

- They prescribe the approved method of accounting and disclosure.
- Where one or more methods of accounting are acceptable, they prescribe one method which is preferred and called the benchmark treatment and the allowed alternative treatment and conditions under which that allowed alternative is applied.
- They prohibit, discourage and restrict use of methods which will not lead to a true and fair view of the financial statements.
- They increase comparability of financial statements. Application of appropriate IFRS reduces areas of uncertainty and subjectivity in financial statements.

It is extremely unlikely that financial statements would give a true and fair view when appropriate IFRS are departed from. When managers depart from the IFRS in preparing financial statements they must include a note to the financial statements that they have departed from the financial statements and they must justify that departure. Auditors can on their part refer to the departure in their audit report and clearly indicate whether or not they concur with the departure.

International standards on auditing (ISAs) are issued by International auditing and practices committee (IAPC) of the International Federation of accountants (IFAC) based in New York. IFAC is the worldwide organization for the accountancy profession. It is comprised of 155 professional accountancy bodies in 114 countries, representing more than 2.4 million accountants in public practice, education, government service, industry and commerce. IFAC's mission is to develop and enhance the profession to enable it to provide services of consistently high quality in the public. In addition to developing auditing standards through the IAASB, IFAC also develops education, ethics, and public sector accounting standards. Membership in IFAC automatically confers membership in International Accounting Standards Board (IASB). ISAs do not override a country's regulations which may be government statutes or statements issued by regulatory or professional bodies in the country.

ISAs are prepared by IASB which has the responsibility of producing a single internationally acceptable set of high quality accounting standards.

AUDITING

Advantages of auditing

- Dispute resolution. A partnership business with a complex profit sharing agreement may require an independent examination of those accounts to ensure accurate assessment and division of those profits.
- Significant changes in ownership and structure can be easily effected if past accounts contain unqualified audit reports. E.g. in mergers.
- Auditors have access to the corporate strategy of the company thus are able to give advice on gaining competitive advantage and on improvement of business efficiency.
- Borrowing of finances from third parties is enhanced with availability of unqualified audit report on the company's financial statements.
- Auditing protects the interests of the shareholders who are separated from the management of their savings invested in the company.
- Auditing assists in prevention and detection of fraud and error in financial statements although this is not the primary objective of an audit.

Existence

This is the assertion that an asset or liability exists at a given date. It is either true or not true that an asset or liability reflected in the balance sheet was in existence at the balance sheet date.

Rights and obligation

This is the assertion that an asset or liability in financial statements pertains to the entity at a given date i.e. an asset is a right of the entity and a liability a genuine obligation of the entity.

Occurrence

This is the assertion that a transaction or event took place which pertains to the entity during the financial period or that a recorded event or transaction actually took place as recorded and it is a valid transaction pertaining the entity. It is either the transaction took place as recorded or not.

Completeness

This is the assertion that there are no unrecorded assets, liabilities, transactions or undisclosed items. It would suggest 100% completion and accuracy however, this is impossible under accrual basis of accounting. The users of the financial statements do not expect 100% completeness in financial statements but completeness within a certain range such that they can still make justifiable decisions. This assertion is therefore assessed for reasonableness as some transactions may be excluded if they are not material.

Valuation

This is the assertion that an asset or liability is recorded at an appropriate carrying value. It is the most crucial assertion of all the assertions. In arriving at appropriate carrying value of an asset or liability, the management considers.

- 1 Overall valuation basis. The management must consider the entity as a whole and make an assessment whether it is appropriate to apply the going concern assumption in preparing the financial statements. The basis of preparing financial statement when entity is going concern is radically different from preparing financial statement on basis that the entity is not a going concern.
- 2 Suitable accounting policies. In determining carrying amount of an asset or liability appropriate accounting policies must be followed. The accounting policies must be in line with the generally accepted accounting principles (GAAPs), appropriate to the circumstances of the entity, applied consistently, be in conformity with entity's industry practices and be adequately disclosed.
- 3 Desirable qualitative characteristics. The suitable accounting policy adopted must be applied after taking into consideration the qualitative characteristics of materiality, prudence and substance over form. Since it may subjective whether an entity is a going concern or not, the accounting policy adopted can be subsequently subjective thus the assertion of valuation can only be assessed for reasonableness.

Measurement

This is the assertion that a transaction or an event is recorded and proper amounts of revenue and expense are allocated to the proper period for proper reporting purposes. Whether a transaction brings into being an asset or liability, revenue or expense depends largely on the capitalization policy of an entity i.e. the guidance as to what items are revenue items and capital items.



CHAPTER 2

THE AUDITOR AND THE COMPANIES ACT

► CHAPTER OBJECTIVES

By the end of this chapter, you are expected to have covered;

- Appointment-companies Act provisions
- Qualifications of an auditor
- Removal of an auditor from office
- Resignation
- Rights and duties of an auditor
- Procedures before and after accepting appointment
- Professional Ethics
- International Standards on Auditing
- Legal and professional framework

► KEY TERMS

Engagement Letter- Before commencement of the audit, the auditor and the client should agree on the terms of the engagement. The agreed terms should be recorded in an audit engagement letter or other suitable form of contract.

Professional Ethics- These are rules of conduct that govern the behavior of an accountant

International Standards on Auditing- Within each country, local regulations govern to a greater or lesser degree, the practices followed by the auditors. Such regulations may either be of a statutory nature or in the form of statements issued by the regulatory or professional bodies in the country concerned. The international auditing standards are intended for international acceptance.

► EXAM CONTEXT

This chapter is tested on a regular basis due to its importance. Questions from this topic may mostly be application based whereby the student is given a scenario and asked questions from it. Ethics is increasingly becoming a key area in the running of companies and so students need to have a good understanding of it.

► INDUSTRY APPLICATION

Whatever is covered in this topic is very relevant in the auditing profession and is all applicable in all audit engagements. It guides the auditor as to his rights and the engagement letter. Also, audit professionals are expected to adhere to the highest standards of ethics and this topic gives the student the rules that are set out by the profession.

- Confirms in writing any verbal arrangements between the client and the auditor.
- Provides the auditor with a medium through which he can clarify the client's and his respective responsibilities.
- The letter informs the client of other services that the auditor's firm can provide e.g. taxation or consultancy.
- Minimizes auditor's liability to third parties.

Principal contents of an engagement letter

- The objective of the audit of the financial statements.
- Management's responsibility regarding the financial statements.
- The scope of the audit including references to applicable legislation or pronouncements of professional bodies to which the auditor complies.
- The fact that because of the test nature of auditing and other inherent limitations of an audit together with inherent limitations of internal control system, there is an unavoidable risk that some material misstatements may remain undiscovered.
- The expectation of unrestricted access to whatever records and documentations.

Other matters included in engagement letter are:

- Expectation of receiving from management written confirmation concerning representations made by the auditor in connection with the audit.
- The basis on which audit fees are computed or any other billing arrangement.
- A request to the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

Audit of components

Where the auditor of a parent company is also the auditor of its subsidiaries, the factors that influence the decision whether to send a separate engagement letter include:

- Legal requirements of disclosure in the financial statements.
- Whether a separate audit reports are to be issued on the subsidiary and parent companies.
- Who appoints the auditors of the component?
- The extent of any work performed by other auditors
- Degree of ownership in the subsidiary by the parent company.
- Degree of independence of subsidiary's management.

Recurring audits

On recurring audits, the auditor should consider whether the circumstances require the terms of engagement to be revised and whether there is need to remind the client of existing terms of engagement. The auditors may decide not to send a new engagement letter each period. However, the following factors may make it necessary to send a new engagement letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change in senior management, board of directors or ownership.
- A significant change in nature or size of client's business.
- Where legal requirements dictate so.



- A duty of care existed i.e. the auditor owed the third parties a duty of care.
- The duty of care was breached through auditor's negligence.
- They suffered a financial loss as a direct consequence of an auditor's negligence.

In Hedley Byrne and Company Limited versus Heller and Partners (1963), it was held that 'a duty of care exists where there is a special relationship between the parties. I.e. where the auditor knew or ought to have known that the financial statements would be made available and would be relied upon by a particular person.' The implication of this statement is that, for there to exist a duty of care, the third part must have been identified in some way to the auditor. E.g. where the directors inform the auditor that the financial statements would be used to obtain a loan, the auditor will have to owe duty of care to the bank in the same way he owes a duty of care to the client.

Ways of minimizing potential liability for professional negligence include:

- By not being negligent.
- Adhering to the requirements in ISAs, codes of professional conduct and utilizing sound professional judgment.
- Agreeing with the client duties and responsibilities of the auditor and the client in the engagement letter to avoid future misunderstandings.
- Defining in the audit report the precise work the auditor has undertaken.
- Stating in the engagement letter the purpose for which the report has been prepared and that the client may not use it for any other purpose.
- Identifying the authorized recipients of reports in the engagement letter in the report.
- Limiting or excluding liability by a term in the engagement letter in the case of third parties a disclaimer in the report.
- Advising the client on the engagement letter on the need to ask for permission before using the auditor's name and withholding such permission when appropriate.

Professional Ethics

A member of a profession owes a duty to the public including the employer, the profession itself and to other members of the profession. Professional ethics are rules of conduct that govern the behavior of an accountant. In Kenya, they are issued by institute of Certified Public Accountants of Kenya (ICPAK) in form of statements and explanatory notes. A professional accountant should act in a manner consisted with the good reputation of the occupation and refrain from any conduct which might bring discredit to the profession. The following are fundamental principles stated by ICPAK to ensure auditors are credible people before they give credibility to financial statements.

