounts, agree the two amounts. ▪ Where a continuous (perpetual) inventory system is maintained, agree the total on the inventory listing to the continuous inventory records, using CAATs.
Cut off	▪ Note the numbers of the last GDNs and GRNs before the year end and the first GDNs and GRNs after the year end and check that these have been included in the correct financial year.
Occurrence and rights and obligations	▪ Enquire of management and review any loan agreements and board minutes for evidence that inventory has been pledged or assigned. ▪ Enquire of management about warranty obligation issues.
Classification	▪ Review the inventory listing to ensure that inventory has been properly classified between raw materials, work-in-progress and finished goods. ▪ Read the notes to the accounts relating to inventory to ensure they are understandable.
Presentation	▪ Review the financial statements to confirm whether the cost method used to value inventory is accurately disclosed. ▪ Read the notes to the financial statements to ensure that the information is accurate and properly presented at the appropriate amounts.

- **The physical inventory count**

Physical inventory count procedures are vital, as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventories and work-in-progress.

ISA 501 Audit evidence – specific considerations for selected items provides guidance for auditors on attending the physical inventory count to obtain evidence regarding the existence and condition of inventory. It states that where inventory is material, auditors shall obtain sufficient appropriate audit evidence regarding its existence and condition by attending the physical inventory count (unless this is impracticable) to do the following:

- Evaluate management's instructions and procedures for recording and controlling the result of the physical inventory count
- Observe the performance of the count procedures
- Inspect the inventory
- Perform test counts

When observing inventory count, the auditor should also consider the following:

- Observe whether the client's staff are following instructions, as this will help to ensure the count is complete and accurate.
- Perform test counts to ensure procedures and internal controls are working properly, and to gain evidence over existence and completeness of inventory.
- Ensure that the procedures for identifying damaged, obsolete and slow-moving inventory operate properly; the auditors should obtain information about the inventory's condition, age, and usage and, in the case of work-in-progress, its stage of completion to ensure that it is later valued appropriately.
- Confirm that inventory held on behalf of third parties is separately identified and accounted for so that inventory is not overstated.
- Conclude whether the count has been properly carried out and is sufficiently reliable as a basis for determining the existence of inventories.
- Consider whether any amendment is necessary to subsequent audit procedures.
- Gain an overall impression of the levels and values of inventories held so that the auditors may, in due course, judge whether the figure for inventory appearing in the financial statements is reasonable

12.3.2.Non- current assets

a) The audit procedures of Property Plant and Equipment (PPE)

The following are some of the substantive audit procedures for non-current assets.

Assertions	Substantive audit procedures
Completeness	**Obtain** or **prepare** a **summary** of tangible non-current assets showing how the following reconcile with the **opening position**. ▪ Gross book value ▪ Accumulated depreciation ▪ Net book value – **Compare non-current assets** in the general ledger with **the non-current assets register** and **obtain explanations** for **differences**. – For a sample of assets which physically exist, agree that they are **recorded** in the **non-current asset register**. – If a non-current asset register is not kept, **obtain a schedule** showing the original costs and present depreciated value of major non-current assets. – **Reconcile** the **schedule** of non-current assets with the **general ledger.**
Existence	▪ Confirm that the company **physically inspects** all items in the non-current assets register each year. – **Inspect assets**, concentrating on high value items and additions in-year. Confirm that items inspected: – Exist – Are in use – Are in good condition – Have correct serial numbers/codes – **Review records** of **income-yielding assets**. – **Reconcile** opening and closing **vehicles** by numbers as well as their amounts.

Valuation	▪ **Reperform** calculation of revaluation surplus. ▪ Confirm whether valuations of all assets that have been revalued have been **updated regularly** (full valuation every five years and an interim valuation in year three generally) by asking the Finance Director and inspecting the previous financial statements. ▪ **Inspect** draft accounts to check that client has recognised revaluation losses in the statement of profit or loss unless there is a credit balance in respect of that asset in equity, in which case it should be debited to equity to cancel the credit. All revaluation gains should be credited to equity. ▪ **Review insurance policies** in force for all categories of tangible non-current assets and consider the adequacy of their insured values and check expiry dates.
	▪ Review depreciation rates applied in relation to: ▪ Asset lives ▪ Residual values ▪ Replacement policy ▪ Past experience of gains and losses on disposal ▪ Consistency with prior years and accounting policy ▪ Possible obsolescence ▪ Review non-current assets register to ensure that depreciation has been charged on all assets with a limited useful life. ▪ For revalued assets, ensure that the charge for depreciation is based on the revalued amount by recalculating it for a sample of revalued assets. ▪ Reperform calculation of depreciation rates to ensure it is correct. ▪ Compare ratios of depreciation to non-current assets (by category) with: – Previous years – Depreciation policy rates ▪ **Scrutinise** draft accounts to ensure that **depreciation policies** and rates are **disclosed** in the accounts.

Rights and obligations	▪ **Verify title** to land and buildings by inspection of: – Title deeds – Land registry certificates – Leases ▪ Obtain a certificate from solicitors/bankers ▪ **Stating purpose** for which the deeds are being held (custody only) ▪ **Stating deeds** are **free** from **mortgage** or **lien** ▪ **Inspect registration documents** for vehicles held, confirming that they are in client's name. ▪ **Confirm** all vehicles are used for the **client's business**. ▪ **Examine documents** of **title** for other assets (including purchase invoices, architects' certificates, contracts, hire purchase or lease agreements). ▪ **Review for evidence** of charges in statutory books and by company search. ▪ **Review leases** of leasehold properties to ensure that company has fulfilled covenants therein. ▪ **Examine invoices received after year end, orders** and **minutes** for evidence of capital commitments.
Additions	▪ These tests are to confirm **rights and obligations, valuation** and **completeness**. ▪ Verify additions by inspection of architects' certificates, solicitors' completion statements, suppliers' invoices etc ▪ **Review** capitalisation of expenditure by examining for non-current assets additions and items in relevant expense categories (repairs, motor expenses, sundry expenses) to ensure that: – Capital/revenue distinction is correctly drawn – Capitalisation is in line with consistently applied company policy ▪ **Inspect** non-current asset accounts for a sample of purchases to ensure they have been **properly allocated**. ▪ Ensure that appropriate **claims** have been made for **grants**, and grants received and receivable have been received, by inspecting claims documentations and bank statements. ▪ Verify that additions have been **recorded** by **scrutinising** the non-current asset register and general ledger.

<table>
<tr><td>Self-constructed assets</td><td>These tests are to confirm the assertions of valuation and completeness.

