

# ***FUNDAMENTALS AND PRINCIPLES OF AUDIT***

## **1.0 LEARNING OBJECTIVES**

After studying this chapter, readers will be able to:

- ◆ Appreciate fundamental principles of auditing.
- ◆ Develop auditing skills and applicable techniques.
- ◆ Understand the concepts of audit independence, objectivity, integrity, confidentiality, due care and competence.
- ◆ Understand the concept of true and fair view associated with expressing an audit opinion.

## **1.1 INTRODUCTION**

This chapter covers fundamentals and principles of auditing. Readers will be acquainted with the various concepts of auditing, develop auditing skills and explore various techniques required for effective financial statement audit.

The auditor may be engaged to perform statutory and non-statutory roles of auditing. In this regard, the professional body to which an accountant belongs sets out the fundamental principles expected to guide his conduct in rendering services to his varied clients. The guidance is contained in a set of rules usually referred to as “Code of Ethics for Members.” The Code when taken with the ethical guidance issued by the professional bodies, for example, the “Rules of Professional Conduct for Members” issued by The Institute of Chartered Accountants of Nigeria, ensure that the professional accountant maintains the highest quality of performance and public confidence in the profession.

The auditor also needs to ensure compliance with the accounting and auditing standards in the discharge of his professional duties. There are sanctions for erring members, ranging from loss of membership status in grievous cases, to reprimands and fines on non-grievous cases.

The auditor should have good knowledge of auditing techniques, their limitations, audit evidence and documentation. The use of auditing techniques, audit evidence and proper documentation enable the auditor to accomplish his or her statutory (or other) roles in a manner that leaves other professionals who may need to review or evaluate his working papers in no doubt as to the nature of work done, actually meeting professional standards and really supporting the audit opinion.

The need for strict adherence to ethical rules and guidance on independence, objectivity, integrity, confidentiality, skills, due care and competence enable the auditor to act in a professional manner and earns the auditor the respect of the investing public and entrepreneurship. It also enables the auditor to moderate his or her conduct, on regular basis, so as not to run foul of the regulations of his professional bodies, as well as the law. A recent development is the passing of a law under which a professional accountant, whether in practice or in business, who fails to see to proper compliance with accounting standards in Nigeria, may, on conviction, be fined or jailed.

The concepts of true and fair view, materiality and judgement guide the auditor in the conduct of his assignment. The concepts help the auditor to know the level and quantum of the transactions and balances to which he should pay attention, and matters which need to be considered in the expression of opinion.

## **1.2 DEVELOPMENT AND OBJECTIVES OF AUDIT**

### **Auditing**

Auditing is broadly defined as a systematic process of objectively obtaining and evaluating evidence in respect of certain assertions about economic actions and events, to ascertain the degree of correspondence between those assertions and established criteria and reporting the results to interested parties.

Auditing usually covers a particular period of time. Auditing may be narrowly defined as a written report on the examination of financial statements for a particular period of time.

### **Independent auditing**

The International Federation of Accountants (IFAC), recognising the responsibilities of the accountancy profession and considering its own role to be that of providing guidance, encouraging continuity of efforts and promoting harmonisation, has deemed it necessary to establish an international “Code of Ethics for Professional Accountants” to be the basis on which the ethical requirements (code of ethics, detailed rules, guidelines, standards of conduct, etc.) for professional accountants in each country should be based.

In Nigeria, the auditor is expected to comply with the ‘Rules of Professional Conduct for Members,’ issued by The Institute of Chartered Accountants of Nigeria.

The Auditors’ Code 011 titled ‘Fundamental Principles of Independent Auditing’ published by the Auditing Practices Board (APB) in the United Kingdom sets out the fundamental principles expected to guide the conduct of auditors in rendering services to their varied clients. The Code when taken with the ethical standards issued by the professional bodies to which the auditor belongs (for example, the Code of Conduct issued by The Institute of Chartered Accountants of Nigeria) and if regularly followed, ensure that the professional accountant maintains the highest quality of performance and public confidence.

The Auditors' Code describes 'independent audit' as providing reasonable assurance that published audited financial reports are free from material misstatement and are in accordance with legislation and relevant accounting standards.

The Nigerian Accounting Standards Board (NASB) is charged with the responsibility of developing and publishing accounting standards to be observed in the preparation of financial statements in Nigeria. The Companies and Allied Matters Act makes it mandatory for auditors to ensure that the financial statements prepared in Nigeria comply with the accounting standards issued by the NASB. The Nigerian Accounting Standards Board Act, 2003 further seeks to promote and enforce compliance with the accounting standards to be observed in the preparation of financial statements.

It is noteworthy to mention that users have much confidence in the audited financial reports, bearing the seal of a Chartered Accountant. Auditors add to the reliability and quality of financial reporting. The reports of the auditors add credibility to the financial information prepared and published by the directors or officers of an entity.

The auditor also prepares a management report which contains matters which have come to his attention in the course of the assignment, together with recommendations for improvement in the internal control and business of the company. The management report, also called domestic report, is normally addressed to the directors of the company.

### **Fundamental principles of independent auditing**

The Auditors' Code, published by APB, prescribes nine fundamental principles of independent auditing, as follows:

- (a) **Accountability**  
Auditors act in the interests of primary stakeholders, whilst having regard to the wider public interest.

The identity of primary stakeholders is determined by reference to the statute or agreement requiring an audit: in the case of companies, the primary stakeholders are the general body of investors.

- (b) **Integrity**  
Auditors should act with integrity, discharging their responsibilities with honesty, fairness and truthfulness. Integrity helps to insulate auditors from matters of conflict of interests and elevate their objectivity.