1. **Integrity:** A member should be straight forward, honest and sincere in his approach to professional work. A member must be aware of his role in the society and maintain high standards of conduct should not satisfy what he knows as untrue as true and should take caution not to mislead intentionally or unintentionally.
2. **Professional independence:** This is a fundamental concept to the accounting profession as a whole. It is essentially an attitude of mind characterized by objectivity and integrity. A member in public practice should be and should appear to be free in every professional assignment he undertakes, of any interest which might distract him from being objective. He must be impartial and must not allow prejudice or bias to affect his judgment. A member not in practice may be unable to be or seen to be free of any interest which might conflict to the proper approach of his professional work. However, this does not diminish his duty of objectivity in relation to that work.
3. **Confidentiality:** The guide to professional ethics states that information acquired in the course of professional work should not be disclosed except where consent has been

acquired from the client, where there's public duty to disclose or where there is legal or professional duty to disclose such information. A member acquiring information in the course of professional work should neither use nor appear to use that information in his personal or third party advantages e.g. if a member is auditing a limited company and he realizes that the company has made a substantial increase in profits, it would be unethical to advise a friend to buy the shares of this company in anticipation of the expected increase in the share prices as a result of increase in profitability.

4. **Technical competence:** A member has duty to carry out his professional work with care and skill and in conformity with the professional ethical standards issued by ICPAK and by the laws of Kenya. A member should not undertake or continue professional work which he himself is not competent to perform unless he obtains such advice and assistance as will enable him to perform such work. To be competent a member should be fully conversant with accounting, book keeping, auditing, financial management, information technology, receivership, liquidation and bankruptcy law, taxation both personal and corporate and must be aware of the economic environment within which his clients operate. To be competent, he must also possess sound judgment. This is in professional as well as economic issues. He should be a good communicator.

Auditor's independence is an important factor in establishing the credibility of an audit opinion. Therefore, ICPAK has given guidance in the best conduct code in situations where the auditor's independence may be impaired. These are:

a) Fees

It is undesirable for a practice to receive a significant proportion of recurring fee income from one client or group of connected clients. A new or old practice is exempted from this provision because in the case of a new practice it has not yet built a sufficient client base and an old practice may be in decline. Therefore when a member finds himself with such a client, he does not resign immediately but first look for opportunities to reduce the significance of that client by looking for more work.

Where practice is deriving a significant portion of its professional fees from one client, the practice will be hesitant to do anything that could result in losing the client i.e. an auditor may be hesitant to qualify his report for fear of losing such a client.

b) Personal and family relationship

A family of personal relationship can affect objectivity therefore an accountant should take step to ensure that this does not interfere with his objectivity in approach to auditing e.g. a problem may arise when a person in practice has a mutual business with an officer of the client company or has close friendship with one of the officers.

c) Beneficial shareholding

A practice should ensure that he does not have as an audit client, a company in which a partner in practice, the spouse or minor child of such partner is the beneficial holder of shares nor should it employ on the audit, any member of staff who is a beneficial holder of such shares. Shares in an audit client may be involuntarily acquired e.g. where a partner inherits such shares or marries a shareholder. In such cases, the shares should be disposed off at the earliest practicable date. If the company's articles of association require that the auditors should have a minimum number shares, then the member should take minimum number allowed. The shares cannot be used by the member in an annual general meeting to vote on the appointment of the auditor and his remuneration.

EXAM QUESTIONS

QUESTION ONE

Your firm has been approached by the directors of UB Bank Ltd. a newly formed commercial bank to undertake the audit for its first complete financial year ended 31 December 1996. Your manager has assigned you the responsibility for leading the team. You have had various discussions with the directors about the timetable and the respective responsibilities of management and the auditor. You have drafted a letter of engagement and have sent it to the managing director for approval and acceptance but the management has not yet responded to your letter.

Required:

- a) Explain why a letter of engagement is sent before any new audit appointment is accepted.
- b) Set out the main contents of a letter of engagement.
- c) Itemize the actions you would take in response to the non-reply by the management to your draft engagement letter.
- d) State when it might be necessary to re-draft an engagement letter and have it re-affirmed by the client's management.

QUESTION TWO

The objectivity of the external auditor may be threatened or appear to be threatened where:

- i. There is undue dependence on any audit client or group of clients.
- ii. The firm, its partners or staff have any financial interest in an audit client.
- iii. There are family or other close personal or business relationships between the firm, its partners or staff and the audit client.
- iv. The firm provides other services to audit clients.

Required:

- a) For each of the four examples given above, explain why the objectivity of the external auditor may be threatened, or appear to be threatened, and why the threat is important.
- b) Describe requirements that reduce the threats to auditor objectivity for each of the four examples given above.

QUESTION THREE

- a) Describe the matters to consider within your firm and the other procedures that must be undertaken before accepting the appointment as auditor to a new client.
- b) Explain why it would be inappropriate to commence the audit before consideration of the matters and the procedures referred to in (a) above have been completed.
- c) Explain the purpose of an engagement letter and list its contents.

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- Consultation. Where necessary, consultation within and without the firm should be carried out with those with appropriate knowledge.
- Acceptance and retention of clients. An evaluation of prospective clients and a review on an ongoing basis of existing clients should be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly and the integrity of the client's management should be considered.
- Monitoring. The firm should continuously monitor the adequacy and operational effectiveness of quality control policies and procedure's.

The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies are understood and implemented.

■ Quality control policies and procedures at individual audit level

- i. Delegation. Audit work should be delegated by the reporting partner to staff who have appropriate experience, training, proficiency and independence. This will provide reasonable assurance that such work will be performed with due care by persons having the required technical competence.
- ii. Direction. Audit assistants to whom work is delegated should be given appropriate instructions. This involves informing audit assistants of their responsibilities and objectives of the procedures they are to perform. It also involves informing them of matters such as nature of client's business and the possible accounting and auditing problems.
- iii. Supervision. This involves monitoring the progress of the audit to consider whether assistants have the necessary skills and competence to carry out their assigned tasks, establishing whether assistants understand the audit instructions and resolving any differences of professional judgment between personnel. Supervision also entails identifying and addressing any significant accounting and auditing questions raised in course of the audit and ensuring that work is being carried out in accordance with the overall audit plan and audit programme.
- iv. Review Work performed by each staff member should be reviewed by a person of equal or higher competence to ensure that work has been performed in accordance with audit programme, has been properly documented and that audit objectives have been met.

■ Peer Review

Peer review may be described as an independent review of a firm's accounting and auditing practices. It is intended that the review be done by practitioners upon fellow practitioners hence the term peer review. The work of the review is limited to:

- Professional aspects of the practice.
- Overall total quality control policies.
- Professional aspects of firm's accounting and auditing practices like maintenance of working papers and custody of financial statements.

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Actions taken when internal control system is identified as weak

- The auditor should bring to the attention of the management all the weaknesses he has identified and discuss with them the possible remedies and corrective measures immediately.
- The auditor should consider changing his audit approach by increasing the level of detailed substantive testing. This is because the weaknesses imply that the system is not operating as designed and therefore cannot be relied upon.
- The auditor should increase the sample size i.e. test as many entries as is considered necessary to avoid any error or fraud undetected.
- The auditor should record significant weakness in the management letter and give his recommendations to management on how the weaknesses can be corrected.
- If the internal control system is extremely weak such that he cannot depend upon it to apply any test, then he should qualify his report or at best give a disclaimer opinion.

The extent of reliance on internal control system by the auditor will depend on factors as: -

- His past experience with the company's internal control system. Any fluctuation in volume of business transactions
- Changes in line managers or top management officials.
- Changes in accounting policies and practices.
- Changes in size of the company.

■ Management Letter

Although the statutory reporting requirements of the Companies Act only calls for the auditor to make a report to the members as to whether the financial statements show a true and fair view. In addition to this, auditors provide management with a summary of their findings concerning strengths and weaknesses of accounting and internal control system as well as material issues arising from review of the financial statements. This summary is called the management letter.

Purposes of management Letter

- Enables the auditor to give his comments on the accounting records that he has examined during the course of the audit. Areas of weakness in internal control system which may result to material errors will be highlighted and brought to management's attention together with advice as to their improvement.
- Provides management with other constructive advice regarding areas where efficiency may be improved.
- Communicates matters arising during the audit so that there is a written record of all such matters. In case of litigation, the auditor may rely on the management letter for defense.
- Ensures auditor's comments on the accounting on the internal control system reach those responsible members of management who have powers to act on the findings.

A report to management will normally be a natural way of adding value to the client and the auditor should incorporate the need to report in the planning of the audit. Before documenting the weaknesses in management letter, the auditor should discuss these with the appropriate officials. This eliminates the possibility that the auditor may have misunderstood the operation of the system and will also enable the company make quick corrective actions. The management letter should be addressed to the board of directors or the audit committee.

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The timing of the management letter will vary. It will often be useful to complete the compliance tests before its submission, so that weaknesses in internal control system may be included. However, serious weaknesses discovered should be reported immediately. This may make it necessary to submit more than one management letter.

The management letter acts as effective feedback that assists management in running the company more efficiently and thus promotes constructive relationship between the auditor and management which may be useful in future audits. The management letter should be both objective and constructive. The auditor should request for comments from management as to all the matters raised indicating what actions management intends to take regarding the matters raised.

CHAPTER SUMMARY

- The auditors need to be aware of the entity and its environment and the controls that are operational in a system so that they can be able to determine the level of reliance that they are going to place on the operating effectiveness and efficiency system and thus determine the amount of testing that they need to carry out.
- The auditor should comprehend the risks that face the entity and how the management manages those risks and how they affect the financial reporting and how the risks may affect cause material misstatements and thus the scope of his work.
- The auditor must understand the information system that operates within the entity and most importantly how the financial reporting system works.
- The external auditor needs to assess the internal auditor's impact on the control environment and how much reliance can be placed on his work.
- The internal audit department may be run by employees of the company or the function may be outsourced.
- The internal audit department is set up by the management to help the management achieve company's objectives and to reinforce corporate governance.