Verify material and labour costs and overheads to invoices, wage records etc.
Ensure expenditure has been analysed correctly and properly charged to capital.
Expenditure should be capitalised if it:

Enhances the economic benefits of the asset in excess of its previously assessed standard of performance
Replaces or restores a component of the asset that has been treated separately for depreciation purposes, and depreciated over its useful economic life
Relates to a major inspection or overhaul that restores the economic benefits of the asset that have been consumed by the entity, and have already been reflected in depreciation
Reviews costs to ensure that no profit element has been included.
Reviews accounts to ensure that finance costs have been capitalised or not capitalised on a consistent basis, and costs capitalised in period do not exceed total finance costs for period.

</td></tr>
<tr><td>Disposals</td><td>
These tests are to confirm rights and obligations, completeness, occurrence and accuracy.
Verify disposals with supporting documentation, checking transfer of title, sales price and dates of completion and payment.
Recalculate profit or loss on disposal.
Consider whether proceeds are reasonable.
If the asset was used as security, ensure release from security has been correctly made.
</td></tr>
<tr><td>Classification</td><td>
Review non-current asset disclosures in the financial statements to ensure they meet IAS 16 criteria.
For a sample of fully depreciated assets, inspect the register to ensure no further depreciation is charged.
</td></tr>
</table>

Substantive audit procedures for Intangible non-current assets

Key assertions for intangible non-current assets are **existence** and **valuation.**

Auditor has to apply different audit procedures during the audit of Intangible non-current assets. The following are the substantive procedures that should be performed by the auditors.

1. **Audit procedures for good will**
   - Agree the consideration to sales agreement by **inspection**.
   - Consider whether asset valuation is reasonable.
   - Agree that the calculation is correct by **recalculation**.
   - **Review** the impairment review and **discuss** with management.
   - Ensure valuation of goodwill is reasonable / there has been no impairment not adjusted through **discussion** with management.
2. **Research and development (R&D) costs**
   - Confirm that capitalized development costs conform to IAS 38 criteria by **inspecting** details of projects and **discussions** with technical managers.
   - Confirm feasibility and viability by **inspection** of budgets.
   - **Recalculate** amortization's calculation to ensure it commences with production / is reasonable.
   - **Inspect** invoices to verify expenditure incurred on R&D projects.
3. **Other intangible assets**
   - Agree purchased intangibles to purchase documentation agreement by **inspection**.
   - **Inspect** specialist valuation of intangibles and ensure it is reasonable.
   - Review amortization calculations and ensure they are correct by **recalculation**.

12.3.3. Substantive audit procedures for Account Receivables

Receivables are usually audited using a combination of test of details and analytical procedures. The audit of receivable is important as this is likely to be a material area. A combination of analytical procedures and tests of details are used, with sales also being tested in conjunction with trade receivables.

Existence, completeness and valuation are the key assertions relating to the audit of receivables. Receivables are often tested in conjunction with sales. The key assertions for sales are occurrence, completeness and accuracy.

The following are the audit procedures that can be performed during the audit of receivables:

Assertions	Substantive Procedures
Completeness	▪ Agree the balance from individual receivables ledger accounts to receivables' listing and vice versa. ▪ Match the total of the receivables' listing to the sales ledger control account ▪ Cast and cross cast the trial balance before selecting any samples to test ▪ Trace a sample of shipping document to sales invoices and into the sales and receivable ledger ▪ Complete the disclosure checklist to ensure that all the disclosures relevant to receivables have been made ▪ Compare the level of prepayments of the previous year to ensure that the figure is materially correct and complete. ▪ Compare the gross profit percent by product line with the previous year industry data
Accuracy	▪ For a sample of sales invoices, compare the prices and terms to authorized prices list and terms of trade documentation ▪ Test whether discounts have been properly applied by recalculating them ▪ From sample of invoices, check whether tax has been accurately computed
Occurrence	▪ For sample of sales transactions recorded in the ledger , vouch the sales invoice back to customer orders and dispatch documentation
Occurrence and rights and obligations	▪ Determine, through discussions with management whether any receivables have been pledged, assigned or discounted and whether such items require separate disclosure.
Classification and understandability	▪ Review the aged analysis for any credits, non-receivables and long term receivables and consider whether such items require separate disclosure. ▪ Read the disclosure notes relevant to receivables in the financial statement and review for understandability.
Accurate and valuation	▪ Read the disclosure notes to ensure that the information is accurate and properly presented at the appropriate amounts.

Note that part of the substantive audit procedures, the auditor should always endeavour to request for confirmation for all financial position balances (those included in the sample) from third parties ie debtors, creditors and banks.

Part of the audit procedures, the auditor need to request confirmation from the concerned debtors.

a) Receivables confirmation

ISA 505 states that when it is reasonable to expect customers to respond, the auditor should ordinarily plan to obtain direct confirmation of receivables to individual entries in an account balance. Verification of trade receivables by direct confirmation the normal means of providing audit evidence to satisfy the objective of checking whether customers exist and owe bonafide amounts to the company (existence and rights and obligation).

b) Two methods of confirmation

- **Positive**

A positive external confirmation requests the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information.

- **Negative**

Negative confirmation provides less persuasive audit evidence than positive confirmation. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

  - The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
  - The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions or conditions;
  - A very low exception rate is expected; and
  - The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

12.3.4. Cash and bank Balances

a) Bank balances

The following are key procedures the auditor should consider during the audit of bank balances. During the audit of bank balances, the auditor has to test the assertions of completeness, valuation, existence, cut-off and presentation.

The auditor shall perform the following audit procedures:

- **Obtain standard bank confirmations** from each bank with which the client conducted business during the audit period.
- **Reperform arithmetic** of bank reconciliation.
- **Trace cheques shown as outstanding** from the bank reconciliation to the cash book prior to the year end and to the **after-date bank statements** and **obtain explanations** for any **large or unusual items** not cleared at the time of the audit.
- **Compare cash book(s)** and **bank statements** in detail for the last month of the year, and **match items outstanding** at the reconciliation date to bank statements.
- **Review bank reconciliation** previous to the year-end bank reconciliation and test whether **all items** are cleared in the last period or **taken forward** to the year-end bank reconciliation.
- Obtain satisfactory explanations for **all items** in the **cash book** for which there are **no corresponding entries** in the **bank statement** and vice versa by **discussion** with finance staff.
- **Verify contra items** appearing in the cash books or bank statements with original entry.
- Verify by **inspecting** paying-in slips that **unclear banking** is **pa**id in prior to the year end.
- **Examine all lodgments** in respect of which payment has been refused by the bank; ensure that they are cleared on representation or that other appropriate steps have been taken to effect recovery of the amount due.
- Verify balances per the cash book according to the bank reconciliation by **inspecting** cash book, bank statements and general ledger.
- **Verify** the **bank balances** with reply to **standard bank letter** and with the **bank statements**.
- **Inspect** the cash book and bank statements before and after the year end for **exceptional entries** or **transfers** which have a material effect on the balance shown to be in-hand.
- Identify whether any **accounts** are **secured** on the **assets** of the company by **discussion** with management.