Confidential information obtained in the course of the audit is disclosed only when required in the public interest, or by operation of law.

- (c) **Objectivity and independence**  
Auditors should be seen to be objective in all their dealings with their clients. They express opinions independent of the entity and its directors.

- (d) **Competence**  
This is the ability to carry out professional duty with great knowledge and skills. Auditors should exhibit competence, derived from the acquired qualifications, training and practical experience. Auditing demands understanding of financial reporting and business issues, together with expertise in accumulating and assessing the evidence necessary to form an opinion.
- (e) **Rigour**  
Auditors approach their work with thoroughness and attitude of professional scepticism. This was emphasised in the famous pronouncement of Lord Dennins, which states that “an auditor is not a blood hound, but should approach his job with professional scepticism believing that someone, somewhere, has made a mistake and that a check needs to be carried out to ensure that no such mistake was made and this forms the whole essence of auditing.” Auditors assess critically the information and explanations obtained in the course of their work and such additional evidence as they consider necessary for the purpose of their audits.
- (f) **Judgement**  
Auditors apply professional judgement, taking account of materiality in the context of the matters on which they are reporting.
- (g) **Clear communication**  
Auditors’ reports contain clear expressions of opinion which are set out in writing for proper understanding.
- (h) **Association**  
Auditors allow their reports to be included in documents containing other information only if they consider that the additional information is not in conflict with the matters covered by their reports and that they have no cause to believe it to be misleading.
- (i) **Providing value**  
Auditors add to the reliability and quality of financial reporting. They provide to directors and officers constructive observations arising from the audit process, thereby contributing to the effective operation of the business entity.

**Objective and general principles governing the audit of financial statements.**

Auditing Practices Board’s Statement of Auditing Standard 100 titled ‘Objective and General Principles Governing an Audit of Financial Statements’ says that the “objective of an audit of financial statements is to enable auditors to give an opinion on those financial statements taken as a whole, and thereby provide reasonable assurance that the financial statements give a true and fair view

(where relevant) and have been prepared in accordance with relevant accounting or other requirements.”

The standard states the following matters which the auditor should consider in undertaking the audit of financial statements:

- (a) the auditor should carry out procedures designed to obtain sufficient and appropriate evidence in accordance with the auditing standards, determine with reasonable confidence whether the financial statements are free of material mis-statements;
- (b) evaluation of the overall presentation of the financial statements in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and
- (c) issuing of a report, containing a clear expression of the auditor’s opinion on the financial statements.

In Nigeria, financial statements are prepared with the objective that they present a true and fair view of the state of affairs of the entity and of the profit or loss for that period, and comply with the Companies and Allied Matters Act, CAP C20, LFN 2004.

In the preparation of financial statements, there are inherent uncertainties and use of judgement in making accounting estimates and selecting appropriate accounting policies. Consequently, financial statements may be prepared in different ways and still present a true and fair view.

The auditor’s opinion adds credibility to the financial statements prepared by the directors. Users have reasonable assurance that the financial statements which carry the seal of the independent auditor, present a true and fair view of the state of affairs of the reporting entity. However, the user should not assume that the opinion of the auditor is a guarantee as to the future viability of the entity or an assurance that the efficiency or effectiveness with which management has conducted the affairs of the entity in one year will continue in future years.

### **Responsibility for the financial statements**

The directors are responsible for the preparation of financial statements which give a true and fair view of the state of affairs and of the profit or loss for that period. The directors should ensure that the financial statements comply with the provisions of the Companies and Allied Matters Act, Cap. C 20, LFN 2004.

The directors are obliged to ensure that:

- (a) Proper accounting records are maintained;
- (b) Internal control procedures are instituted which, as far as is reasonably possible, safeguard the assets, prevent and detect fraud and other irregularities;
- (c) Applicable accounting standards are followed;
- (d) Suitable accounting policies are adopted and consistently applied;
- (e) Judgements and estimates made are reasonable and prudent; and

- (f) The going concern basis is used, unless it is inappropriate to presume that the company will continue in business.

It is the responsibility of the auditors to form an independent opinion based on the audit of the financial statements and to report to the members thereon. The audit of the financial statements does not relieve the directors of any of their responsibilities on the financial statements.

### **Scope of Audit Assignment**

The auditor should consider the following matters in determining the scope of work:

- (a) The relevant statements of accounting standards;
- (b) The auditing standards;
- (c) The requirements of relevant professional bodies; and
- (d) Legislation, regulations and the terms of the audit engagement.

The auditor should note that although the basic principles of auditing are the same in the public and the private sectors, auditors of public sector often have wider objectives, additional duties and statutory responsibilities laid down in legislation, directives or codes of practice of the public sector entities.

### **Reasonable assurance**

The term 'reasonable assurance' is central to an independent audit, as certain degree of judgement has to be exercised in the conduct of the audit. The level of assurance which the auditor provides when reporting on financial statements may be regarded as reasonable in the particular context but cannot be taken to be absolute.

The auditor exercises judgement in the conduct of his work, especially on:

- (a) The gathering of evidence, particularly in deciding the nature, timing and extent of audit procedures; and
- (b) The drawing of conclusions based on the evidence gathered; particularly assessing the reasonableness of the estimates made by the directors in preparing the financial statements.

Due to the inherent limitations of any audit, the extent to which the risks that auditors take by giving inappropriate opinions on financial statements can be reduced or restricted. The limitations include those that may result from:

- (a) Inability of the auditor to examine all items within an account balance or class of transactions as it may not be cost effective to do so;
- (b) Inherent limitations which may be embedded in any accounting control system;
- (c) The possibility of management override, collusion or misrepresentation for fraudulent purposes; and
- (d) Audit evidence, in certain cases, being persuasive rather than conclusive.