QUIZ

1. What is the difference between internal audit and external audit?
2. List the five elements of internal control.
3. What are the factors that are responsible to the growth of the internal audit function?
4. List the approaches used to record the internal control system by the auditor.
5. Differentiate control environment from control procedures



ANSWERS TO THE QUIZ

1. Differences between external audit and internal audit.
 - Scope of work: For an internal auditor the scope is determined by management whereas for an external auditor it is laid down by statutes and professional requirements of the institute (ICPAK).
 - Approach: An internal auditor may have many aims in his work including an appraisal of the efficiency of the internal control system and management information system. The external auditor is primarily concerned with the truth and fairness of accounts.
 - Responsibility: The internal auditor is answerable only to management. The external auditor is responsible to shareholder and the public at large.
2. Internal control has five elements:
 - The control environment
 - The entity's risk assessment process.
 - The information system.
 - Control activities.
 - Monitoring of Controls.
3.
 - i. Increase in size of business
 - ii. Dynamic business
 - iii. Legislation and regulatory requirements
 - iv. Competition
 - v. Evolution of IT
4. Flowcharts
 - Narrative descriptions
 - Questionnaires

EXAM QUESTIONS

QUESTION ONE

List down internal control procedures for raw material purchasing system of a large manufacturing firm

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CHAPTER 5

FRAUD & ERROR (ISA 240)

► CHAPTER OBJECTIVES

By the end of this chapter the student is expected to have covered the following:

- I. Definition of errors and types of errors
- II. Frauds, defalcations and other irregularities
- III. Detection, correction and prevention
- IV. Errors and frauds in specific areas in a business.

► INTRODUCTION

When the auditor is carrying out his work, he comes across deviations or misstatements in the financial statements. These misstatements may be due to an unintentional error or one that was committed with intent thus. The misstatements may also be due to non compliance with laws and regulations or due to fraud. During the planning of the audit, the auditor should expect to detect material misstatements in the financial statements due to fraud or error if any. This chapter is covered by ISA 240 on *The Auditor's Responsibility to Consider Fraud In An Audit Of Financial Statements*.

When planning and performing audit procedures, evaluating and reporting the results thereof, the auditor should consider the risk of misstatement in the financial statements resulting from fraud or error. The objective of an audit is to report on whether the financial statements are free from material misstatements. This implies that if there are material misstatements as a result of fraud or error and the auditor fails to detect and report on this, then his opinion would be wrong.

► KEY TERMS

Error: It is an unintentional mistake in the financial information, which can occur any time during processing and recording of transactions.

Fraud: This refers to intentional misrepresentation of financial information by one more individuals among management, employees or third parties.

Irregularity: is the deliberate distortion of information together with the related misappropriation of assets.

► EXAM CONTEXT

This is topic can either be tested on its own or in a context of another question. It can also be a scenario whereby the student is expected to distinguish between a fraud and an error.



- Suppression or omission of effects of a transaction on accounting record e.g. placing a genuine debtor well known bad debts in the balance sheet thus misrepresenting the financial position of the company.

Fraudulent financial reporting may be committed because management is under pressure from outside or inside the entity to report unrealistic profit levels. A perceived opportunity for fraudulent financial reporting or misappropriation of company assets may exist when an individual believes that an internal control can be overridden. This could be because an individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

The distinction between fraud and error is of little importance so far as audit procedure are concerned. This is because the audit procedure used to detect errors is the same used to detect fraud. The only difference may arise where the auditor may be required by law to disclose certain illegal acts to the regulatory authority.

■ Responsibility for detection of fraud and error

The primary responsibility for the detection and prevention of fraud and error rests with the management of the company. This responsibility is fulfilled through the implementation and continuous operation of adequate system of internal controls. Such system reduces but does not eliminate the possibility of fraud and error. The auditor on his part seeks reasonable assurance that fraud and error which may be material to the financial statements has not occurred or if it has occurred, the effect is properly reflected in the financial statements. At this point, the auditor should plan his work so that he has reasonable expectation of detecting material misstatements in the financial information resulting from fraud and error. It is important to emphasize that the auditor cannot be held responsible for failing to detect errors and frauds. However, he is expected to carry out his work in a manner that he is in a position to detect material errors and frauds. Failure to detect such material errors implies that the financial statements are materially misstated.

■ Expectations gap

This is the gap that exists between external auditor's understanding of their role and duty and the expectations of various users of the financial statements and the general public regarding the process and the outcome of the external audit. I.e. the expectation by users of financial statements that auditor should detect and prevent error and fraud as a duty, while actually it is not his duty but of the directors.

The public may conceive the auditor's role as including;

- Protecting the company against fraud and irregularities
- Providing early warning of future insolvency i.e. certifying the company as a going concern.
- Providing useful general assurance of the financial wellbeing of the company and its continued profitability.

Most users of financial statements believe that the auditor has prepared the statements and should therefore be in a position to explain the performance results of the company. Some other users of the financial statements do not understand the audit opinion issue.

Possible means of reducing the expectations gap include:



■ Qualities of audit evidence

ISA 500 requires that 'the auditor should obtain sufficient audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.'

What do we mean by:

- a) Sufficiency
- b) Appropriate

Sufficient means that there needs to be enough evidence. What is enough is a matter of professional judgment.

Appropriate break down into:

- a) Relevance.
Relevance of audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on financial statements. It therefore refers to the ability of the evidence to assist the auditor in testing management assertions.
- b) Reliability
Reliability of audit evidence refers to the credibility of that evidence the credibility is influenced by its source and its nature

■ Use of assertions in generating audit evidence

When preparing financial statements the management makes certain implicit or explicit assertions about the financial affairs of the company.

Consequently, when the auditor is obtaining evidence from a substantive procedure, he is concerned about testing or substantiating the truth of those assertions. The assertions are categorized as follows.

1. **Assertions about timing of transactions and events for the period under audit i.e.**
 - Occurrence transaction and events that have been recorded have occurred and pertain to the entity.
 - Completeness
 - Cut off. Transactions and events have been recorded in the appropriate accounting period
 - Accuracy Amounts and other data relating to the recorded transactions have been recorded appropriately.
 - Classification. Transactions and events have been recorded in the correct period
2. **Assertions about account balances at the year end.**
 - Existence. Assets or liabilities exist at a given date
 - Rights and obligations
 - completeness
 - valuation and allocation
3. **Assertions about presentation and disclosure.**
 - Occurrence and rights and obligation. Disclosed events and transactions and other matters have occurred and pertained to the entity
 - Completeness All disclosures that should have been included e.g. compositions of director's fees.
 - Measurement and valuation. Financial and other information are disclosed fairly and at appropriate amounts

Management may be unwilling to sign letters of representation or pass minutes required by the auditor. If management declines, the auditor should inform the management that he will himself prepare a statement in writing setting out his understanding of any representations that they have been made during the course of the audit and send this statements to management with a request for confirmation that the auditor's understanding of the representations is correct.

If management disagrees with the auditor's statement of representations, discussions should be held to clarify the matters in doubt and if necessary a revised statement prepared and agreed. Should management fail to reply, the auditor should follow up the matter to ensure the position as set out in his statement is correct

In rare circumstances, the auditor may be completely unable to obtain written representations which he requires e.g. because of the refusal by management to cooperate or because management declines to give proper representations required on the ground of its own uncertainty regarding that particular issue. In such circumstances, the auditor may have to conclude that he has not received all information and explanations required and consequently may need to consider qualification his audit report an ground of limitation in scope of the audit.

■ ISA 620 Using the work of an expert

The auditor should obtain sufficient appropriate audit evidence that the work of the expert is adequate for the purpose of the audit.

An expert is a person possessing specialized skills, knowledge and experience in another field other than auditing and accounting. From his experience, an auditor only has general knowledge on matters outside his profession and is not expected to have the skills of a person trained or qualified to work in another profession. Consequently, the auditor may need the advice of another expert for example, a pharmacist when verifying stock in the laboratory or lawyers in arriving at the legal interpretation of legal cases against a client.

Situations where the auditor may require work of an expert

- The legal interpretation of contracts, laws and regulations
- Valuations of certain types of assets e.g. precious stones, minerals and buildings
- Actuarial valuation e.g. for pension funds
- When measuring the work to be completed in construction contracts.

In deciding whether to use the work of an expert the auditor should consider.

- The materiality of an item being examined in relation to the financial statements as a whole.
- The nature and complexity of the item including the risk.
- The audit evidence available in respect with the item.

Factors considered before relying on the work of the expert

The auditor should consider;

- The skills and competence of the expert. The auditor should consider this by examining the expert's professional qualifications, licenses or membership of an appropriate professional body. The experience and reputation of the expert in the field in which the auditor is seeking evidence is very important.
- Objectivity and independence of the expert.. The auditor should consider whether the expert is independent from the client. The risk of independence being impaired increases where the expert is employed by the client. In such cases he owes his loyalty to the client because there exists a financial relationship.

Describe and explain the main audit procedures and processes that take place during the interim and final audit of a large entity.

QUESTION THREE

Curdco is a company that runs a chain of fast food restaurants. The company has a centralized operating style and managers of individual restaurants have very limited decision-making powers on day-to-day operational matters. The company's centralized administration is responsible for the buying of food, the payment of staff, the maintenance and cleaning of restaurants by staff employed by a national agency, and all other matters relating to the running of the business. The company has good internal controls over purchasing. Inventory counts are conducted at each restaurant at the year-end. Your firm has recently been appointed as auditor to Curdco.

Required:

- a. List the account headings you would expect to find in Curdco's schedule of accounts payable and accrued expenditure.
- b. Describe and give reasons for the audit tests you would carry out to obtain audit evidence for Curdco's accounts payable and accrued expenditure.
- c. Explain the difficulties faced by auditors, and the decisions that auditors have to make, in conducting direct confirmations of accounts payable.