- **Consider** whether there is a **legal right** of **set-off** of overdrafts against positive bank balances.
- Determine whether the bank accounts are **subject** to any **restrictions** by **enquiries** with management.
- **Review draft accounts** to ensure that disclosures for bank are complete and accurate and in accordance with accounting standards.

b) Cash balances

Cash balances/floats are often individually immaterial but they may require some audit emphasis because of the opportunities for fraud that could exist where internal control is weak.

The auditor will be very much concerned whether the cash exists, is complete, and belongs to the company (rights and obligations) and is also stated at the correct value.

The following are some of the substantive audit procedures the auditor has to perform:

- Count all cash balances and agree to petty cash book or other record kept.
- Count all cash at same time and ensure all work is done in presence of staff.
- Obtain a certificate of cash in hand from staff member.
- Enquire about IOUs or cheques cashed.
- Confirm balances are in agreement with the accounts.
- In addition, check whether the IOUs and un-cashed cheques have subsequently been cleared timely.

12.3.5. Liabilities

Liabilities are classified into:

- Accounts payables and accruals
- Non-current Liabilities
- Capital and
- Reserve

During the audit of these balances, the auditor should consider the nature and transactions that effect each balance. Below are audit procedures for each of the balances of the above highlighted balances:

a) Audit procedure for accounts payables and accruals

Assertions	Audit procedures
Completeness	▪ Obtain a list of trade accounts payables and **agree** the total to the general ledger by casting and cross-casting. ▪ Test for unrecorded liabilities by **enquiries of management** on how unrecorded liabilities and accruals are identified and examining post year end transactions. ▪ Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. ▪ Examine files of unmatched purchases orders and suppliers' invoices for any **unrecorded liabilities.** ▪ Perform a **confirmation of accounts** payables for a sample. ▪ Complete the **disclosure checklist** to ensure that all the disclosures relevant to liabilities have been made. ▪ **Compare** the current year balances for trade accounts payables and accruals with the previous year. ▪ **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing amounts owed to these suppliers in the previous year. ▪ **Compare** the payables turnover and payables days to the previous year and industry data. ▪ **Reperform casts of payroll records** to confirm completeness and accuracy. ▪ **Confirm** payment of net pay per payroll records to cheque or bank transfer summary. ▪ **Agree** net pay per cashbook to payroll. ▪ **Inspect** payroll for **unusual items** *and* **investigate** them fu*rther* by **discussion** with management. ▪ Perform **proof-in-total (analytical procedures)** on payroll and compare to figure in draft financial statements to assess reasonableness.
Existence	▪ **Vouch** selected amounts from the trade accounts payables listing and accruals listing to supporting documentation, such as purchase orders and suppliers' invoices. ▪ Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. ▪ Perform a **confirmation of accounts payables** for a sample.

	▪ Perform **analytical procedures** comparing current year balances with the previous year to confirm reasonableness, and also calculating payables' turnover and comparing with the previous year.
Rights and obligations	▪ Vouch a sample of balances to supporting documentation, such as purchase orders and suppliers' invoices, to obtain audit evidence regarding rights and obligations.
Accuracy, valuation and allocation	▪ **Trace** selected samples from the trade accounts payables listing and accruals listing to the supporting documentation (purchase orders, minutes authorising expenditure, suppliers' invoices etc). ▪ Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. ▪ For a sample of **accruals, recalculate** the amount of the accrual to ensure the amount accrued is correct. ▪ **Compare** the current year balances for trade accounts payables and accruals with the previous year. ▪ **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing with amounts owed to these suppliers in the previous year. ▪ Compare the payables turnover and payables days with the previous year and industry data. ▪ **Recalculate** the mathematical accuracy of a sample of suppliers' invoices to confirm the amounts are correct. ▪ **Recast** calculation of **remuneration**. ▪ **Reperform** calculation of **statutory deductions** to confirm whether correct. ▪ Confirm validity of **other deductions** by **agreeing** to related supporting documentation. ▪ **Recast** calculation of **other deductions**.
Cut off	▪ For a sample of vouchers, **compare the dates** with the dates they were recorded in the ledger for application of correct cut-off. ▪ **Test transactions** around the year end to determine whether amounts have been recognised in the correct financial period. ▪ **Perform analytical procedures** on purchase returns, comparing the purchase returns as a percentage of sales or cost of sales to the previous year

Occurrence	▪ For a sample of vouchers, **inspect** supporting documentation, such as authorised purchase orders. ▪ **Agree individual remuneration** per payroll to personnel records, records of hours worked, salary agreements etc. ▪ Confirm **existence** of employees on payroll by meeting them, attending wages pay out, inspecting personnel and tax records, and confirmation from managers. ▪ **Agree benefits** on payroll to supporting correspondence.
Classification	▪ **Review** the trade accounts payables listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately. ▪ **Read** the disclosure notes relevant to liabilities in the draft financial statements and review for understandability.
Presentation	▪ Read the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

Note that payables are audited with purchases/expenses. This therefore requires the auditor to adopt some audit procedures for income statements items (classes of transactions and events). In this regard, some of assertions like cut off and occurrence are tested.

- **Substantive audit procedures for provisions**

The auditor should observe the requirements of IAS 37 during the audit of provisions. As per IAS 37 provision, a provision is a liability of uncertain timing and amount. It is therefore of paramount importance for audit to apply appropriate audit procedures while carrying the audit of the provisions. The auditor should endeavour to apply these audit procedures.

- **Obtain details** of all **provisions** which have been included in the **accounts** and all **contingencies** that have been disclosed
- **Obtain** a **detailed analysis** of all **provisions** showing opening balances, movements and closing balances.
- Determine for each material provision whether the company has a present obligation as a result of past events
- Review of correspondence relating to the item
- Discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation?

- **Determine** for each material provision **whether** it is **probable** that a **transfer of economic benefits** will be required to settle the obligation by:
- Checking whether any **payments** have been made in the post year end period in respect of the item by reviewing after-date cash
- **Review of correspondence** with solicitors, banks, customers, insurance company and suppliers both pre and post year end
- **Sending** a **letter** to the **solicitor** to obtain their views (where relevant)
- **Discussing** the **position** of similar **past provisions** with the directors. Were these provisions eventually settled?
- **Considering** the **likelihood** of **reimbursement.**
- **Recalculate** all provisions made.
- **Compare** the **amount provided** with any post year end payments and with any amount paid in the past for similar items.
- In the event that it is not possible to estimate the amount of the provision, check that a **contingent liability** is **disclosed** in the accounts.
- **Consider** the **nature** of **the client's business**. Consider likely provisions not disclosed by the management of a company under audit.
- **Consider** the adequacy of **disclosure** of provisions, contingent assets and contingent liabilities in accordance with IAS 37.

b) Audit procedures for Non-Current Liabilities

Relevant assertions	Substantive audit procedures
Completeness, accuracy , presentation, disclosure , rights and obligation, valuation	▪ **Obtain/**prepare schedule of loans outstanding at the year-end date showing, for each loan: name of lender, date of loan, maturity date, interest date, interest rate, balance at the end of the period and security. ▪ **Compare opening balances** to previous year's papers. ▪ **Test the clerical accuracy** of the analysis. ▪ **Compare balances** to the **general ledger**. ▪ **Agree name** of **lender** to **register of debenture holders** or equivalent (if kept).