At the planning stage of an audit, the auditor should take cognisance of the possibility that material mis-statement may exist and should plan to perform

the audit with that possibility in mind. In this regard, the auditor examines critically and with professional scepticism the information and explanations provided, and not assume that they are necessarily correct.

Auditors, in addition to audit risk, are exposed to loss or injury to their professional practice from litigation, adverse publicity or other events arising in connection with the financial statements that they have audited and reported upon. The audit risk and exposure are present even where the auditors have performed their assignments in accordance with the auditing standards and reported appropriately on those financial statements.

### **Ethical Principles**

In carrying out the audit of financial statements, auditors should comply with the ethical guidance issued by their relevant professional bodies. Ethics is more of a norm or a certain code of conduct expected of a group of individuals or a professional body. It dictates some degree of inward values expected of such groups of individuals or body.

The ethical principles which govern the auditors' professional responsibilities include:

- (a) Integrity;
- (b) Objectivity;
- (c) Independence;
- (d) Professional competence and due care; professional behaviour; and
- (e) Confidentiality.

In Nigeria, the auditor should comply with the 'Rules of Professional Conduct for Members' issued by The Institute of Chartered Accountants of Nigeria and the accounting standards issued by the Nigerian Accounting Standards Board. The 'Rules of Professional Conduct for Members' cover the following matters:

- (a) Fundamental principles;
- (b) Integrity, objectivity and independence;
- (c) Conflicts of interest;
- (d) Confidentiality;
- (e) Changes in professional appointment;
- (f) Consultancy;
- (g) Association with non-members;
- (h) Fees;
- (i) Obtaining professional work;
- (j) The names and letterheads of practising firms;
- (k) Second and other opinions;
- (l) Members in business; and
- (m) Enforcement of ethical standards.

### 1.3 AUDITING TECHNIQUES AND THEIR LIMITATIONS, AUDIT EVIDENCE AND DOCUMENTATION

#### **Audit Evidence**

“Audit evidence” means the information obtained by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence encompasses the quantity and quality (or reliability) of evidence to be obtained by auditors. It is important for auditors to obtain sufficient, appropriate and reliable audit evidence to enable them draw reasonable conclusions on which to base their audit opinion.

#### **Ways of obtaining audit evidence**

The APB Statement of Auditing Standard No. 400 covers ‘audit evidence’. The Standard provides guidance on the quantity and quality of evidence which auditors should obtain and the procedures for obtaining the evidence. Audit evidence may be obtained from:

- (a) An appropriate mix of tests of control and substantive procedures; and
- (b) Substantive procedures and enquiries made to ascertain the adequacy of the accounting system as a basis for the preparation of the financial statements.

An auditor should understand the following matters in relation to audit evidence:

- (a) The nature of audit evidence;
- (b) The sufficiency of audit evidence;
- (c) The appropriateness of audit evidence;
- (d) The evaluation of audit evidence; and
- (e) Reliability of audit evidence.

#### **The nature of audit evidence**

An auditor may use the following accounting data as sources of audit evidence to test audit objectives:

- (a) The books of original entry;
- (b) Related accounting manuals; and
- (c) Records, such as worksheets and spreadsheets which support the amounts in the financial statements.

In recent times, there is a growing awareness of accounting data being kept in the electronic form, but there are still cases of records kept manually. Audit evidence should be corroborated. Corroborating audit evidence includes both written and electronic information, for example;

- (a) Cheques;
- (b) Records of electronic transfers;
- (c) Invoices;
- (d) Contracts;
- (e) Minutes of meetings; and
- (f) Confirmations, and written representations.

### **Sufficiency of audit evidence**

Sufficiency is the measure of the quantity of audit evidence. The auditor at times relies on evidence that is persuasive rather than convincing in forming an opinion on a set of financial statements. Relying on persuasive evidence could be as a result of:

(a) **Cost considerations**

The auditor may examine a sample of the transactions that make up the account balances or class of transactions. Examination of **all** the transactions on a test basis would be convincing.

(b) **The nature of evidence**

The auditor may be presented with an inconclusive evidence which would be conclusive, when taken in conjunction with other ones.

Consequently, the auditor often seeks audit evidence from different sources or of a different nature to support the same assertion in order to provide reasonable, but not absolute, assurance that the financial statements are free from material mis-statement.

### **Appropriateness of audit evidence**

There is a relationship between sufficiency and appropriateness of audit evidence. Both sufficiency and appropriateness apply to audit evidence obtained from tests of control and substantive procedures. Appropriateness is the measure of the quality or reliability of audit evidence and its relevance to a particular assertion while sufficiency is the measure of the quantity of audit evidence.

The auditor's judgement as to what is sufficient and appropriate audit evidence is influenced by such factors as:

- (a) The auditor's assessment of the nature and degree of risk of mis-statement at both the financial statement level and the account balance or class of transaction level;
- (b) The nature of the accounting and internal control systems, including the control environment;
- (c) The materiality of the item being examined;
- (d) The experience gained during previous audits and the auditor's knowledge of the business and industry;
- (e) The findings from audit procedures, and from any audit work carried out in the course of preparing the financial statements, including indications of fraud or error; and
- (f) The source and reliability of information available.

Auditors should consider the implications of their inability to obtain sufficient appropriate audit evidence in their report.

### **The Evaluation of audit evidence**

An evidence is considered appropriate when it is both relevant and reliable

- (a) **Relevance:**  
A relevant audit evidence should relate to the audit objective being tested; and
- (b) **Reliability:**  
A useful audit evidence should be able to support the true state of an assertion or audit objective.

