The Auditor and Other Services

The auditor can from time to time provide other services other the auditing. These services may include:

- Writing up the books of account
- Balancing books of accounting
- Setting up accounting systems
- Computerizing manual accounting systems
- Financial advise
- Mergers and take – over accounting
- Merger and take – over advice
- Liquidation and receivership work and advice

Qualities of an Auditor

There are three qualities necessary for an independent auditor. These are:

i. Competence
ii. Independence and
iii. Integrity

These qualities are explained here below.

Competence

Any person who intends to practice as an audit must be thoroughly trained and must prove his/her competence. In Kenya only members of ICPAK are allowed by law to practice as auditors. Members of foreign accounting bodies are also allowed to practice as auditors. For one to practice as auditor, one required to a member of a recognized accounting body besides being under a registered accountant for at least two years.

Independence

An independent auditor is who cannot give biased opinion. Total independence is likely not to be achieved but independence is important.Independence is the freedom from conditions that threaten the ability of the audit activity to carry out audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

Integrity

A person of high integrity is a person who is honest, discrete and tactful.

Advantages and Disadvantages of Auditing

Advantages of an Audit

i. Provides assurance and credibility to the accounts for the benefit of potential investors.
ii. Used for detection of errors and frauds which could lead to the failure of an organization.
iii. Audited accounts are used by the organization to raise finance from both public and other sources as they boost an organization's credit rating.
iv. An audit is used to boost the morale of accounting staff who will keep the accounts to date and act as source of management information upon which decisions can e made.
v. It is used by partnerships as a basis of sharing profits and therefore minimizing disputes between partners.
vi. They are used by income tax authorities to ascertain the tax liability and avoid any possible dispute between the company and income tax department.
vii. The audited accounts are used to admit partners in a partnership business in that these accounts will indicate not only the net assets but also the capital the new partner has to contribute.
viii. Audited accounts are useful in case of a sale of business, a merger, an acquisition or takeover of a business as it indicates the fair value of assets to be acquired.
ix. They are used by insurance companies to settle insurance claims arising out of losses that may be insured in which case the client cannot have conflicting situations which the insurers would object.

Disqualifications for Appointment as Auditor

Section 161 of Companies Act Cap 486 states:

(1)A person or firm shall not be qualified for appointment as auditor of a company unless he, or in the case of a firm, every partner in the firm is the holder of a practising certificate issued pursuant to section 21 of the Accountants Act, 2008.

(2) (a) None of the following persons shall be qualified for appointment as auditor of a company–

(i) an officer or servant of the company;

(ii) a person who is a partner of or in the employment of an officer or servant of the company;

(iii) a body corporate:

Provided that subparagraph (ii) shall not apply in the case of a private company.

(b) References in this subsection to an officer or servant shall be construed as not including references to an auditor.

(3) A person shall also not be qualified for appointment as auditor of a company if he is, by virtue of subsection (2), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(4) If any person who is not qualified so to act is appointed as auditor of a company such person and the company and every officer in default shall each be liable to a fine not exceeding four thousand shillings.

In conclusion Section 161 of Companies Act Cap 486 clearly states the following:

i. Any person or person who does not hold a practising certificate disqualified as an auditor
ii. An officer of the company cannot be appointed as an auditor
iii. A person who is a partner of an officer of the company cannot be appointed as an auditor
iv. A relative of an officer of the company cannot be appointed as an auditor
v. If a person who cannot be appointed as an auditor is appointed in default then the appointing authority is liable to a fine of not exceeding five thousands shillings

Right of Access to Books and Attend Meeting

Section 162 stipulates that:

(1) The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the Seventh Schedule.

purpose to postpone the submission of the relevant accounts to a general meeting from one calendar year to the next, the registrar may on the application or with the consent of the directors of the company whose financial year is to be extended direct that, in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return shall not be required in the earlier of the said calendar years.

Accounts and auditors' Report to be Annexed to Balance Sheet

Section 156 of the Companies Act Cap 486 states that:

(1) The profit and loss account, and, so far as not incorporated in the balance sheet or profit and loss account, any group accounts laid before the company in general meeting, shall be annexed to the balance sheet, and the auditors' report shall be attached thereto.

(2) Any accounts so annexed shall be approved by the board of directors before the balance sheet is signed on their behalf.

(3) If any copy of a balance sheet is issued, circulated or published without having annexed thereto a copy of the profit and loss account or any group accounts required by this section to be so annexed, or without having attached thereto a copy of the auditors' report, the company and every officer of the company who is in default shall be liable to a fine not exceeding one thousand shillings.

Directors' report to be attached to balance sheet

Section 157 of the Companies Act states that:

(1) There shall be attached to every balance sheet laid before a company in general meeting a report by the directors with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend, and the amount, if any, which they propose to carry to reserves within the meaning of the Sixth Schedule.