	▪ **Trace additions** and **repayments** to **entries** in the **cash book.** ▪ **Confirm repayments** are in accordance with **loan agreement.** ▪ **Examine cancelled cheques** and **memoranda** of **satisfaction** for **loans repaid**. ▪ **Verify** that **borrowing limits** imposed by agreements are **not exceeded**. ▪ **Examine signed board minutes** relating to **new borrowings/repayments.** ▪ **Obtain direct confirmation** from **lenders** of the amounts outstanding, accrued interest and what security they hold. ▪ **Verify that interest charged** for the period is in accordance with statements and supporting agreements, and consistent with known interest rates. Consider the adequacy of accrued interest. ▪ **Confirm assets charged** have been **entered** in the **register of charges** and **notified** to the **Registrar**. ▪ **Review restrictive covenants** and provisions relating to default: – **Review** any correspondence relating to the loan – **Review confirmation** replies for non-compliance – If a **default appears** to exist, determine its **effect**, and schedule findings ▪ **Review minutes and cash book** to confirm that all loans have been recorded. ▪ **Review draft accounts** to ensure that **disclosures** for non-current liabilities are correct and in accordance with accounting standards. Any elements repayable within one year should be classified under current liabilities.

c) Substantive audit procedures for capital and related issues

The auditor should review transactions and events could have affected the equity. This helps the auditor in collecting sufficient and appropriate audit evidences. Thus, come up with the appropriate audit conclusion. The following are some of audit procedures auditors perform during the review of capital balance disclosed in the financial statements of a company.

- **Share capital**
  - **Agree** the **authorised share capital** with the statutory documents governing the company's constitution.
  - **Agree changes** to **authorised share capital** with **properly authorised resolutions.**
- **Issue of shares**
  - **Verify any issue** of share capital or other changes during the year with general and **board minutes.**
  - **Ensure issue** or **change** is within the **terms** of the **constitution**, and directors possess appropriate **authority** to issue shares.
  - **Confirm** that **cash** or **other consideration** has been **received or receivable(s) is included** as called-up share capital not paid.
- **Transfer of shares**
  - **Verify transfers of shares** by reference to:
    - Correspondence
    - Completed and stamped transfer forms
    - Cancelled share certificates
    - Minutes of directors' meeting
  - **Review the balances** on **shareholders' accounts** in the register of members and the total list with the amount of issued share capital in the general ledger.
  - **Agree dividends** paid and declared pre year end to **authority** in minute books and **reperform calculation** with **total share capital** issued to ascertain whether there are any outstanding or unclaimed dividends.
  - **Agree dividends payment** to **documentary evidence** (say, the returned dividends warrants).
  - Test that **dividends do not contravene** distribution of provisions by reviewing the legislation.

- **Reserves**
  - Agree **movements on reserves** to supporting authority.
  - **Ensure that movements on reserves do not contravene** the **legislation** and the **company's constitution** by reviewing the legislation.
  - **Confirm** that the **company** can **distinguish distributable** reserves from those that are **non-distributable**.
  - **Ensure** that **appropriate disclosures** of movements on reserves are made in the company's accounts by **inspection** of the financial statements.

12.3.6. Substantive audit procedures for expenses

During the audit of expenses, the auditor should focus on potential risks. The following are key potential risks:

- Occurrence- recorded transactions may have not occurred /not valid
- Completeness- not all transactions are recorded
- Accuracy- some transactions are inaccurate
- Cut- off- some transactions are recorded in wrong accounting period

The following are some of audit procedures for expenses;

- For transactions sample, obtain their relevant supporting documents such as invoice, goods received note and payment advice note
- Review the supporting documents and check whether the transactions occurred and relate to the entity
- Check whether all expenses were recorded in the books of accounts at the correct amounts by agreeing the recorded amounts with their relevant supporting documents such as invoices, good delivered note and good received note and invoice register, verify the accuracy of the amounts shown on the invoices by reconciling the invoices with good received note and payment advice.
- Ensure that the transactions were recorded in the correct accounts following the entity's chart of accounts by agreeing the entries passed with the entity's chart of accounts
- Confirm whether the expenses relate to the correct period(accounting period) by comparing when services have been consumed/benefited(in accrual basis of accounting) and the period of accounting for the expenses.

12.3.7. Substantive procedures for revenue

During the audit of revenue both test of controls and substantive audit procedures are applied. The following are some of substantive audit procedures that should be executed by the auditor during the audit of revenue:

- Compare the total revenue with that reported in previous years and the revenue budgeted, and investigate any significant fluctuations.
- For a sample of customer orders, trace the details to the related despatch notes and sales invoices and ensure there is a sale recorded in respect of each (to test the completeness of revenue).

For a sample of sales invoices for larger customers, recalculate the discounts allowed to ensure that these are accurate.

- Select a sample of despatch notes in the month immediately before and month immediately after the year end. Trace these through the related sales invoices and resultant accounting entries to ensure each sale was recorded in the appropriate period.
- Obtain an analysis of sales by major categories of toys manufactured and compare this to the prior year breakdown and discuss any unusual movements with management.
- Calculate the gross profit margin for the year and compare this to the previous year and expectations. Investigate any significant fluctuations.
- Recalculate the sales tax for a sample of invoices and ensure that the sales tax has been correctly applied to the sales invoice.
- Select a sample of credit notes issued after the year end and trace these through to the related sales invoices to ensure sales returns were recorded in the proper period.

Note that the audit of revenue should always linked with audit of receivables.

Application activity 12.3

You are the Senior auditor at MK CPA Ltd and you are requested to perform the audit of the following balances disclosed in the financial statements of MT Ltd for year ended 30 October 2022.

a) Stock of FRW 10,000,000
b) PPE of FRW 50,000,000
c) Receivables FRW 50,000,000
d) Revenue FRW 100,000,000

Identify four substantive audit procedures you would perform during the audit of the above balances.

Skills lab activity 12

With the guidance of the teacher, the learners should be shared the school financial statements and underlying records (accounting information).