### **Tests of control**

Internal control is a means whereby an entity's board or entity's senior management obtains a reasonable assurance that the entity's set objectives are achieved. These constitute all management mechanisms such as approved authorisation process, policies and procedures that should be followed in fulfilling organisational objectives, in order to give assurance that the procedures are followed in conducting the business of the entity.

Auditors usually select a sample of transactions passing through the procedures and test whether they were appropriately conducted in accordance with the laid down guidelines. In conducting tests of control for the purpose of obtaining audit evidence, the auditor should consider the sufficiency and appropriateness of the audit evidence obtained to support the assessed level of control risk.

Audit evidence may be obtained from the accounting and internal control systems in the following areas of design and operations:

- (a) **Design:**  
The accounting and internal control systems are capable of preventing or detecting material mis-statements during the period covered by the audit.
- (b) **Operation:**  
The systems exist and have operated effectively throughout the relevant period covered by the audit.

The tests described above are referred to as 'compliance testing'; which is test of controls that provide audit evidence to ensure that they are working as designed. This is different from substantive tests, which are designed to provide audit evidence that transactions reported in the financial statements are accurate, complete and valid.

### **Substantive procedures**

In conducting substantive tests for the purpose of obtaining audit evidence, auditors should consider the extent to which the evidence obtained from substantive procedures together with any information obtained from tests of controls support the relevant financial statements.

As a basis for the preparation of financial statements, the directors make certain assertions. The assertions constitute representations of the directors that are embodied in the financial statements. The directors, by approving the financial statements, are making representations about the information therein.

The following matters constitute representations or assertions usually made by the directors in approving financial statements:

- (a) **Existence:**  
An asset or a liability exists at a given date.
- (b) **Rights and Obligations:**  
An asset or a liability pertains to the entity at a given date.
- (c) **Occurrence:**  
A transaction or event took place which pertains to the entity during the particular period.
- (d) **Completeness:**  
There are no unrecorded assets, liabilities, transactions or events, or undisclosed items.
- (e) **Valuation:**  
An asset or liability is recorded at an appropriate carrying value.
- (f) **Measurement:**  
A transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period.
- (g) **Presentation and Disclosure:**  
An item is disclosed, classified and described in accordance with the applicable reporting framework (for example, relevant legislation and applicable accounting standards).

The auditor should obtain evidence to support each financial statement assertion. The audit evidence presented in support of one assertion (for example, existence of stock) does not compensate for failure to obtain audit evidence regarding another (for example, its valuation). Tests may, however, provide audit evidence for more than one assertion (for example, testing subsequent receipts from the entity's debtors may provide some audit evidence regarding both their existence and valuation).

In planning an assignment, the auditor prepares programmes comprising detailed audit procedures and objectives. The objectives cover the financial statement assertions made by the directors. The auditor seeks to ensure that both the objectives and the audit programmes enable him to satisfy himself that the planned work will result in the appropriate evidence being obtained.

In conducting substantive tests, the auditor should consider the nature, timing and extent of substantive procedures. These may depend, amongst other factors, on the following matters:

- (a) The auditor's assessment of the control environment and accounting systems generally;
- (b) The inherent and control risks relating to each assertion;
- (c) Evidence obtained from audit work performed during the preparation of the financial statements; and

- (d) Where tests of control provide satisfactory evidence as to the effectiveness of accounting and internal control systems, the extent to which relevant substantive procedures may be reduced, but not entirely eliminated.

### **Reliability of Audit Evidence**

The reliability of audit evidence is influenced by its source which may either be internal or external; and by its nature which may be visual, documentary or oral. The auditor must be aware of the following matters in assessing the reliability of audit evidence:

- (a) Audit evidence from external sources (for example, confirmation received from a third party) is more reliable than that obtained from the entity's records;
- (b) Audit evidence obtained from the entity's records is more reliable when the related accounting and internal control systems operate effectively;
- (c) Audit evidence obtained directly by auditors is more reliable than that obtained by or from the entity;
- (d) Audit evidence in the form of documents and written representations are more reliable than oral representations; and
- (e) Original documents are more reliable than photocopies, telexes or facsimiles.

When the audit evidence obtained from different sources are consistent with one another, they become persuasive to the auditor. When the auditor's evaluation of audit evidence results in the fact that evidence from one source is inconsistent with that from another, it is the responsibility of the auditor to determine what additional procedures must be undertaken to resolve the inconsistency.

Because of cost considerations, the auditor may examine a sample of the transactions that make up the account balance or class of transactions. The auditor must consider the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. The auditor, however, is not relieved of any blame if he omits a necessary procedure as a result of any constraint.

### **Procedures for obtaining audit evidence**

Auditors normally obtain audit evidence by inspection, observation, enquiry, confirmation, computation and analytical procedures. The choice of one or a combination of the procedures which the auditor may adopt is dependent, in part, upon the period of time during which the audit evidence sought is available and the form in which the accounting records are maintained.

### **Inspection**

Inspection involves the following:

- (a) Examination of records, documents or tangible assets;
- (b) Provision of audit evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing;

Three major categories of documentary audit evidence are listed below in descending degree of reliability as audit evidence:

- (a) Evidence created and provided to auditors by third parties;
- (b) Evidence created by third parties and held by the entity; and
- (c) Evidence created and held by the entity.

Inspection provides reliable audit evidence about the existence of the tangible assets inspected, but not necessarily as to the ownership or value of such assets.

### **Observation**

The auditor by observation looks at a procedure being performed by others. For example, the auditor observes the counting of stock by the entity's staff or the performance of internal control procedures as part of the conduct of an audit.