QUESTION FOUR

There are a number of different methods of obtaining audit evidence. Methods include:

- Analytical procedures.
- Audit sampling
- Tests of controls.
- Detailed testing of transactions and balances.
- Computer assisted audit techniques (CAATs)

These methods overlap and may be used for different purposes during an audit of financial statements.

Required:

- a. Explain the advantages and disadvantages of each of the five methods of evidence gathering listed above.
- b. Describe the relationship between the five methods of evidence gathering described above.

QUESTION FIVE

- (a) Explain the purpose of a management representation letter.
- (b) A suggested format for the letter of representation has been sent by the auditors to the directors of a client company. The directors have stated that they will not sign the letter of representation this year on the grounds that they believe the additional evidence that it provides is not required by the auditor.

4. Discovery sampling

This method extends acceptance sampling to an acceptance level of zero. E.g. a system with controls exists in an investment trust company to ensure that all bonus issues are recorded. Even if one bonus has not been recorded, the auditor will be unable to accept the controls and will have to seek other evidence. This method requires a large sample. A form of discovery sampling is monetary unit sampling.

Monetary unit sampling

Monetary unit sampling is appropriate for use with large variance population e.g. debtors or stock where individual units have widely different sizes or values. This method is suited to a population where errors are not expected and it implicitly takes into account the auditor's concept of materiality.

Procedure of monetary unit sampling

- i. Determine the sample size taking into account the size of the population and the minimum acceptable error rate.
- ii. List the items of population e.g. list of debtors could be as

Debtor	Amount (Sh)	Cumulative amount
TMK& Co.	500	500
AQ & Sons	200	700
T Ltd	1,450	1,970
W Co.	4,420	6,390
:	:	:
		240,000

Total 240,000

- iii. Assume that the total numbers of debtors is 1500. If sample size chosen is 100 items, then a random start of say Shs 1000 can be chosen and every Shs 2100th item thereafter i.e. using systematic sampling with random start. The idea is that the population of debtors is not 1500 but Shs 240000 with single units of Shs 1. Therefore, we chose to sample to be picked from the cumulative shillings amount.
- iv. At the end of the process, evaluate the result which might be a conclusion that the auditor is 95% confident that the debtors are overstated by more than Shs. X where X is the materiality factor chosen.
- v. If the conclusion is that the auditor finds that the debtors are overstated by more than Shs X, then he may take a large sample or investigate the debtors fully.

Disadvantages of monetary unit sampling

- i. Does not cope easily with errors of understatement. A debtors balance which is understated will have a smaller chance of being selected than if it was correctly valued hence there is a reduced chance of selecting that balance and discovering the error.

- c) Find out the amount of installments and when they should be paid and get the ledgers recording of these installments. Ensure that capital payments are separated from revenue payment. The auditor should calculate the amounts and compare them to those that are recorded.
- d) Check the recording of these items in the cashbook and the bank statement to ensure that the two are in agreement. Check the profit and loss for proper recording.

■ Audit of Salaries and Wages

The audit of salaries and wages is a little different from the audit of other expenses or payments of an enterprise. The difference is that the audit procedures lay emphasis on checking the strength of the internal control system. This therefore means that to carry out a proper audit one should have a very good understanding of the features of a strong internal control system for payment of salaries and wages.

Some of the frauds which can be perpetrated by the employees and which the auditor should look out for include:

- Dummy/ghost workers: these are workers who do not exist.
- Fraudulent double payment for employees: this could be done by giving different names for the same person.
- Payment for work not done and unclaimed wages being misappropriated.
- Inflating payroll by wrong increments or showing increment when it is not due.
- Improper deductions being made or being misappropriated.
- Manipulation of commission.

The auditor should check the following areas carefully:

- Time workers-who come in shifts who work for certain number of hours a day
- Piece workers employed to do certain job
- The preparation of wage
- The payment of wages
- Dummy workers
- The recording of salaries and wages and also employee records

Audit tests for salaries and wages

- Test the internal control system of payment of wages. Check if there is possibility of this system detecting ghost or dummy workers or any similar fraud.
- Check the procedure of employment and dismissal of employees, which should be authorized by a responsible officer.
- Verify that there is proper recording of wages.
- For time basis check time records.
- Check authorization of overtime.
- Verify authority for deductions and ensure proper recording.
- Check castings of wages.
- Ensure all stages of preparation of payment of wages are properly authorized.
- Check total of wages paid to control account.
- Test a number of entries of payments to employees and ensure that they were received by employees.
- Reconcile signature of original employment to that signed on receipt of the wages

Freehold land and buildings

Audit objectives

- To verify that there was proper authorization to acquire the land and the buildings
- That land and building exist
- That the company has legal ownership rights over these assets
- That these assets are valued at an appropriate amount
- That these assets are properly presented and disclosed in the financial statements according to the relevant financial reporting standards such as international accounting standard No. 16, 17 or 40

Audit procedures

To be able to meet the above objectives, the auditor carries out the following audit procedures:

a) Cost and authorization

This is verified by inspecting to the appropriate documentation such as the sale agreement and surveyors certificates. To verify whether the acquisition was authorized the auditor can inspect the minutes of the board of director's meetings at which such the green light was given acquire the assets in question.

b) Existence

This can be verified through physical inspection of the land or the building.

c) Ownership rights

This can be verified by inspecting the title documents. The auditor should also ensure that such title documents are in the name of the company and are free from any charges e.g. the land title deed should not be charged as security for a loan. If this is the case then such information should be disclosed in the financial statements.

d) Valuation

Freehold land should be disclosed at cost. Leasehold land should be amortized over the life of the lease. Generally buildings should be carried at the depreciated historical cost or at depreciated revalued amounts.

The auditor should ensure that:

- The depreciation policy adopted is appropriate i.e. the rate applied and the estimated useful life.
- Where buildings or land has been revalued that this is carried out by a qualified and reputable valuer and the revaluation seems reasonable.
- That the land and buildings are evaluated for impairment and where necessary written down to the impaired value.

e) Presentation and disclosure

For purpose presentation fixed assets should be split into appropriate classes. The following information should be disclosed:

Depreciation policy

Useful life's

Total depreciation charge for the period

Additions of new assets or disposals during the period

Any assets that are charged in favour of another person.

Plant and machinery

Audit objectives

- The auditor will be aiming at proving the following assertions

Stocks and work in progress

Stock includes:

- Finished goods held for sales in the ordinary course of business
- Work in progress
- Raw materials

Stock comprises a significant portion of the company's assets and hence has a material effect on the presentation of the financial statements.

Problem encountered in the verification of stock

- i. The amounts involved are invariably material.
- ii. Stock has a one for one impact on the reported profits i.e. an increase in stock increase the reported profit. It is therefore open to distortion by management.
- iii. Stock does not derive from the normal double entry system; it is arrived at by stock taking carried out at the year-end.
- iv. Stocks are portable and valuable opening themselves to pilferage and deterioration either intentional or accidental.
- v. The number of items involved is usually numerous creating verification problems as far as existence and condition is concerned.
- vi. Although stocks are valued at the lower of cost and net realizable value, what constitutes cost can vary from one management to another and the basis of determining that cost can be subject to so many different methods all resulting in different values for the same items.
- vii. It is an area that is susceptible to manipulation by management provision for obsolescence, slow moving and damaged stocks is a question of judgment therefore it is easy for the auditor to disagree with management.
- viii. Stock is normally made up of different items e.g. work in progress, raw materials all these can be valued on a different basis and amalgamated and described as stocks.
- ix. Stock may be overstated by inclusion of goods sold but not dispatched to customers.

Audit objectives

- a. Ascertain the existence of stock.
- b. Ascertain that stock is appropriately valued at lower of cost and net realizable value. Adequate provisions are created for dead and slow moving stock.
- c. Verify the completeness and accuracy of the stock balance.
- d. Verify that stock is appropriately presented and disclosed in the financial statements.

Audit of stock

Cost

This involves determining the method adopted by the organization in costing stocks. The auditor should then check the acceptability and appropriateness of the adopted policies.

The rest of the exercise is to test that the adopted exercise is correctly applied.

Valuation

Stock should be valued at lower of cost and net realizable value where net realizable value is defined as the amount that could be realized on the open market in the ordinary course of business less the cost of putting them into a saleable condition and less the cost of sales.

It is up to the auditor to ensure that the net realizable value is properly calculated and is in accordance with the accounting standards.



- External verification: With many liabilities it is possible to verify the liability directly with the creditor.
- The auditor must always perform a post balance sheet review with regard to liabilities.

Current liabilities

Tax payable

Audit objectives

To verify that:

- All tax liabilities have been taken up in the books i.e. completeness
- Tax liabilities have been accurately computed.
- All tax liabilities are disclosed in the financial statements.

Audit procedures

- Obtain or prepare the tax computation.
- Review the correspondence between the clients and the tax authority in case any queries have been raised so that the auditor can determine the status of those year's returns.
- Vouch installment payments to the cashbook and the receipts from the Income Tax Department.
- Obtain or prepare a schedule showing the year of income, the balance brought forward, the amount paid in year under audit, charge to the P&L A/c and the balance carried down.
- Balance brought forward should be in agreement with the balance for the previous year.
- The amount paid in the year should be agreeing with the cash flow statement and the cashbook.
- Balance carried forward to the draft balance sheet.

The auditor should ensure that disclosure is adequate. Note to the accounts should explain the basis for driving at the provision for tax that year. On the face of the P&L account the corporation tax charge for that year should be separately disclosed.

Trade creditors

Audit objectives

The auditor seeks to ascertain:

- The completeness and accuracy of the creditors balances.
- That all creditors exist and are genuine liabilities of the entity.
- Creditors are properly presented and disclosed in the financial statements.