(2) The said report shall deal, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries, with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the classes of business in which the company has an interest, whether as member of another company or otherwise.

Review Questions

Question One

a. What must appear in the books of accounts
b. List down the statutory books
c. Who is responsible for the maintaining of books of accounts?
d. What is the auditor's interest in these books

Question Two

An auditor is required by the Companies' Act Cap 486 to carry out such investigation as will enable him to form an opinion as to whether proper accounting records have been kept by a company .you are required to list down the requirements laid down in the Companies Act Cap 486 in respect of the accounting records

Question Three

The Companies' Act Cap 486 lays down certain requirements in relation to the accounting records which every company shall keep. You are required to state the records that must maintained and state the information to contained in these records accounting records and the preparation of financial statements. Preferably this should be done in a separate letter but such services may form the subject to a section in the audit engagement letter.

In the case of the provision of taxation services, the responsibilities for the various procedures such as preparation of tax computations and submission of return to the relevant authorities should be clearly set out, either in a section of the main letter or in a separate letter.

Where accounting, taxation or other services are undertaken on behalf of an audit client, information may be provided to members of the audit firm other than those engaged on the audit. If this is case, it may appropriate for the audit engagement letter to indicate that the auditor is not to be treated as having notice, for the purpose of his audit responsibilities,of the information given to such people.

5. Fees

Mention should normally be made of fees and of the basis on which they are computed, rendered and paid.

6. Agreement of Terms

The engagement letter should include a request to management that they confirm in writing the agreement to terms of the engagement. It should be clearly understood that, when agreed, the letter will give rise to contractual obligation and its precise content must therefore be carefully considered. In the case of a company, the auditor should request that the letter of acknowledgement be signed on behalf of the board.

Example of Engagement Letter

This form of letter is generally appropriate for client companies. It is not intended to be used in relation to every enterprise, as it must be tailored to specific circumstances.

To the directors of XYZ ltd

The purpose of this letter is to set out basis on which we (are to) act as the auditors of the company (and its subsidiaries) and the respective areas of responsibility of the company and of ourselves.

1.0 **Audit**

Chapter Six – Accounting and Internal Control Systems

Introduction

The topic considers the auditor's interests in both accounting systems and internal control systems. The auditor has a lot interest in accounting and internal control systems since their adequacy will be vital. Strong systems of accounting and internal control are reliable.

Auditor's Interest in Accounting System

The auditor has a lot of interest in the client's accounting systems due to:

The auditor should ascertain the enterprise's system of recording and processing transactions and asses its adequacy as a basis for the preparation of financial statements

The auditor has a duty, in preparing their report carry out investigations so as to enable them form an opinion.

Whether proper accounting records and accounts have been maintained or not it is duty of the auditor to make an opinion in his report.

Management's Interest in Accounting System

The management of a business enterprise requires that complete and accurate accounting books and other records are maintained due to the following reasons:

The business operations are easy to control when proper books and records are maintained

Day to day records of debtors and creditors are indispensable

Assets and other resources are easily safeguarded

It is easy to prepare reliable and accurate financial statements if and only proper books of accounts are maintenance

It is a statutory requirements to maintain these accounting records and books

What constitutes an adequate system of accounting depends upon a number of factors such complexity of the organisation, nature of the business and other factors.

Importance of Accounting Control System

A system of accounting and record keeping will only succeed if there are strong internal control systems. The purposes of these controls are:

Has a system in place of internal control over processing and recording of transactions to the extent that all transactions are recorded correctly both in principle and numerically

The accounting records can adequately be relied upon to form a basis for preparing of financial statements.

It is important that the auditor vouches each and every transaction recorded in the books of accounts.

Substantive Testing

Substantive testing is defined in auditing standards as "Those tests of transactions and balances, and other procedures such as analytical review, which seek to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or in the financial statement"

The reliability of records is usually established by the auditor through investigation of the system of recording transactions. It is also established through investigating the system of internal control. However, not all data can be verified through investing the systems of internal and accounting. Some transactions and data must be verified by use of direct evidence. This is usually referred to as substantive testing. Substantive testing can be applied to the following situations:

Where internal control system is weak and cannot be relied upon

Unusual or extra – ordinary or one – off transactions

All assets and liabilities at the balance sheet date

In practice the auditor has to consider the grounds of the effectiveness and cost of whether to rely on the systems of control. In some cases sufficient evidence can be got through analytical review. In some cases, a combination of internal control reliance, substantive testing and analytical review provides the necessary and required audit evidence.