### **Enquiry and Confirmation**

**Enquiry** involves seeking information within and outside the entity. Enquiry may be formal or informal. Responses to enquiries obtained from third parties may confirm or disprove information previously made available to the auditor.

**Confirmation** involves obtaining response to an enquiry to corroborate information previously made available to the auditors in the course of the audit. Examples of direct confirmation are as follows:

- (a) Confirmation of debts by communication with debtors;
- (b) Confirmation of legal cases by communication with the entity's solicitors; and
- (c) Confirmation of bank balances by communication with the entity's bankers, etc.

### **Computation**

The auditor uses computation to check the arithmetical accuracy of source documents and accounting records. Computation also involves performing independent calculations.

### **Analytical procedures**

Analytical procedures consist of the analysis of relationship between:

- (a) Items of financial data;
- (b) Items of financial and non-financial data, derived from the same period; and
- (c) Comparable financial information deriving from different periods or different entities.

Analytical procedures are used to identifying consistencies and predicted patterns or significant fluctuations and unexpected relationships, and the results of investigations performed.

### **Documentation**

It is the duty of the auditor to document matters which are important in providing evidence to support the audit opinion and evidence that the audit

was carried out in accordance with auditing standards, accounting standards and relevant regulations.

The International Federation of Accountants (IFAC) published the International Standard on Auditing titled 'Documentation' which establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

The Auditing Practices Board (APB) Statement of Auditing Standard 230 on 'Working papers' provides guidance on 'Working papers'.

The Public Company Accounting Oversight Board (PCAOB) has also recently issued Auditing Standard No. 3 - Audit Documentation. In this section, 'documentation' and 'working papers' are used interchangeably.

"Documentation" means the materials (working papers) prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit. The PCAOB auditing standard No. 3 describes 'audit documentation' as 'the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise'. Working papers may be in the form of data stored on paper, film, electronic media or other media.

Working papers:

- (a) assist in the planning and performance of the audit;
- (b) assist in the supervision and review of the audit work; and
- (c) record the audit evidence resulting from the audit work performed to support the auditor's opinion.

### **Duties of Auditors on Working Papers**

It is the duty of the Auditor to:

- (a) Prepare working papers which are sufficiently complete and detailed to provide an overall understanding of the audit;
- (b) Record in the working papers information on planning the audit work, the nature, timing and extent of the audit procedures performed, the results thereof, and the conclusions drawn from the audit evidence obtained;
- (c) Record auditor's reasoning on all significant matters which require the exercise of judgement, together with the auditor's conclusion thereon;
- (d) Document areas involving difficult questions of principle or judgement; and
- (e) Record the relevant facts known to the auditor at the time the conclusions were reached on matters of judgement or principles.

The extent of working papers to be prepared and retained is a matter of professional judgement. In determining the extent of working papers to be prepared and retained the auditor should consider:

- (a) The legal and professional requirements; and

- (b) What would be necessary to provide another auditor who has no previous experience with the audit with an understanding of the work performed.

### **Form and Content of Working Papers**

The following matters may affect the form and content of working papers:

- (a) Nature of the engagement;
- (b) Form of the auditor's report;
- (c) Nature and complexity of the business;
- (d) Nature and condition of the entity's accounting and internal control systems;
- (e) Needs in the particular circumstances for direction, supervision and review of work performed by assistants;
- (f) Specific audit methodology and technology used in the course of the audit;
- (g) Use of standardised working papers, for example, checklists, specimen letters, standard organisation of working papers;
- (h) Need to facilitate the delegation of work while providing a means to control its quality; and
- (i) Schedules, analyses and other documentation prepared by the entity and the need to be satisfied that those materials have been properly prepared.

### **Contents of Working Papers**

The contents of working papers will generally include the following:

- (a) Information concerning the legal and organisational structure of the entity;
- (b) Extracts or copies of important legal documents, agreements and minutes;
- (c) Information concerning the industry, economic and legislative environment within which the entity operates;
- (d) Evidence of the planning process including audit programmes and any changes thereto;
- (e) Evidence of the auditor's understanding of the accounting and internal control systems;
- (f) Evidence of inherent and control risk assessments and any revisions thereof;
- (g) Evidence of the auditor's consideration of the work of internal auditing and conclusions reached;
- (h) Analysis of transactions and balances;
- (i) Analyses of significant ratios and trends;
- (j) A record of the nature, timing and extent of audit procedures performed and the results of such procedures;
- (k) Evidence that the work performed by assistants was supervised and reviewed;
- (l) An indication as to who performed the audit procedures and when they were performed;

- (m) Details of procedures applied regarding components whose financial statements are audited by another auditor;
- (n) Copies of communications with other auditors, experts and other third parties;
- (o) Copies of letters or notes concerning audit matters communicated to or discussed with the entity, including the terms of the engagement and material weaknesses in internal control;
- (p) Letters of representation received from the entity;
- (q) Conclusions reached by the audit concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated; and
- (r) Copies of the financial statements and auditor's report. (Chitty, 2004; IFAC ISA 230).
- (s) Checklists for compliance with statutory disclosure requirements and accounting standards; and
- (t) Management letter setting out internal control weaknesses in the system to the client.

### **Confidentiality, Safe Custody, Retention and Ownership of Working Papers**

'Working papers are the property of the auditors. Although portions of or extracts from the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity's accounting records' (IFAC ISA 230).

The auditor should therefore adopt appropriate procedures:

- (a) For maintaining the confidentiality and safe custody of the working papers; and
- (b) For retaining the working papers for a period sufficient to meet the needs of the practice and in accordance with legal and professional requirements of record retention.