Audit procedures

- i) Obtain a creditors listing and verify that the total per the listing agrees with the total per the ledger.
- ii) From the listing select a sample of creditors and carry out the following procedures
 - Obtain or prepare a reconciliation of the creditors balance per the ledger to the suppliers' statements.
 - Obtain explanations for all the reconciling items and where appropriate ensure that the reconciling items have been adjusted in the books of account. The reconciling items will mainly include suppliers invoices not posted in the clients ledger or payments not reflected in the suppliers statements.



- vii. Agree total amount outstanding with register of debenture holders.
- viii. If loans are secured, verify charge is registered at company's house.
- ix. Verify disclosure is in accordance with Companies Act requirements. Note that long term loans which are repayable within 12 months of the accounting date must be shown as such.

Post balance sheet events considerations

Post balance sheet events are those events both favorable and unfavorable that occur between the balance sheet date and the day the accounts are approved by the Board of Directors.

Types of events

- Adjusting events - those that provide additional evidence about conditions existing at the balance sheet date.

Non- adjusting events - those that are indicative of conditions that arose after the balance sheet date.

Examples of adjusting events

An enterprise should adjust the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date. The following are adjusting events which require an enterprise to adjust the amounts recognized in its financial statements.

- The resolution after the balance sheet date a court case which, because it confirms that an enterprise already had a present obligation at the balance sheet date, requires the enterprise to adjust a provision already recognized or to recognize a provision instead or merely disclosing a contingent liability.
- The bankruptcy of a customer which occurs after the balance sheet date usually confirms that a loss already existed at the balance sheet date on a debtor and that the company needs to adjust the carrying amount of debtors by writing off the amount that is irrecoverable.
- The sale of stock after the balance sheet date may give evidence about the net realizable value at the balance sheet date. This can be used to revalue the stock to the lower of cost and net realizable value.
- The discovery of a fraud or errors that show that the financial statements were correct.

Examples of non-adjusting post balance sheet events

A company should not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the balance sheet.

Decline in the market value of investments between the balance sheet date and the date when the financial statements are authorized for issue. The fall in the market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances that have arisen in the following period. Therefore the company should not adjust the carrying value of its investments.

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In planning the audit, the auditor should consider how the presence of computerized information systems may affect client's accounting and internal control system and the conduct of the audit. This is because computerized information systems have unique features compared to manual systems and require inbuilt adequate controls to ensure that the accounting system can be relied upon for complete and accurate accounting records. These features include;

- Consistency unlike manual systems. Computerized information systems will process transactions consistently. This implies that if the system is properly programmed, the all transactions will be processed consistently and accurately. On the other hand, if there are any programming errors, the transactions will be consistently processed inaccurately.
- Concentration of functions and controls. In a computerized information system, few people are involved in processing of financial information. This may compromise segregation of duties such that persons involved in writing of programs may also be involved in processing transactions. This increases risk of manipulation of operating programs and data. Programs and data are held together increasing the potential for unauthorized access and alteration.
- Computerized information systems are designed to limit paperwork.. This result in less visible evidence to support transactions processed which ultimately leads to loss of the audit trail.
- Ease of access of data and computer programs. Where there are no proper controls over access to computers at remote terminals, there is increased danger of unauthorized access and alteration of data and programs.
- Use of programmed controls. In a computerized environment, controls are programmed together with data processing instructions e.g. protection of data against unauthorized access may be by way of using passwords and user profiles that grant different levels of access to the system. Use of programmed controls implies that the auditor must adopt an audit approach to test effectiveness of those controls.
- System generate transactions. Many systems are capable of generating transactions automatically without manual intervention e.g. calculation of interest from customer's accounts may be done and charged to income automatically. If the system set up is interfered with, this could affect the accuracy and integrity of transactions generated.
- Data and programs are stored in portable magnetic disks and tapes which are vulnerable to theft and intentional or accidental alteration.

Internal controls in a computerized information system

To mitigate the risks occasioned by the features of a computerized information system, the management should design internal controls over the system. These controls are mainly classified into general controls and application controls.

1. General controls.

These relate to the environment within which the computer based systems are developed, maintained and operated aimed at providing reasonable assurance that the overall objectives of internal controls are achieved e.g. completeness, accuracy and validity of financial information.



The objective of the general controls is to ensure the proper development and implementation of applications and the integrity of program files and information. These controls could either be manual or programmed and are classified into;

- System development controls
- Access controls.
- Computer operations and other controls.

a. System development controls.

These relate to controls that must be exercised by the client when developing new systems or modifying existing systems. The controls that can be exercised during systems development can be discussed in the following groupings.

Appropriate review testing and approval of new systems.

The organization should set up a steering committee composed of senior management and high level representatives of system users who should the development and implementation of the new system.

Management should approve specifications of the new system after the steering committee has assessed the user needs. Before the new system is commissioned for use, appropriate testing should be carried out to ensure that both the hardware and the application programs are operating effectively. The testing will provide assurance that the new system is reliable.

The information technology manager, user department and the appropriate management level should give appropriate approval of new system before being placed under operation and after reviewing completeness of system documentation and results of its testing.

Controls over program changes

Program changes refer to modifications made to existing programs. Changes in the computer system should be subject to strict controls e.g. a written request for an application program changes should be met by user department and authorized by designated manager or committee. Once changes have been made, appropriate testing should be carried out to ensure that the modified system is reliable.

The system documentation should then be amended to reflect the changes and appropriate approval obtained for the modified system to start running.

User training should also be carried out as appropriate.

System documentation.

This involves putting together information that supports and explains computer applications. The documentation provides details of capability of the system and how it is operated.

System documentation is important in conducting user training and also enables the management to effectively review the system by considering whether appropriate controls have been put in place during system development.

Parallel running.

Before switching to the new system, the whole system should be tested by running it alongside the old system for a specified period. This is important because it provides user with the opportunity to familiarize themselves with the new system before it is fully implemented and ensures that the new system is reliable and data is correctly carried forward from the old to the new system.



- There should be adequate virus detection. Procedures for dealing with virus infection are.
 - Establishing a formal security policy which requires only clean and certified copies of software are installed and checking data introduced from external sources for viruses.
 - The company can also install antivirus software.
 - Clean back up should be maintained and there should be adequate segregation of duties such that people with powers and knowledge in making amendments to the application programs should not have the responsibility for initiation and processing transactions and even making amendments to existing data.

■ 2. Application controls

The objective of application controls which may be manual or programmed is to ensure completeness and accuracy of accounting records and the validity of transactions processed.

Application controls are therefore important in providing assurance that all transaction are recorded on timely basis and that only valid transactions are captured by the system. Application controls are divided into;

1. Input controls.
2. Processing controls.
3. Output controls
4. Controls over master files and standby data

However, some of the controls management implement would cut across the four categories mentioned above. E.g. some edit checks could provide comfort over the completeness and accuracy of the input data by the way the data is processed and output information obtained and also provide protection over standby data.

Input controls.

Most errors in data processed by computerized information systems can be traced to errors made when the data was being input into the system. Controls over input fulfill the following objectives.

Completeness of input. This ensures that all transactions that took place have been processed.

Accuracy. This ensures that the recorded transactions have been captured accurately.

Validity. This ensures that only valid or genuine transactions appropriately authorized have been recorded. It also ensures credibility and reliability of recorded transactions.

To achieve the above objectives the most common types of input controls that management can implement are called edit controls and examples include:

Field checks. These controls check that all data fields required to process the transactions have been filled with correct information. The controls also ensure accuracy of processed data and its completeness because transactions cannot be properly processed if necessary data is missing.

Valid character checks. These check that data fields are filled with data of the correct type. E.g. that amounts column is filled with numerical variables. This also ensures correctness of input data.

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Substantive tests in computerized environment

Substantive testing of computer records is possible and necessary. The extent depends on the degree of reliance the auditor has placed on the internal controls. Substantive testing includes two basic approaches both of which would be used.

Manual testing techniques.

- Review of exception reports. The auditor attempts to confirm these with other data. e.g. comparison of an outstanding dispatch note listing with the actual dispatch notes.
- Totaling. Relevant totals for example for debtors and creditors can be manually verified.
- Re-performance. The auditor may re-perform a sample of computer generated calculations. E.g. for depreciation and interest expense.
- Reconciliations. These will include reconciliations for computer listings with creditor's statements, bank statements, actual stock and personnel records.
- Comparison with other evidence such as results of debtor's circularization, attendance at stock take and physical inspection of fixed asset.

Computer audit programs sometimes generalized audit software. These programs are also called inquiry or interrogation programs. Computer audit programs are computer programs used by the auditor to;

- Read magnetic files and to extract specified information from the files.
- To carry out audit work on the contents of the files.

Uses of computer audit programs.

- In the selection of representative or randomly chosen transactions or items for audit tests.
- The scrutiny of files and selection of exceptional items for testing. E.g. On wages payments over Shs.1000 or all stock items worth more than Shs.100,000 in total.
- Comparison of two files and printing out the difference. E.g. payrolls at two selected dates.
- Preparing exception reports. E.g. overdue debts.
- Stratification of data such as stock items or debtors with a view to examine only the material items.
- Carrying out detailed tests and calculations.
- Verifying data such as stock or fixed assets at the interim stage and then comparing the examined file with the end file so that only changed items need to be examined at the final audit.

The Control file

When auditing computerized information systems, it will be found that much reliance is placed within the system upon standard forms and documentation in general, as well as upon strict adherence to procedures laid down. This is no surprise, of course, since the ultimate constraining factor in the system is the computers own capability and all users are competitors for its time. It is therefore important that an audit control file be built as part of working papers and the auditor must that he is on the distribution list for notifications of all new procedures, documents and system changes in general.