- Students will use financial information and carry out analytical review of different informations presented in financial statement where deemed necessary. They will be asked to carry out the comparison of the current financial information with the previous year and asses the relationships of the identified differences , and be helped to assess the explanations
- Students will use financial information and evaluate the reliability of the data from which the expectation has been developed
- Students will be helped on how to establish substantive audit tests on each balance, class of transactions and disclosure included in the financial statement
- Students will be helped on how to obtain audit evidences during performance of the substantive audit tests on individual transactions, balances and disclosures

End unit 12 assessment

1. What is the purpose of substantive audit procedures?
2. Differentiate substantive audit procedures from analytical procedures
3. What are the different methods of collecting audit evidences?
4. What is the main purpose of audit evidences?
5. What are the key audit procedures you would perform on the following financial statements balances
   a) Cash and bank balances
   b) Liabilities
   c) Property plant and equipment
   d) Revenue
   e) Expenses

UNIT 13 AUDIT JUDGEMENT

Key unit competence: To be able to form an audit judgement

Introductory activity

Auditors are required to plan and conduct the audit in conformity withInternational Standards on Auditing. The standards require an auditor to plan and conduct the audit accordingly and provide the appropriate audit opinion on the audited financial statements.

The auditors may issue unqualified or qualified opinion. In the process of deciding on the appropriate audit opinion, there are cases where an auditor is obliged to make judgements. Making the appropriate judgements depends on the auditor's experience and skills. This calls for an auditor to perform the audit of financial statements and make proper judgments with view of forming an audit opinion.

1. In what circumstances do you think the auditor can make judgements?

13.1. Form of audit judgement

Learning activity 13.1

Look at the image above and answer the following questions:

1. What do you see on the above image?
2. When and why an auditor needs to make judgement.

13.1.1. Overall review of financial statement

a. The meaning of audit judgement

Audit judgement can be defined as any decision or evaluation made by an auditor, which influences or governs the process and outcome of an audit of financial statements.

b. Financial statements and related disclosures refer to a company's financial statements and notes to the financial statements as presented in accordance with Generally Accepted Accounting Principles (GAAP)

c. Review of financial statements

Auditors must perform and document an overall review of the financial statements before reaching an opinion. This review should include a **review of accounting policies** and a **review for consistency and reasonableness.**

The auditors will have a draft set of financial statements which should be supported by appropriate and sufficient audit evidence when the bulk of the substantive procedures have been carried out. At the beginning of the end of the audit process, it is usual for the auditors to undertake an overall review of the financial statement.

Compliance with accounting regulations/policies

The auditors should consider whether:

- The information presented in the financial statements is in accordance with local/national statutory requirements
- The accounting policies employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity.

When examining the accounting policies, auditors should consider:

- Policies commonly adopted in particular industries
- Policies for which there is substantial authoritative support
- Whether any departures from applicable accounting standards are necessary for the financial statements to give a true and faire view
- Whether the financial statements reflect the substance of the underlying transactions and not merely their form.

Review for consistency and reasonableness

- The auditors should consider whether the financial statements are consistent with their knowledge of the entity's business and with the results of other audit procedures, and the manner of disclosure is fair. The principal considerations are as follows: whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit.
- Whether it reveals any new factors which may affect the presentation of, or disclosure in, the financial statements.
- Whether analytical procedures applied when completing the audit, such as comparing the information in the financial statements with other pertinent data, produce results which assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the knowledge of the entity's business.
- Whether the presentation adopted in the financial statements may have been unduly influenced by the director's desire to present matters in a favourable or unfavourable light.
- The potential impact on the financial statements of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any.

Analytical procedures

Analytical review procedures are used as part of the overall review procedures at the end of an audit, but key factors which should be reviewed include: important accounting ratios, variances and variations caused by industry or economic factors.

The auditors would also discuss business matters with the directors, such as changes in the **sales mix, price rises, wages increases,** and see if the **directors' comments** about such matters made sense of the figures in the financial statements.

For example: if a director said that everyone had received a pay increase of 3%, this would make sense of small rise in wages cost although no new staff had been hired. The auditors would verify this explanation by looking to see if the payroll reflects this 3% rise.

The auditors also assess if there are any areas in the financial statements which are significantly different from the previous financial statements and obtain explanations from these. At this stage, the auditor is concerned whether the financial statements are internally consistent, so predictable relationships in particular will be important.

ISA 700 states that forming an opinion as to whether the financial statements give a true and fair view involves evaluating the fair presentation of the financial statements.

The auditor must consider:

- Whether the financial statements (after any adjustments as a result of the audit process) are consistent with the auditor's understanding of the entity and its environment
- The overall presentation, structure and content of the financial statements
- Whether the financial statements, including disclosures in the notes, faithfully represent the underlying transactions and events.

Analytical procedures performed at or near the end of the audit help corroborate conclusions formed during the audit and assist in arriving at the overall conclusions regarding fair presentations.

13.1.2. Events after the end of the period

The auditors should consider the effect of subsequent events on the financial statements, up to the date the financial statements are signed

a) Subsequent events

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. (ISA 560).

Subsequent events include:

- Events occurring between the end of the reporting period and the date of the auditor's report
- Facts discovered after the date of the auditor's report

b) Events after the reporting period

Events after the reporting period deal with the treatment in financial statements of events, both favourable and unfavourable, occurring after the period-end.

There are two types of events:

Adjusting events: are those that provide further evidence of conditions that existed at the end of reporting period

Non-adjusting events: are those that are indicative of conditions that arose after the end of the report period.

Events occurring up to the date of the auditor's report ISA 560.6

The auditor shall perform procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

These procedures should be applied to any matters examined during the audit which may be susceptible to change after the period end. They are in addition to tests on specific transactions after the date of the financial statements, e.g. cut-off tests.

Depending on the auditor's risk assessment, procedures may involve the review or testing of accounting records or transactions occurring between the date of the financial statements and the auditor's report.

The ISA lists procedures to identify subsequent events which may require adjustments or disclosures. They should be performed as near as possible to the date of the auditor's report. (ISA 560.7)

Procedures testing subsequent events	
Enquiries of management (ISA 560)	▪ Status of items involving subjective judgement/ accounted for using preliminary data ▪ New commitments, borrowings or guarantees ▪ Sales or acquisition or destruction of assets ▪ Issues of shares/debentures or changes in business structure ▪ Developments involving risk areas, provisions and contingencies ▪ Unusual accounting adjustments ▪ Major events (e.g. going concern problem) affecting appropriateness of accounting policies for estimates
Other procedures	▪ Obtain an understanding of any procedures management has established to ensure that subsequent events are identified ▪ Consider procedures of management for identifying subsequent events ▪ Read minutes of general board/committee meetings ▪ Review latest accounting records and financial information.

Reviews and updates of these procedures may be required, depending on the length of the time between the procedures and the signing of the auditor's report and the susceptibility of the items to change over time.

ISA 560.8

If the auditor identifies events that require adjustment of, or disclosure in, the financial statements the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

The ISA also requires the auditor to obtain written representations confirming that all subsequent events have been adjusted or disclosed.