## **1.4 INDEPENDENCE, OBJECTIVITY, INTEGRITY, CONFIDENTIALITY, SKILLS, CARE AND COMPETENCE**

### **Independence**

IFAC Code of Ethics for Professional Accountants states that "it is in the public interest and, therefore, required by this Code of Ethics, that members of assurance teams, firms and, when applicable, network firms be independent of assurance clients".

The Code states that "Assurance engagements are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria. The International Standard on Assurance Engagements issued by The International Auditing and Assurance Standards Board (IAASB), describes the objectives and elements of assurance engagements to provide, either a high or a moderate

level of assurance. IAASB has also issued specific standards for certain assurance engagements. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (moderate level assurance) of financial statements”.

The Code provides guidance to auditors in determining whether a particular engagement is an assurance engagement and states that, this will depend upon whether the assurance engagement exhibits all of the following elements:

- (a) A three party relationship involving:
  - (i) A professional accountant;
  - (ii) A responsible party; and
  - (iii) An intended user;
- (b) A subject matter;
- (c) Suitable criteria;
- (d) An engagement process; and
- (e) A conclusion.

There is a broad range of engagements to provide a high or moderate level of assurance. Such engagements may include:

- (a) Engagements to report on a broad range of subject matters covering financial and non-financial information;
- (b) Attest and direct reporting engagements;
- (c) Engagements to report internally and externally; and
- (d) Engagements in the private and public sector.

The subject matter of an assurance engagement may take many forms, such as the following:

- (a) Data (for example, historical or prospective financial information, statistical information, performance indicators);
- (c) Systems and processes (for example, internal controls); or
- (d) Behaviour (for example, corporate governance, compliance with regulation, human resource practices).

The Code further identifies that not all engagements performed by professional accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include:

- (a) Agreed-upon procedures;
- (b) Compilation of financial or other information;
- (c) Preparation of tax returns when no conclusion is expressed, and tax consulting;
- (d) Management consulting; and
- (e) Other advisory services.

The Code also provides a conceptual approach to independence which requires the following:

Independence requires:

(a) **Independence of mind**

The state of mind, that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and

(b) **Independence in appearance**

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude that a firm's, or a member of the assurance team's integrity, objectivity or professional scepticism had been compromised.

**Rules of Professional Conduct**

The 'Rules of Professional Conduct for Members' issued by The Institute of Chartered Accountants of Nigeria provides guidance on integrity, objectivity and independence. The Rules require that a member should behave with integrity in all professional, business and financial relationships. The Rules also call for a degree of objectivity and independence to be exercised by a member of the Institute in financial reporting and similar roles outside the audit.

**Integrity and objectivity**

IFAC Code of Ethics states that "integrity implies not merely honesty but fair dealing and truthfulness. The principle of objectivity imposes the obligation on all professional accountants to be fair, intellectually honest and free of conflicts of interest".

The Code identifies that, professional accountants serve in many different capacities and should demonstrate their objectivity in varying circumstances. Professional accountants in public practice undertake assurance engagements, and render tax and other management advisory services. Other professional accountants prepare financial statements as a subordinate of others, perform internal auditing services, and serve in financial management capacities in industry, commerce, the public sector and education. They also educate and train those who aspire to be admitted into the profession. Regardless of service or capacity, professional accountants should protect the integrity of their professional services and maintain objectivity in their judgement.

In selecting the situations and practices to be specifically dealt with, in ethics requirements relating to objectivity, the Code states that adequate consideration should be given to the following factors:

(a) Professional accountants are exposed to situations which involve the possibility of pressures being exerted on them. These pressures may impair their objectivity;

(b) It is impracticable to define and prescribe all such situations where these possible pressures exist. Reasonableness should prevail in

- establishing standards for identifying relationships that are likely to, or appear to, impair a professional accountant's objectivity;
- (c) Relationships should be avoided which allow prejudice, bias or influence of others to override objectivity;
  - (d) Professional accountants have an obligation to ensure that personnel engaged on professional services adhere to the principle of objectivity; and
  - (e) Professional accountants should neither accept nor offer gifts or entertainment which might reasonably be believed to have a significant and improper influence on their professional judgement or those with whom they deal. What constitutes an excessive gift or offer of entertainment varies from country to country but professional accountants should avoid circumstances which would bring their professional standing into disrepute.

In addition to the above, the 'Rules of Professional Conduct for Members' issued by the Institute of Chartered Accountants of Nigeria provides a framework within which members can identify actual or potential threats to objectivity and assess the safeguards which may be available to offset such threats.

### **Professional Competence**

The IFAC Code of Ethics for Professional Accountants states that professional accountants should not portray themselves as having expertise or experience which they do not possess.

Professional competence may be divided into two separate phases:

- (a) **Attainment of professional competence**  
The attainment of professional competence requires initially a high standard of general education followed by specific education, training and examination in professionally relevant subjects, and whether prescribed or not, a period of work experience. This should be the normal pattern of development for a professional accountant.
- (b) **Maintenance of professional competence**
  - (i) The maintenance of professional competence requires a continuing awareness of developments in the accountancy profession including relevant national and international pronouncements on accounting, auditing and other relevant regulations and statutory requirements.
  - (ii) A professional accountant should adopt a program designed to ensure quality control in the performance of professional services consistent with appropriate national and international pronouncements.

The 'Rules of Professional Conduct for Members' issued by The Institute of Chartered Accountants of Nigeria provides that a member should not accept or perform work which he or she is not competent to undertake, unless he or she obtains such advice and assistance as will, enable him or her competently carry out the work.