**iv. Scope paragraph**

This paragraph is a factual statement about what the auditor did in the audit. This paragraph states how the audit was planned and performed in accordance with ISAs and states that the audit is designed to obtain reasonable assurance whether the financial statements are free of material misstatements.

v. Opinion paragraph

This final paragraph states the auditors conclusions based on the results of the audit. This part of the report is so important that often the audit report is simply called the auditor's opinion. The opinion paragraph is stated as an opinion rather than a statement of absolute fact or a guarantee.

vi. Audit report date

The appropriate date for the report is the one on which the auditor has completed the most important audit procedures in the field. This date is important to users of financial statements as it indicates the last day of auditor's responsibility for review of significant events that have occurred after date of financial statements.

vii. Name of audit firm

The firm's name is used because the entire firm has the legal responsibility to ensure that the quality of audit meets professional standards.

Types of audit opinions

- a. Unqualified opinion.
- b. Disclaimer opinion
- c. Qualified opinion
- d. Adverse opinion

a) Unqualified opinion.

This is issued when the auditor is satisfied in all material aspects that enable him express the required opinion on financial statements without any reservation. This is sometimes called a clean opinion. It is expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the relevant financial reporting standards.

Emphasis on matter report

There are occasions when the auditor has no reservation as to the financial statements but where they exists unusual events, conditions or accounting policies and he feels that unless the reader may not reach a proper understanding of the financial position and results. In such circumstances, the auditor should express an unqualified opinion including an extra paragraph called 'emphasis of the matter paragraph' to draw attention of the reader to the unusual matter.

The addition of such an emphasis of matter paragraph does not lead to a qualification of the audit



Examples

- (i) Disagreement on Accounting Policies- Inappropriate Accounting method – Qualified Opinion

'We have audited(remaining words are the same as illustrated in the introductory paragraph of the unqualified report above.)

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph of the unqualified report above).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, isn't in accordance with International Accounting Standards. The provision for the year ended December 31, 20x1 should be based on the straight line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly the non current assets should be reduced by the accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx respectively.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and (remaining words are the same as illustrated in the opinion paragraph of the unqualified report above).

- (ii) Disagreement on Accounting Policies – inadequate disclosure - qualified opinion

'We have audited ... (remaining words are the same as illustrated in the introductory paragraph of the unqualified report above).

We conducted our audit in accordance with.. (remaining words are the same as illustrated in the scope paragraph of the unqualified report above).

On January 15, 2007, the company issued debentures in the amount of xx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 20x1. In our opinion, disclosure of this information is required by (Insert reference to statutory or regulatory requirement).

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph of the unqualified report above).

- (iii) Disagreement on Accounting Policies – inadequate disclosure – adverse opinion

We have audited ... (remaining words are the same as illustrated in the introductory paragraph of the unqualified report above).

We conducted our audit in accordance with.. (Remaining words are the same as illustrated in the scope paragraph of the unqualified report above).

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair of (or do not 'present fairly') the financial position of the company as at December 31, 20x1, and of result of its operations and its cash flows for the year then ended in accordance with (insert relevant IASs or national standards) .. And do not comply with (Insert relevant statutes or law).

Effects of disagreements on auditor's opinion

When the auditor concludes that the effect of the matter giving rise to disagreement is so fundamental that the financial statements are misleading, the auditor should issue an adverse opinion.

If the nature of the disagreement is material but not fundamental, the auditor should issue a qualified opinion indicating that all other aspects of the financial statements are okay except for the matter giving rise to the disagreement.

Material but not pervasive

The auditor may not include qualifying remarks in his audit report unless the matter is material. Material but not pervasive means that the reservation the auditor has is material in the context of a segment of the financial statements but not to the financial statements taken as a whole.

Material and pervasive

A matter becomes material and pervasive when it is material in the context of the financial statements taken as a whole. A limitation of scope becomes pervasive when it makes the financial statements misleading for decision making purposes or of little value for decision making purposes. A disagreement becomes pervasive when it makes the financial statements taken as a whole to be totally misleading.

Qualification matrix

Nature of circumstance	Material but not significant	Fundamental
Limitation of scope or uncertainty	Qualified opinion (except for opinion)	Disclaimer of opinion
Disagreement	Qualified opinion (except for opinion)	Adverse opinion

Going Concern (ISA 570)

The going concern concept is a fundamental concept of IAS 1 (disclosure of accounting policies) which governs the preparation and presentation of financial statements. This concept states that the transactions and the financial statements have to be recognized and prepared in such a way that the entity shall continue with operations for the foreseeable future period and shall not cease to be in existence, stop or curtail its present production either currently or in the near future.

The auditor when reporting on the financial statements is categorically concerned of the going concern concept because;

- It affects true and fair view of the financial statements
- It facilitates qualification of audit reports.
- It confirms compliance of financial statements with the generally accepted accounting principles and policies.
- The auditor's main interest will be that all material matters affecting the financial statements have been disclosed.

If fundamental accounting principles governing the financial statements have been properly observed in all material aspects, the financial statements presented show a true and fair view.

c) Disclaimer of opinion

This is issued when the possible effect of a limitation on scope or uncertainty is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and as a result he is unable to express an opinion on the financial statements. A disclaimer of opinion implies that the auditor is unable to form an opinion because sufficient audit evidence could not be obtained.

d) Adverse opinion

This is expressed when the effects of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. The auditor states that due to the nature of the disagreement in his opinion the financial statements do not show a true and fair view.

e) Limitation of scope

If for any reason the auditor is unable to receive all the information and explanation he deems necessary for the purposes of his audit then there has been a limitation in the scope of his work. It means that the auditor is unable to conclude objectively.

QUIZ

1. List the different types of Audit opinions.
2. List the basic elements of the audit report.
3. List the factors that lead to the qualification of an audit Report.

QUESTION THREE

The Companies Act (Cap.486) sets out the duties of the auditors for a company in respect of his report and other matters.

Required:

- a. State four situations under which the Act requires auditors to qualify their report.
- b. State two circumstances in which the auditors may qualify their report owing to inherent uncertainty.
- c. State four types of circumstances in which the auditors may qualify their report as a result of disagreement with the directors

QUESTION FOUR

An extract from the draft audit report produced by an audit junior is given below:

Basis of Opinion

'We conducted our audit in accordance with Auditing Standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of all the estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.'

'We planned and performed our audit so as to obtain as much information and explanation as possible given the time available for the audit. We confirm that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the company's annual report.'

Required:

Identify and explain the errors in the above extract.

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- Whether in their opinion and to the best of their knowledge and according to explanations given to them financial statements give information required by companies act in the manner so required and give the true and fair view.
- In the balance sheet, the state of affairs at the end of its financial year. In the profit and loss account, the profit or loss for the year.

QUESTION TWO

(a) Reliance on work of internal auditors

As requested, the external auditors will seek to rely on the work of internal audit to the maximum extent possible. This might cover planning, risk assessment, tests of controls and substantive testing.

In all cases, the external auditor should be aware that the purpose of internal audit's work will not be primarily directed towards the financial statements.

In relation to the cyclical audit of internal controls, it may be possible to rely on the work of internal audit in relation to all of the areas noted, but only if the internal controls audited affect the financial statements. It may be that internal audit's work on operations and customer support is less relevant than its work in other areas.

In relation to the four-year review of internal controls – the extent of reliance will depend on how long ago the last review was conducted. If it was conducted recently, it will provide help in relation to the external auditor's assessment of the accounting and internal control systems.

In relation to risk management – the relevance of internal audit work depends on the extent to which risks in relation to reporting in general and the financial statements in particular, have been addressed separately by management. This work will be relevant to the external auditor's risk assessment and planning.

(b) Information required

- (i) The information required to determine the extent of external audit reliance on internal audit's cyclical audit will be:

Internal audit's systems documentation (the work on information systems and finance may include documentation of the company's accounting and internal control systems);

Internal audit's planning documentation which may cover a risk analysis, tests of controls and substantive procedures;

The results of tests of control and substantive procedures;

Documentation on the four-year review of internal controls, particularly in relation to the finance and information services functions.

- (ii) The external auditors should ask to see all documentation relating to the work performed by internal audit on information services restructuring during the year because the external auditor's assessment and testing of systems will be split into two parts, pre- and post-restructuring.
- (iii) Other documentation requested will include internal audit's operating procedures manuals and documentation relating to the recruitment, training and development of internal audit staff, and management responses to internal audit recommendations. This information is required to enable the external auditor to form an opinion on the competence and effectiveness of the internal audit function.

(c) Circumstances in which it would not be possible to rely on the work of internal audit

- (i) It may not be possible to rely on the work of internal auditors if they:
- Are not competent (this relates to experience as well as qualifications).

QUESTION TWO

Report to audit committee

Inventory control and Sales System

Seed division

12 June 2007

The internal audit of the inventory and sales system identified the following weaknesses:

Weakness	Potential effect of weakness	Recommendation
Recording of orders. Orders placed on the internet site are transferred manually to the inventory and sales system. Manual transfer of order details may result in information being transferred incompletely or incorrectly. E.g. order quantities may be incorrect or the wrong product code recorded.	Customers will be sent incorrect goods resulting in increased customer complaints.	The computer systems should be amended so that order details are transferred directly between the two systems. This will remove manual transfer of details limiting the possibility of human error.
Control over orders and packing lists. Each order/packing list is given a random alphabetical code. While this is useful, using this type of code makes it difficult to check completeness of orders at any stage in the dispatch and invoicing process.	Packing lists can be lost resulting either in goods not being dispatched to the customer or the customer's credit card not being charged.	Order/packing lists are controlled with a numeric sequence. At end of each day sales in the sequence of packing lists are investigated.
Obtaining payment The customer's credit card is charged after dispatch of goods to the customer, meaning that goods are already sent to the customer before payment is authorized.	Rhapsody Co will not be paid for the goods dispatched where the credit card company rejects the payment request. Given that customers are unlikely to return seeds, Rhapsody will automatically incur bad debts.	Authorization to charge the customer's credit card is obtained prior to dispatch of goods to ensure Rhapsody Co is paid for all goods dispatched.
Completeness of orders. The computer system correctly ensures that order details are available for all charges to customer credit cards. However, there is no overall check that all orders recorded on the inventory and sales system have actually been invoiced.	Entire orders may be overlooked and consequently sales and profit understated.	The computer is programmed to review the order file and orders where there is no corresponding invoice for an order; these should be flagged for subsequent investigation.