ISA 560.9

The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosure.

13.1.3. Going concern

The auditor should communicate to the audit committee, when applicable, the following matters relating to the auditor's evaluation of the company's ability to continue as a going concern:

- If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt.
- If the auditor concludes, after consideration of management plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events.
- If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:
    - The effects, if any, on the financial statements and the adequacy of the related disclosure; and
    - The effects on the auditor's report.

Factors considered when management make an assessment on going

- The **degree of uncertainty** about the events or conditions being assessed increases significantly the further into the future the assessment is made.
- Judgements are made on the basis of the **information available** at the time.
- Judgements are affected by the **size** and **complicity** of the entity, the **nature** and **condition** of the business and the **degree** to which it is **affected** by **external factors**.

The examples of possible indicators of going concern problems are as follows:

Financial indications

- Net liabilities or net current liability position where the company has more liabilities than assets
- The company needs borrowing facilities which have not been agreed
- Relying too heavily on short-term borrowing
- Major debt repayment falling due where the company will need to borrow again if it can
- Major restructuring of debt – this may indicate difficulties in repaying the debt which in turn may indicate going concern issues.
- Indications that creditors want to call in loans
- Negative operating cash flows in budgets or financial statements
- Major losses or cash flow problems which have arisen since the reporting date
- The company stopped paying dividends or falling behind in paying them
- Inability to pay suppliers' invoices (payables) on due dates
- Inability to comply with terms of loan agreements
- Reduction in normal terms of trade credit by suppliers
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments
- Substantial sales of non-current assets not intended to be replaced

Operating indications

- Loss of key management without replacement
- Loss of key staff without replacement
- Loss of a major market, franchises, licence, or principal supplier

- Labour difficulties or shortages of important supplies as this would prevent the company from carrying out its business and eventually its ability to remain in business
- Fundamental changes in market or technology
- Excessive dependence on a few product lines where the market is depressed
- Technical developments which render a key product obsolete

Other indications

- Non-compliance with capital or other statutory requirements
- Pending legal proceedings against the entity that may, if successful, result in judgements that could not be met
- Changes in legislation or government policy
- Issues which involve a range of possible outcomes so wide that an unfavourable result could affect the appropriateness of the going concern basis

The significance of such indications can often be mitigated/reduced by other factors.

- The effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital.
- The loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

13.1.4. Written representations

a) The meaning of key concepts

- **Written representation**

Written representations are written statements by management, provided to the auditor, to confirm certain matters or to support other audit evidence.

- **Management**

Management can be defined as the person (s) with executive responsibility for the conduct of the entity's operations.

b) Acknowledgement by Management of their responsibilities

The auditor shall request management to provide a written representation that:

- It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement; and

- All transactions have been recorded and are reflected in the financial statements.

Audit evidence obtained during the audit that management has fulfilled the responsibilities is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

c) Representations by management as audit evidence

The auditor should obtain written representations from management on matters material to the financial statements when other audit evidence cannot reasonably be expected to exist. It may be necessary to inform management of the auditor's understanding of materiality.

The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing.

The auditor should obtain written representations from management that:

- It acknowledges its responsibility for the design and implementation of internal control to prevent and detect error; and
- It believes the effects of those uncorrected financial misstatements aggregated by the auditor during the audit are immaterial to the financial statements taken as a whole.

During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements, the auditor will need to:

- Seek corroborative audit evidence from sources inside or outside the entity,
- Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained and
- Consider whether the individuals making the representations can be expected to be well informed on the particular matters.

Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has a material effect on the financial statements and such audit evidence is expected to be available, this will constitute a limitation in the scope of the audit, even if a representation has been received on the matter.

In certain instances, audit evidence other than that obtained by performing inquiry may not be reasonably expected to be available; therefore the auditor obtains a written representation by management.

If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

ISA 580 lists a number of other ISAs which require specific written representations. These include the following:

- The effect of uncorrected misstatements is immaterial, both individual and in aggregate
- All known actual possible litigation and claims have been disclosed
- Whether assumption used in making accounting estimates are reasonable
- All subsequent events requiring adjustment or disclosure have been adjusted for or disclosed
- Future actions and feasibility of plans relating to going concern issues.

Documentation of written Representations by Management

The auditor would ordinarily include, in audit working papers, evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.

A written representation is ordinarily more reliable audit evidence than an oral representation and can take the form of:

- A representation letter from management,
- A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management,
- Relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.

Basic elements of a representation letter

A representation letter should:

- Be addressed to the auditors
- Contain specified information

- Be appropriately dated and signed by the management. It would ordinarily be dated the same date as the auditor's report.

Actions if management refuse to provide representations

If management does not provide one or more of the requested written representations the auditor shall:

- Discuss the matters with management;
- Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations and audit evidence in general; and
- Take appropriate actions, including determining the possible effect on the opinion in the auditor's report;

In these circumstances, the auditors should consider whether it is appropriate to rely on other representations made by management during the audit.

13.1.5. Completion

a) Summarising uncorrected misstatements

Misstatement is a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework, and can arise either from error or fraud. (IFAC, 2016)

The auditor should consider the cumulative effect of uncorrected misstatements.

The summary of uncorrected misstatements will not only list misstatements from the current year, but also those in the previous year(s). This will allow uncorrected misstatements to be highlighted which are reversals of uncorrected misstatements in the previous year, such as in the valuation of closing/opening inventory. Cumulative uncorrected misstatements may also be shown, which have increased from year to year. It is normal to show both the statement of financial position and the statement of profit or loss and other comprehensive income effect, as in the example given here.

b) Evaluating the effect of misstatements

Misstatements, including omissions are considered to be material if they, individual or in the aggregate, could reasonably be expected to influence the decisions of users taken on the basis of the financial statements.

The concept materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

The aggregate of uncorrected misstatements comprises:

- **Specific misstatements** identified by the auditors, including the net effect of uncorrected identified during the audit of the previous period if they affect the current period's financial statements;
- Their **best estimate of other misstatements** which cannot be quantified specifically (ie .projected errors).

If the auditors consider that the aggregate of misstatements may be material, they must consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements (which management may wish to do anyway).

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.

If the aggregate of the uncorrected misstatements that the auditors have identified approaches the materiality level, the auditors should consider whether it is likely that undetected misstatements, when taken with aggregated uncorrected misstatements, could exceed the materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditors should consider reducing the risk by:

- Performing additional audit procedures;
- Requesting management to adjust the financial statements for identified misstatements.

The schedule will be used by the audit manager and partner to decide whether the client should be requested to make adjustments to the financial statements to correct the errors.

c) Completion checklists

Audit firms frequently use checklists (which must be signed off) to ensure that all final procedures have been carried out, all material amounts are supported by sufficient appropriate evidence, and so forth.