## **Confidentiality**

The IFAC Code of Ethics states that professional accountants have an obligation to respect the confidentiality of information about a client's or employer's affairs acquired in the course of professional services. The duty of confidentiality continues even after the end of the relationship between the professional accountant and the client or employer. The Code states that:

- (a) Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.
- (b) Professional accountants have an obligation to ensure that staff under their control and persons from whom advice and assistance is obtained respect the principle of confidentiality.
- (c) Confidentiality is not only a matter of disclosure of information, It also requires that a professional accountant acquiring information in the course of performing professional services does, neither use, nor appear to use that information for personal advantage, or for the advantage of a third party.
- (d) A professional accountant has access to a lot of confidential information about a client's or employer's affairs not otherwise disclosed to the public. Therefore, the professional accountant should be relied upon not to make unauthorised disclosures to other persons. This does not apply to disclosure of such information in order to properly discharge the professional accountant's responsibility according to the profession's standards.
- (e) It is in the interest of the public and the profession that, the profession's standards relating to confidentiality be defined and guidance given on the nature and extent of the duty of confidentiality and the circumstances in which disclosure of information acquired during the course of providing professional services shall be permitted or required.
- (f) It should be recognised, however, that confidentiality of information is part of statute or common law and therefore detailed ethical requirements in respect thereof, will depend on the law of the country of each member body.

Matters which should be considered in determining whether confidential information may be disclosed are as follows:

- (a) When disclosure is authorised - when authorisation to disclose is given by the client or the employer, the interests of all the parties including those third parties whose interests might be affected should be considered.
- (b) When disclosure is required by law - examples of when a professional accountant is required by law to disclose confidential information are:
  - (i) To produce documents or to give evidence in the course of legal proceedings; and
  - (ii) To disclose to the appropriate public authorities infringements of the law which come to light.

- (c) There is a professional duty or right to disclose when need arises:
  - (i) To comply with technical standards and ethics requirements; such disclosure is not contrary to this section;
  - (ii) To protect the professional interests of a professional accountant in legal proceedings;
  - (iii) To comply with the quality (or peer) review of a member body or professional body; and
  - (iv) To respond to an inquiry or investigation by a member body or regulatory body.

When the professional accountant has determined that confidential information can be disclosed, the following points should be considered:

- (a) Whether or not all the relevant facts are known and substantiated, to the extent it is practicable to do so; when the situation involves unsubstantiated fact or opinion, professional judgement should be used in determining the type of disclosure to be made, if any;
- (b) What type of communication is expected and the addressee; in particular, the professional accountant should be satisfied that the parties to whom the communication is addressed are appropriate recipients and have the responsibility to act on it; and
- (c) Whether or not the professional accountant would incur any legal liability having made a communication and the consequences thereof.

In all such situations, the professional accountant should consider the need to consult legal counsel and/or the professional organisation(s) concerned.

The 'Rules of Professional Conduct for Members' issued by the Institute of Chartered Accountants of Nigeria provides, in relation to confidentiality, that

- (a) Information confidential to a client or employer acquired in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper source, or where there is a legal right or duty to disclose.
- (b) Where a legal right or duty of disclosure does exist, the client or employer should normally be notified in advance of the disclosure being made.

### **Skills, care and diligence**

The 'Rules of Professional Conduct for Members' issued by The Institute of Chartered Accountants of Nigeria provides that a member should carry out his or her professional work with due skill, care, diligence and expedition and with proper regard for technical and professional standards expected of him or her as a member. A member should conduct himself or herself with courtesy and consideration towards all with whom he comes into contact, during the course of performing his or her work. Under the section on Professional Competence and Due Care of the Fundamental Principles as contained in the IFAC Code of Ethics for Professional Accountants, it is stated that "a professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge

and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques”.

### **Publicity**

The IFAC Code of Ethics for Professional Accountants provides guidance on Publicity. It states that in the marketing and promotion of themselves and their work, professional accountants should:

- (a) Not use means which bring the profession into disrepute;
- (b) Not make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; and
- (c) Not denigrate the work of other accountants.

The ‘Rules of Professional Conduct for Members’ issued by the Institute of Chartered Accountants of Nigeria provides as follows:

In relation to practice promotion, a member may seek publicity for his or her services, achievements and products and may advertise his or her services, achievements and products in any way consistent with the dignity of the profession in that he should not project an image inconsistent with that of a professional person bound to high ethical and technical standards.

In relation to advertisement, the code states that advertisement must comply with the law and should be legal. An advertisement should be clearly distinguishable as such.

## **1.5 TRUE AND FAIR VIEW, MATERIALITY AND JUDGEMENT**

### **True and Fair View**

The concept of “true and fair view” occupies a central place in financial reporting. The concept which has been debated over time has a powerful, direct effect on accounting practice and it is the ultimate test for financial statements. The Companies and Allied Matters Act requires the auditors to include in their report whether the financial statements show a true and fair view of the affairs of the entity at a balance sheet date. The auditing standards also put the concept of “true and fair view” in perspective.

The “true and fair view” is a dynamic concept in that, over time, the concept has always moved in sympathy with changes in accounting and business practice. The more the laws change and the more accounting and auditing standards change, the more the requirements which the auditor must meet to ensure the financial statements upon which he or she is reporting, meet the concept of ‘true and fair’ view. The concept affects the interpretation of the components of financial reporting and comes to play in setting procedures for the conduct of audit in an accounting practice.

It is important to note that financial statements will not give a “true and fair view” unless the information they contain is sufficient in quantity and quality

to satisfy the reasonable expectations of the readers to whom they are addressed. The concept of “true and fair view” influences accounting standards and other authoritative pronouncements.