All networked systems are also subject to the risk of error because of the possibility of the loss or corruption of data in transit. They are also subject to the risk of fraud where the transmission of data is not securely encrypted.

All entities that employ staff who handle company assets (such as receipts from customers) are subject to the risk that staff may make mistakes (error) or that they may misappropriate those assets (fraud) and then seek to hide the error or fraud by falsifying the records.

Stone Holidays is subject to problems arising from the risk of fraud perpetrated by customers using stolen credit or debit cards or even cash. Whilst credit card companies may be liable for such frauds, attempts to use stolen cards can cause considerable inconvenience.

There is a risk of fraud perpetrated by senior management who might seek to lower the amount of money payable to the central fund (and the company's tax liability) by falsifying the company's sales figures, particularly if a large proportion of holidays are paid for in cash.

There is a risk that staff may seek to maximize the commission they are paid by entering false transactions into the computer system that are then reversed after the commission has been paid.

QUESTION TWO

External auditors: fraud and error in an audit of financial statements

External auditors are required by ISA 240 to consider the risks of material misstatements in the financial statements due to fraud. Their audit procedures must then be based on a risk assessment. Regardless of the risk assessment, auditors are required to be alert to the possibility of fraud throughout the audit and maintain an attitude of professional skepticism, notwithstanding the auditors' own experience of the honesty and integrity of management and those charged with governance. Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements due to fraud.

Auditors should make enquiries of management regarding management's assessment of fraud risk, its process for dealing with risk, and its communications with those charged with governance and employees. They should enquire of those charged with governance about the oversight process.

Auditors should also enquire of management and those charged with governance about any suspected or actual instance of fraud.

Auditors should consider fraud risk factors, unusual or unexpected relationships, and assess the risk of misstatements due to fraud, identifying any significant risks. Auditors should evaluate the design of relevant internal controls, and determine whether they have been implemented.

Auditors should determine an overall response to the assessed risk of material misstatements due to fraud and develop appropriate audit procedures, including testing certain journal entries, reviewing estimates for bias, and obtaining an understanding of the business rationale of significant transactions outside the normal course of business. Appropriate management representations should be obtained.

Auditors are only concerned with risks that might cause material error in the financial statements. External auditors might therefore pay less attention than internal auditors to small frauds (and errors), although they must always consider whether evidence of single instances of fraud (or error) are indicative of more systematic problems.

It is accepted that because of the hidden nature of fraud, an audit properly conducted in accordance with ISAs might not detect a material misstatement in the financial statements arising from fraud. In practice, routine errors are much easier to detect than frauds

Where auditors encounter suspicions or actual instances of fraud (or error), they must consider the effect on the financial statements, which will usually involve further investigations. They should also consider the need to report to management and those charged with governance.

Where serious frauds (or errors) are encountered, auditors need also to consider the effect on the going concern status of the entity, and the possible need to report externally to third parties, either in the public interest, for national security reasons, or for regulatory reasons. Many entities in the financial services sector are subject to this type of regulatory reporting and many countries have legislation relating to the reporting of money laundering activities, for example.

QUESTION THREE

Materiality. A matter is material if its inclusion or omission will affect the decision reached by the user of the account and if they affect the view of the account. Whether an item is material may depend on the degree of approximation of item of which it is a part. There may be critical points 'when materiality can be important, for example in turning a small profit into a small loss or just making a company's assets exceed its liabilities or reversing a trend.

Duty of confidentiality. The guide to professional ethics states that information acquired in the course of professional work should not be disclosed except consent has been acquired from client or where there is public duty to disclose or where there is a legal or professional duty or right to disclose. A member acquiring information in the course of professional work should neither use nor appear to use that information for his personal advantage or for the advantage of a third party.

Professional indemnity insurance. There is a tendency to sue the auditor knowing that he will not have to pay but his insurer will. The auditor seeks to pay some premiums to an insurance firm so that in case of any suit filed against him the insurer can pay. The effect of this is that the insurer will insist on reasonable skill and care on the part of the insured.

Peer review may be described as an independent review of a firm's accounting and auditing practices. It is intended that the review be done by practitioners upon fellow practitioners hence the term "peer review". The work of the review is limited to:-

- Professional aspects of the practice.
- Overall total quality control policies.

Quality control; Audits should be extremely well done and yet be completed expeditiously and economically. The auditor should ensure that audits are carried out.

In accordance with international accounting standards.

In conformity with statutory and contractual requirements.

In accordance with ethical standards.

In agreement with any professional standards set out by the firm and by other professional bodies.

Economically and to time schedules with minimum risk.

to differentiate between elements of a population which may be subject to differing internal controls.

Disadvantages

There is always a risk that the auditor's sample is not representative of the population as a whole (known as 'sampling risk'). Auditors calculate and accept this risk, and perform other procedures to compensate for it, but it always remains a risk.

Sampling relies on the use of judgment in relation to materiality, exceptions, and in drawing conclusions, for example. Judgment can be abused, or simply fail, particularly where staff are inexperienced.

3. Tests of controls

Advantages

Tests of controls enable the auditor to establish whether a control system in operation is effective. If properly designed controls are operating as prescribed, auditors can reduce the level of substantive testing required at the period-end.

Tests of controls mean that auditors do not have to concentrate all of their efforts on substantive procedures at the period-end which would in many cases be impractical, inefficient and not cost-effective.

Disadvantages

Tests of controls are often performed on a sample basis (disadvantages noted above).

Tests of controls are often performed on routine transactions for which there are high quality automated controls. The very high risk areas in financial statements are often outside this area and relate to non-routine transactions and more intangible environmental or general controls which are not easy to test.

4. Detailed testing of transactions and balances

Advantages

Detailed testing enables the auditors to form a view as to whether the figures on which he is reporting are fairly stated and often involves third party, written confirmation which is a good source of audit evidence.

In detailed testing of transactions and balances, auditors are directly examining the figures and assertions that appear in the financial statements.

Disadvantages

Detailed testing of transactions and balances is often performed on a sample basis (disadvantages noted above).

The level of testing of transactions and balances is determined by the level of comfort obtained by the auditor from tests of controls. If too much comfort has been obtained from tests of controls, it is likely that any error will be compounded by an inadequate level of testing of transactions and balances.

5. Computer assisted audit techniques (CAATs)

Advantages

CAATs reduce the level of human error in testing and enable a very high level of audit evidence to be derived.

The use of CAATs frees up expensive human resources that would otherwise be engaged in routine, mechanical work to concentrate on judgmental areas.

CAATs enable the auditors to test a large volume of data, or the operation of the controls in a system, accurately and quickly. They are therefore very-cost efficient when operated properly.

Disadvantages

CAATs are expensive to set up and require the co-operation of the client. It is usually necessary for a continuing audit relationship to be present before it is worth committing the audit resources.



Major changes in client systems often require major changes in CAATs which is expensive. If the audit fee is based on the assumption that the prior year's CAATs can be used, and a change is made without warning, the client may have unrealistic expectations about the level of service that can be provided for the fee.

(b) Relationship between the methods of evidence gathering

Analytical procedures are often first used during the planning stage of the audit. Materiality levels and levels of tolerable error are often derived (at least in part) from analytical procedures. These are in turn used in audit sampling procedures.

Analytical procedures help the auditor determine the audit approach (the levels and areas for tests of controls and detailed testing).

The results of tests of controls determine the level of detailed testing of transactions and balances. Analytical procedures provide indirect evidence as to the effective operation of internal controls (if controls are working, analytical procedures may help prove that the population as a whole is fairly stated).

Detailed tests of transactions and balances are often performed towards the end of the audit in conjunction with analytical procedures – analytical procedures compensate to an extent for the weaknesses in sampling procedures both for tests of controls and detailed testing of transactions and balances (and vice versa).

Sampling is used for both tests of controls and detailed testing of transactions and balances. Where CAATs are used, sampling may not be necessary because CAATs can often be used to test the whole population, either for tests of controls, or for detailed testing of transactions and balances.

QUESTION FIVE

- a) Management representations are a form of audit evidence. They are contained in a letter, written by the company's directors and sent to the auditor, just prior to the completion of audit work and before the audit report is signed.

Representations are required for two reasons:

Firstly, so the directors can acknowledge their collective responsibility for the preparation of the financial statements and to confirm that they have approved those statements.

Secondly, to confirm any matters, which are material to the financial statements where representations are crucial to obtaining sufficient and appropriate audit evidence.

In the latter situation, other forms of audit evidence are normally unavailable because knowledge of the facts is confined to management and the matter is one of judgment or opinion.

Obtaining representations does not mean that other evidence does not have to be obtained. Audit evidence will still be collected and the representation will support that evidence. Any contradiction between sources of evidence should, as always, be investigated.

(b) Lack of representation letter

The auditor may take the following actions:

Discuss the situation with the directors to try and resolve the issue that the directors have raised. The auditor will need to explain the need for the representation letter again (and note that the signing of the letter was mentioned in the engagement letter).

Ascertain exact reasons why the directors will not sign the letter. Consider whether amendments can be made to the letter to incorporate the directors' concerns that will still provide the auditor with appropriate and sufficient audit evidence.