For example, extracts from an audit checklist might contain the following points:

	Y	N	N/A	Comments
Sample planning and recording				
Are sample sizes based on risk, materiality and population?				
Is sample selection explained?				
Are samples representative of transaction types on the period under review?				
Misstatement and errors				
Has the effect of projected errors been assessed on the population as a whole?				
Were additional procedures undertaken where errors were found?				
Were misstatements assessed for implications of fraud?				
Has the aggregate of uncorrected misstatements been identified?				
Has the summary been assessed and considered in relation to the audit opinion?				
Has the treatment of significant, uncorrected misstatements been discussed with management?				
	Y	N	N/A	Comments
Audit assertions				

Have audit assertions about transactions and events and related disclosures for the period under review been considered and satisfied for: ▪ Occurrence ▪ Completeness ▪ Accuracy ▪ Cut-off ▪ Classification ▪ Presentation				
Have audit assertions about account balances and related disclosures at the period end been considered and satisfied for: ▪ Existence ▪ Rights and obligations ▪ Completeness ▪ Accuracy valuation and allocation ▪ Classification ▪ Presentation				
Have all material balances and transactions been subject to appropriate audit work and adequate audit evidence obtained?				
Specific audit procedures				
Have analytical review procedures been adopted and fully recorded?				
Have accounting policies been reviewed?				
Have external confirmations been received as appropriate?				
Evidence of going concern assessment by management and review by auditor?				
Have subsequent events been reviewed and documented as appropriate				
Have written representations been received from management as appropriate?				

Application activity 13.1

Questions

1. What are the principal considerations in a review of the financial statements for consistency and reasonableness?
2. In certain instances, audit evidences other than that obtained by performing inquiry may not be reasonably expected to be available. Therefore the auditor obtains a written representation from management.

   Identify the actions that be taken by the auditor if the management refuse to provide the representation.

Skills lab activity 13

In their learning team, with guidance of a teacher, students will formulate audit judgement.

End unit 13 assessment

1. Identify the main purposes of a representation letter and how far can auditors rely on the audit evidence it provides?
2. What matters should auditors consider when examining accounting policies?
3. What are the two types of subsequent events?
4. What are the consequences regarding the realisation of assets and liabilities if the going concern basis of accounting is not appropriate?
5. Which of the following statements concerning written representations is true?
   a. Written representations are appropriate evidence when evidence the auditors expected to be available is unavailable.
   b. If written representations given do not agree with other evidence, auditors should not trust any other representations made by management during the course of the audit.
   c. The representation letter must not be dated after the auditor's report.
   d. The representation letter must contain a list of all material adjustments to the final financial statements.

UNIT 14 | AUDIT REPORT

Key unit competence: To be able to prepare an appropriate report

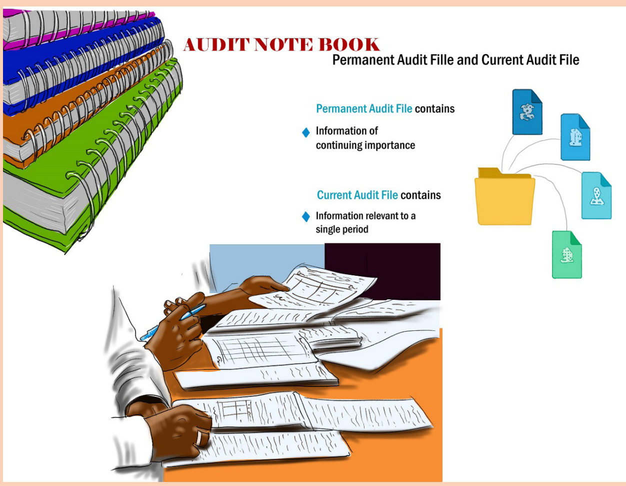
Introductory activity

In modern world, organizations are required to report concerning the general performance to their stakeholders on regular basis. In this regard, different reports such as audit reports, activity reports, and financial reports are being prepared and submitted timely to concerned stakeholders. Some of those reports are statutory and some are not. Those reports are therefore used by different stakeholders to make informed decisions.

Question: How do you call the document prepared by the auditor at the end of audit process which contains his conclusion, opinion and recommendations?

14.1. Auditor's report

Learning activity 14.1



After observing pictures above, identify the documents related to the audit work?

14.1.1. Meaning of audit report

An audit report is a document that expresses an auditor's opinion on a company's financial performance and compliance with Generally Accepted Accounting Principles (GAAP).An audit report is a written opinion of an auditor regarding an entity's financial statements.

An audit report is a document from the auditor of a company that is the end result of the audit process. It states the auditor's opinion on whether the company's financial statements are in compliance with the Generally Accepted Accounting Principles (GAAP) and if they are free from material misstatement.

The audit report is the end-product of the external audit process. It is the document in which the auditor expresses his/her professional judgment on whether the financial statements present a 'true and fair view'.

Is a document prepared by an auditor at the end of auditing process that consolidates all of his/her findings and observations about a company's financial statements.

14.1.2. Basic elements of an audit report

No	Sections/ elements	Descriptions
1	Title	Independent Auditor's Report. The title of the audit report should be simple and includes the word "independent".
2	Address	The report should clearly state to whom it is addressed. It is addressed to the shareholders or board of directors of a company.
3	Introduction/ Scope	This would be a statement that states the name of the company that is being audited, the dates of the financial period that the audit covers, which is usually the fiscal year.
4	Responsibilities of directors and auditors	This section clearly states the responsibilities of the directors of the company being audited, and the responsibilities of the auditor. It states that the management and directors of the company accept the duty of providing the auditor with all the financial documentation required for the audit. It also states that the documentation provided is true and accurate to the best of the director's knowledge. It is stated that the auditor's role is to audit the financial statements given by the company. It also states that the auditor must form his opinion based on the information provided.

5	References/ Basis of opinoin	The section states that the audit was conducted in compliance with the standards and describes the audit process and resources. This section may be longer than the rest.
6	Opinion	This section clearly states the auditor's opinion. The auditor's opinion is given in the report regarding the financial statements and the words" the accounts show a true and fair view" are normally used.
7	Other reporting responsibility	If there are any other reporting responsibilities such as legal or regulatory requirements they are mentioned here.
8	Auditor's Address:	The auditor gives his/her address
9	Date and place of the report	The date and city where the report was signed by the auditor.
10	Signature of the auditor	Signed by the auditor

a) Example of audit report

An example of an unmodified audit report is set out below.

INDEPENDENT AUDITOR'S REPORT

(Appropriate addressee)

Report on the financial statements

We have audited the accompanying financial statements of BATAMU Ltd Company, which comprise the statement of financial position as at 31 December 2021, and the statement of comprehensive income, statement of changes in equity, and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view (or present fairly, in all material respects,) of the financial position of BATAMU Ltd Company as at 31 December 2021, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

(Auditor's signature)

(Date of the report)

(Auditor's address)

b) Qualities of a good audit report

Qualities of a good audit report are:

- It should not be biased to any party with financial stake in the business.
- It should be forceful.
- It should be based on constructive criticism/ideas.