Analytical Review

At the end of the detail audit work after systems testing and substantive testing has been complete, the auditor needs to have the audit evidence that:

Proper books and records have been kept and form a reliable basis for preparation of financial statements *state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.*

Essential Requirements

The companies' Act Cap 486 in the sixth schedule and section 147 requires that the auditor should state whether in his / her opinion the accounts:

i. Give a true and fair view
ii. Complies with the Companies' Act Cap 486 and other legislation
iii. Comply the auditing standards

The auditor is required to state these matters expressly in his/her report

The auditing guidelines requires that the auditor must

i. Identify those to whom the report is addressed
ii. Identify the financial states that the report relates
iii. Refer specifically to whether the financial statements have audited in accordance with the approved Auditing Standards
iv. Refer specifically whether in his/ her opinion, the financial statements give a true and a fair view
v. Refer specifically to any matters prescribed by relevant legislation.

In some instances the auditor is required to make further statements. The circumstances under consideration here includes

a. If, in the auditors opinion, proper books of accounts and records have been maintained through – out the period under study
b. If, in the auditors opinion, proper returns have not been received from branches he has not visited
c. If the accounts are not in agreement with the accounting records and returns

Section Four – the name of the auditor

The section contains the name of the that performed the audit work

Section Five – Date the Auditors' Report was signed

This section has the date the report was duly signed

Types of Auditors' Reports

There are two types of audit reports. These are:

i. Unqualified Reports – these are clean reports whereby the auditor was satisfied that all the necessary information and clarifications were properly made. All the issues that the auditor may have raised were properly addressed and all the supporting documents provided

ii. Qualified Reports – these are reports whereby the auditor was not satisfied with the explanation clarification and other matters that he/she required from the officers development for it to be effective. The controls that should be exercised during the systems development can be categorized into four:

Review, testing and approval of new systems

The basic principles of these controls

- ✓ The user departments must be included in review and testing. The input for the user departments is vital in this stage. Once the user departments are have input considered then the systems can reflect the need for these user department
- ✓ For the proposed system should have a written specification that should be approved by this management
- ✓ Communication between the user department and the computer department should be established during testing. Testing of new system is as vital as actual development of the development.

Controls over program

Program change refers to modification made to application program. These changes should be done under strict controls. These changes must be check against incorrect or incomplete data input.

Parallel running of the new and old system

It is important that before switching to new system, the whole system must be tested by running it parallel to the old systems. It is important to run the two systems alongside for sometimes while the same time testing the input and output from the two systems

Documentation procedures

This is collection of information that support and describe the computer application, including development. The documentation should be secured in a library with access control.

Plan of Organisation in Computer Activity

The business should have proper segregation of duties and functions and policies and procedures relating to control within the computerized accounting systems.

Segregation of Duties within Systems Function

In highly integrated AIS, procedures that used to be performed by separate individuals are combined.

Any person who has unrestricted access to the computer, its programs, and live data could have the opportunity to both perpetrate and conceal fraud.

To combat this threat, organizations must implement compensating control procedures.

Authority and responsibility must be clearly divided among the following functions:

- ✓ Systems administration
- ✓ Network management
- ✓ Security management
- ✓ Change management
- ✓ Users
- ✓ Systems analysis
- ✓ Programming
- ✓ Computer operations
- ✓ Information system library
- ✓ Data control

It is important that different people perform these functions.

Allowing a person to perform two or more of these functions exposes the company to the possibility of fraud.

Physical Access Controls

How can physical access security be achieved?

- ✓ Place computer equipment in locked rooms and restrict access to authorized personnel
- ✓ Have only one or two entrances to the computer room
- ✓ Require proper employee ID
- ✓ Require that visitors sign a log
- ✓ Use a security alarm system
- ✓ Restrict access to private secured telephone lines and terminals or PCs.

Review Questions

Question One

Many auditors now use laptop computers to perform various audit tasks. However, if audit firms use laptop computers they risk data being corrupted and appropriate controls must therefore be put in place to prevent the corruption of data.

a. Explain six ways which the auditors can use laptop computers in their audit work other than computer assisted audit techniques
b. Explain the computer assisted audit techniques listed below
    i. Embedded audit facilities
    ii. Integrated test facilities
c. Briefly describe two types of software that might be used by auditors in their work other than Computer Assisted Audit Techniques
d. Describe the controls that auditors should implement when using laptop computers

Question Two

a. In the context of a computer based accounting system, explain the meaning of the following terms
    i. General Controls
    ii. Application Controls
b. State six examples of controls to prevent unauthorized changes to data files that you would expect to in a new computer based accounting system
c. A company wishes to change from an old computerized system to a more modern computer based accounting system. Explain how and why both systems should run parallel prior to the changeover to new system.

Question Three

"Most errors in computer based accounting systems can be traced to faulty input. Controls over the completeness and validity of all inputs are vital. Control over data conversion, control over rejections and their correction and reprocessing, batch controls and computer edit controls affect both completeness and validity"