- e. Factor to consider before relying on work of an expert
- The skills and competence of the expert. This is done by considering the expert's professional qualifications, membership to appropriate professional bodies, experience and reputation in the field the auditor is seeking evidence.
 - Objectivity and independence of the expert. The risk of impairment increases when the expert is employed by the client or where he is related financially with the client.
 - The sources of data used by the expert in arriving at his opinion. If the sources can be regarded as reliable, the auditor can reasonably use the work of the expert as audit evidence.
 - The assumptions and methods used by the expert. These should be reasonable and appropriate to the circumstances.

QUESTION TWO

- (a) Sampling risk is the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion reached if the entire population were subjected to the audit procedure.

The auditor may conclude from the results of testing that either material misstatements exist, when they do not, or that material misstatements do not exist when in fact they do. Sampling risk is controlled by the audit firm ensuring that it is using a valid method of selecting items from a population and/or increasing the sample size.

Non-sampling risk arises from any factor that causes an auditor to reach an incorrect conclusion that is not related to the size of the sample.

Examples of non-sampling risk include the use of inappropriate procedures, misinterpretation of evidence or the auditor simply 'missing' an error.

Non-sampling risk is controlled by providing appropriate training for staff so they know which audit techniques to use and will recognize an error when one occurs.

- (b) The audit manager suggests checking all invoices, effectively ignoring any statistical sampling; in other words this is not statistical sampling. Audit tests will be applied to all of the sales invoices. This approach may be appropriate for the audit of Tam because:
- The population is relatively small and it is likely to be quicker to test all the items than spend time constructing a sample.
 - All the transactions are not large but could be considered material in their own right, e.g. compared to project. As all the transactions are material, then they all need to be tested.

The audit senior suggests using statistical sampling. This will mean selecting a limited number of sales invoices from the population using probability theory ensuring a random selection of the sample and then applying audit tests to those invoices only. This approach may be appropriate because:

- The population consists of similar items (i.e. it is homogeneous) and there are no indications of the control system failing or changing during the year. There is the query about how long it will take to determine and produce a sample, which may make statistical sampling inappropriate in this situation.

- Reviewing the list of employees paid each week/month and printing a list of employees, who have not been paid, for further investigation.
 - Detecting unreasonable items: Reviewing the list of net wages for large or negative payments.
 - Detecting violation of system rules: For example, where other people besides the accountant have been overriding overtime payments or employees amending their own gross wages.
 - Conducting new analysis as part of the analytical review of wages. For example, calculating total wages for the year from the number of employees and average wages paid.
 - Completeness checks – ensuring there is an electronic record of all employees who ‘clocked in’ for a day’s work and ‘clocked out’ again.
- (c) Audit test data consists of data submitted by the auditor for processing on the client’s computer-based accounting systems.

The data can be processed during a normal processing run (a ‘live’ testing situation) or in a special run outside of the normal processing cycle (a ‘dead’ testing situation).

In Walsh, the auditor can create a ‘dummy employee’ record on the wages master file, and then use a magnetic card to mimic that employee working a certain number of hours in the company over the course of, for example, one week.

Knowing how many hours has been input into the wages system; the auditor can calculate the expected net pay and then compare this to the actual net pay produced by the computer system.

If the amounts agree then this provides appropriate audit evidence of the accuracy of recording and processing of the wages software.

The problems of using this audit technique include:

- The possibility that the client’s computer system will be damaged by the testing being undertaken by the auditor. For example, by errors being caused by entering data that the client’s software cannot process.
- The need to reverse or remove any transactions input by the auditor. The transactions may be incorrectly or incompletely removed leaving dummy data in the client’s live computer system.
- Use of test data can be expensive – the auditor needs to ensure that the benefit gained from the test outweighs the expense. In this situation, it will take a long time to input employee details and there may be more efficient audit tests available.



CHAPTER 10: AUDIT TESTS

QUESTION ONE

a) Shortcomings

- There is no check that expenses claimed by salesmen claimed by salespersons were actually expended. Invoices just need to be presented for payment to be made without a third party confirmation. This is appropriate because invoices can be falsified.
- There is no check that the expenses were properly incurred by salespersons in carrying out their duties.
- The deputy chief accountant could easily perpetrate fraud alone or with collusion with the salespersons as no one verifies her work.

Improvements

- Each salesperson should complete a weekly log showing, mileage covered and calls made. The logs and expense claims should be submitted to sales manager who should check and sign the log before passing it to the deputy chief accountant.
 - At intervals, a member of the accounts staff should verify that claimed mileage is consistent with mileage shown on the car's odometer.
 - The directors should verify that complete and signed documentation is attached to and is consistent with the cheques presented to the. They should then cancel the presented documents to prevent a second presentation.
- b). Tests of control are those tests which seek to provide audit evidence that internal control procedures are being properly applied throughout the period under review. Tests of control that could be performed are;
- Select a sample of the payments and obtain the related documentation. Verify that each claim is fully supported by vouchers and the additions are correct.
 - Examine the cheques made to the salespersons and verify that they are made out properly and are properly signed. This may form part of the audit of the bank transactions.
- c)
- Inform management verbally immediately and in writing in the management letter.
 - Consider whether the discovery casts doubt on the effectiveness of the system hence whether further audit tests may be required.
 - Consider whether the discovery casts doubt on the company records in general and hence whether further audit procedures may be necessary in selected areas.

QUESTION TWO

a)

1. Safety of unclaimed wages.

- Misappropriation of unclaimed wages.
- The money being used to write off debtors accounts.
- Use of the cash as petty cash and buying office items not authorized.
- Double payments to already paid workers through collusion with clerk.

- Inventories may be high risk if they are valuable, and/or easily portable. The valuation of inventories is a matter requiring the exercise of judgment, which means that inventories are sometimes used to manipulate the appearance of both the income statement and the balance sheet.
- In the income statement, there is a direct relationship between the inventory figure and the profit for the period. If closing inventories are overstated, profits will be overstated.
- Many key accounting and performance ratios are calculated using the inventory figure. These include inventory turnover, inventory days, the current ratio and working capital ratios. Many companies use these ratios for internal purposes and many third parties, such as investment analysts, also use these figures to assess performance.
- Poor inventory control will be reflected in inventory figures at the period-end. For many companies, excess inventory is a sign of serious problems.
- Some significant cases of litigation against auditors have involved the alleged overstatement of inventories in financial statements of companies where the auditors have issued an unqualified audit report before the company has been taken over.
- There is sometimes relatively little audit evidence for the inventory figure, particularly for small companies and it is therefore important for auditors to scrutinize the evidence available carefully and consider the scope for misstatement or deliberate manipulation of the inventory figure.

(b) Cost and net realizable value

- IAS 2 requires that cost comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
- Costs of purchase include the purchase price, import duties and other taxes, transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and similar items are deducted.
- Costs of conversion include costs directly related to units of production such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials to finished goods.
- Fixed production overheads are indirect costs of production that remain relatively constant regardless of the volume of production such as depreciation, the maintenance of factory buildings and equipment and the cost of factory management and administration. The allocation of fixed overheads is based on a normal level of production.
- Variable production overheads vary directly, or nearly directly, with the volume of production and include indirect materials and labour. The allocation of variable overheads is based on actual levels of production.
- Other costs might include the costs of designing products for specific customers and borrowing costs, which may be included in certain circumstances.
- Costs not included are storage costs, unless these are necessary to the production process prior to completion, general administrative overheads and selling costs.
- Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale, such as advertising costs.

(c) Audit evidence

- The costs of purchase for a furniture manufacturing company will include purchase costs such as the cost of timber, metals, fabrics, fillings and adhesives.
- These costs can be checked on a sample basis from the inventory records through to the daybooks, ledgers and purchase invoices, ensuring that the correct amounts have been recorded in the correct period.

Control policies and procedures Control activities are the policies and procedures that help ensure management directives are carried out. Those pertinent to an audit include performance reviews, information processing, physical controls and segregation of duties.

Control risk The risk that material error in a balance or transaction class will not be prevented or detected on a timely basis by internal controls.

Corroborate (corroborating) (corroboration) (corroborative) To strengthen with other evidence, to make more certain.

Cumulative effect of changing to a new accounting principle is the effect on retained earnings at the beginning of the current period. It is included in net income after extraordinary items. Only the direct effect (net of income tax effect) is considered.

Cutoff Designating a point of termination. An auditor uses tests of cutoff to obtain evidence that transactions for each year are included in the financial statements of the appropriate year.

Detection risk The risk audit procedures will lead to a conclusion that material error does not exist when in fact such error does exist.

Detective control A control designed to discover an unintended event or result.

Disclosure Revealing information. Financial statement footnotes are one way of providing necessary disclosures.

Discovery sampling Acceptance sampling (sampling to determine whether internal control compliance is greater than or less than the tolerable deviation rate) when the expected attribute occurrence rate is zero.

Document (documentary) (documentation) Written or printed paper that bears information that can be used to furnish decisive evidence. Could also be a recording, computer readable information, or a photograph.

Edit check reasonableness, validity, limit, and completeness tests that are programmed routines designed to check input data and processing results for completeness, accuracy and reasonableness.

Effective internal control Reasonable assurance that the entity's operational objectives are achieved, that published financial statements are reliably prepared, and applicable laws and regulations are complied with.

Effectiveness Producing a desired outcome. An audit procedure is effective if the evidence supports a correct conclusion.

Efficiency The ratio of the audit evidence produced to audit resources used.

Engagement letter A letter that represents the understanding about the engagement between the client and the CPA. The letter identifies the financial statements and describes the nature of procedures to be performed. It includes an explanation of the objectives of the procedures, an explanation that the financial information is the responsibility of the company's management, and a description of the form of report.

Error Unintentional misstatements or omissions in financial statements. Errors may involve mistakes in gathering or processing accounting data, incorrect estimates from oversight or misinterpretation of facts, and mistakes in application of principles relating to amount, classification, presentation or disclosure.

Estimation sampling is sampling to estimate the actual value of a population characteristic within a range of tolerable misstatement.

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