- It should offer constructive and timely suggestions to the management so as to solve problems highlighted in the report.
- It should be clear and concise.

c) Importance of audit report

For the audited company

- Helps to reveal a true and fair view of the company's financial statements
- Reveals errors and frauds committed or inherent in the company's books of accounts
- Traces the strength and weaknesses of the internal control system
- Shows if the internal auditing function is working properly
- Helps to ensure if the company fulfils legal requirements

For the shareholders or associates

- Helps them to ensure if their shares are earning interest by the company and if it is profitable to continue to invest in the company
- Helps to know if the statutory requirements are being implemented by the company

For the tax authorities

- The audit report ensures to the government if the taxes due by the company are properly given by the company
- Ensures if other legal requirements like social security contributions are being implemented
- Ensures that the company respects accounting principles, company's Act and other regulations in application
- Ensures if the public funds are being used properly by government institutions and other private institutions

For the thirds parties

- For employees audit report helps them to ensure the continuity of the company's activities so as to ensure their job security and continuity of employment
- For the customers they are proud of their relationships with their supplier (audited company) if good management and fair and true image are revealed by the audit report
- For suppliers, they ensure their market with the audited company if true and fair view is revealed by the auditor's report
- For banks and financial institutions, they ensure refund of their loans granted to the audited company

14.1.3. The auditor's report on financial statements

The auditor is required to produce an audit report at the end of the audit which sets out his/her opinion on the truth and fairness of the financial statements. The report contains a number of consistent elements so that users know the audit has been conducted according to recognized standards

The audit report refers to financial statements and you need to know what these are. They consist of the following:

- The statement of financial position (or balance sheet).sss
- The statement of profit or loss (Income statement)
- The statement of changes in equity.
- The cash flow statement.
- The notes to the account

ISA 700 Forming an opinion and reporting on financial statements establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. It states that the auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form the opinion, the auditor needs to conclude as to whether reasonable assurance has been obtained that the financial statements are free from material misstatement. The auditor's conclusion need to consider the following.

- Whether sufficient appropriate audit evidence has been obtained (ISA 330)
- Whether uncorrected misstatements are material (ISA 450)
- Whether the financial statements adequately disclose the significant accounting policies selected and applied
- Whether the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate
- Whether accounting estimates made by management are reasonable
- Whether the information in the financial statements is relevant, reliable, comparable and understandable
- Whether the financial statements provide adequate disclosures to allow users to understand the effect of material transactions and events on the information presented in the financial statements
- Whether the terminology used in the financial statements is appropriate

- The overall presentation, structure and content of the financial statements
- Whether the financial statements represent the underlying transactions and events so as to achieve fair presentation
- Whether the financial statements adequately refer to or describe the applicable financial reporting framework

Application activity 14.1

1. John is a member of ABX ltd Company. Help him to understand the importance of audit report.
2. What are the qualities of a good audit report?

14.2. Unmodified auditor's report and Modified opinions

Learning activity 14.2

Read the words on the picture above and give it opposite

Now we are going to look at the types of audit report that exist. First and simplest is the unmodified audit report.

14.2.1. Unmodified audit's report

Definition of unmodified audit report

An unmodified audit report is an audit report containing an audit opinion not modified in any way – either by changing the unmodified opinion or by adding an extra paragraph such as an 'emphasis of matter' or 'other matters' paragraph after the opinion paragraph.

An unmodified opinion is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the auditor concludes that the financial statements as a whole are not free from material misstatement or cannot obtain sufficient appropriate audit evidence to make this conclusion, the auditor must modify the opinion in accordance with ISA 705 Modifications to the opinion in the independent auditor's report.

We discuss modifications to the opinion in the following sub heading

14.2.2. Modified opinions

A modified opinion is required when:

The auditor concludes that the financial statements as a whole are not free from material misstatements or the auditor cannot obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Types of modifications

There are three types of modified opinions:

a. A qualified opinion
b. An adverse opinion
c. A disclaimer of opinion

Qualified opinion

A qualified opinion must be expressed in the auditor's report in the following two situations:

1. The auditor concludes that misstatements are material, but not pervasive to the financial statements.

   Material misstatements could arise in respect of:
   - The appropriateness of selected accounting policies
   - The application of selected accounting policies
   - The appropriateness or adequacy of disclosures in the financial statements

2. The auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion but concludes that the possible effects of undetected misstatements, if any, could be material but not pervasive.

The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit and could arise from:

- Circumstances beyond the entity's control (e.g. accounting records destroyed)
- Circumstances relating to the nature or timing of the auditor's work (e.g. the timing of the auditor's appointment prevents the observation of the physical inventory count)
- Limitations imposed by management (e.g. management prevents the auditor from requesting external confirmation of specific account balances)

Adverse opinion

An adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both material and pervasive to the financial statements.

Disclaimers of opinion

An opinion must be disclaimed when the auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion and concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Summary of modifications and impact on the auditor's report

The following table summarizes the different types of modified opinions that can arise:

Nature of circumstances	Material but not pervasive	Material and pervasive
Financial statements are materially misstated	qualified opinion	adverse opinion
Auditor unable to obtain sufficient appropriate audit evidence	qualified opinion	disclaimer of opinion

14.2.3. Emphasis of matter and other matter paragraphs in the auditor's report

a) Emphasis of matter paragraphs

An emphasis of matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of matter paragraphs are used to draw readers' attention to a matter already presented or disclosed in the financial statements that the auditor feels is fundamental to their understanding, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated.

b) Other matter paragraphs

Other matter paragraphs are used where the auditor considers it necessary to draw readers' attention to a matter that is relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report.

The other matter paragraph must be included immediately after the opinion paragraph and any emphasis of matter paragraph, or elsewhere in the auditor's report if the content of it is relevant to the other reporting responsibilities section.

The content of the other matter paragraph must reflect clearly that the other matter is not required to be presented and disclosed in the financial statements, and does not include information that the auditor is prohibited from providing by law and regulations or other standards, or information that is required to be provided by management.

Application activity 14.2

1. Explain unmodified auditor's report.
2. Identify three (3) types of modified auditor's opinions.

Skills lab activity 14

In learning group, teacher presents to their students an unmodified audit report in which some elements are missing, ask them to discuss about it. Through discussions, the students must discover the missing elements and rewrite the appropriate report.

End unit 14 assessment

1. What is the importance of audit report to audited company?
2. Explain two main types of audit report.
3. Explain the basic elements of an audit report
4. Define the term audit report
5. Explain emphasis of matter paragraphs.
6. Outline the qualities of a good audit report.
7. What are the auditable finanancial statements

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