### **Materiality**

The APB Statement of Auditing Standard 220 covers ‘Materiality and the audit’. The International Auditing and Assurance Standards Board of IFAC issued International Statement on Auditing 320 on ‘Audit Materiality’.

The International Statement on Auditing on Audit Materiality states that information is considered to be material to the financial statements if the misstatement or omission of such information may reasonably be expected to ‘influence the economic decisions of users’ of those financial statements, including their assessments of management’s stewardship.

Auditors must consider the effect of possible misstatement of relatively small amounts in that a relatively small error in a month end procedure may be an indication of possible material misstatement when the cumulative effect on the financial statements is considered at the end of the financial period.

A misstatement or the aggregate of all misstatements in financial statements is material if, considering the surrounding circumstances:

- (a) It is probable that, the decision of a person who is relying on the financial statements; and
- (b) Who has a reasonable knowledge of business and economic activities (the user), would be changed or influenced by such misstatement or the aggregate of all misstatements.

### **Steps in establishing materiality**

The steps to be followed in establishing materiality of an audit item are:

- (a) Set a threshold at the planning stage about materiality;
- (b) Record misstatements identified in the course of the audit; and
- (c) Document the likely misstatements and compare with materiality.

When immaterial information is given in the financial statements, the result may distort the understandability of the other information provided. In such circumstances, the auditors need to consider the exclusion of such immaterial information. However, the requirements of legislation, accounting standards and auditing standards must be considered in determining the nature of information to be given in the financial statements.

### **Principal factors affecting materiality**

The auditor must exercise judgement in determining whether information is material. An item may be material considering its size and nature. The principal factors which may affect materiality are as follows:

- (a) The size of the item when taken in the context of the financial statements as a whole and of the other information readily available in the market

place to investors and users that would affect their evaluation of the financial statements;

- (b) Consideration may be given to the nature of the item in relation to:
  - (i) the basis of transaction or other event giving rise to it;
  - (ii) the significance of the event or transaction;
  - (iii) the legality, sensitivity, normality and potential consequences of the item; and
  - (iv) the disclosure requirement of such item.

The auditor should determine materiality by a combination of these factors, rather than any one in particular. When there are two or more similar items, the auditor should consider the aggregate.

### **Consideration of materiality**

In planning the conduct of an audit, auditors seek to provide reasonable assurance that the financial statements are free of material mis-statement and give a true and fair view. Auditors exercise professional judgement in determining what is material. Both the amount (quantity) and the nature (quality) of mis-statements are considered in determining materiality. There exists a difficulty in ascribing general mathematical definition to 'materiality', in that it has both qualitative and quantitative aspects.

Auditors must consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, a relatively small error in a month-end procedure could be an indication of a potential material misstatement, if that error is repeated each month during the financial year that is being audited.

Auditors should also pay attention to the nature of mis-statements relating to qualitative aspects of a matter. Examples of qualitative mis-statements would be the inadequate or inaccurate description of an accounting policy when it is likely that a user of the financial statements could be misled by the description.

### **Materiality and audit work**

In planning and conduct of an audit, auditors must consider:

- (a) Materiality and its relationship with audit risk; and
- (b) Materiality when determining the nature, timing and extent of audit procedures.

At the planning stage, the assessment of materiality based on the latest available reliable financial information, assists in the determination of an efficient and effective audit approach. The preliminary materiality assessment helps auditors decide such questions as what items to examine, and whether to use sampling techniques. This enables auditors to select audit procedures that, in combination, reduce audit risk to an acceptably low level.

In practice, the assessment of materiality at the audit planning stage, may differ from that at the time of evaluating the results of audit procedures. This may be caused by a change in circumstances, or a change necessitated by the outcome of the audit. For example, if the actual results of operations and financial position are different from those they expected when the audit was planned.

Auditors must consider the implications of factors which result in the revision of their preliminary materiality assessment on their audit approach. In this circumstance, auditors may modify the nature, timing and extent of planned audit procedures. For example, if, after planning for specific audit procedures, auditors determine that the acceptable materiality level falls short of the initial materiality level, the risk of failing to detect a material mis-statement necessarily increases. The risk may be compensated for by the auditors carrying out more audit work.

### **Evaluating the effect of mis-statements**

In evaluating whether the financial statements give a true and fair view, auditors should assess the materiality of the aggregate of uncorrected mis-statements.

The following constitute aggregate of uncorrected mis-statements:

- (a) Specific mis-statements identified by the auditor, including uncorrected mis-statements identified during the audit of the previous period if they affect the current period's financial statements; and
- (b) Auditors' best estimate of other mis-statements which cannot be quantified specifically (for example projected errors).

The auditor must consider whether the aggregate of uncorrected mis-statements is material. If the auditor concludes that the mis-statements may be material, the auditor should consider reducing audit risk by extending audit procedures or requesting the directors to adjust the financial statements. If the directors refuse to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected mis-statements is not material, the auditor should consider the implications in the preparation of his or her report.

## **1.6 SUMMARY AND CONCLUSIONS**

This chapter is designed to give readers a headstart in auditing. The ground work has been laid to enable readers to grasp the very principles and fundamental concepts that will prepare their minds for the core discourses to follow. Consequently, concepts such as the integrity, ethical tone of the auditor that will not only impact on their understanding of the nobility of the profession they are preparing for, but will also help them prepare their minds for the career pursuit in auditing, have been given adequate coverage.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

**1.7 REVISION QUESTIONS****1.7.1. MULTIPLE CHOICE QUESTIONS**

1. “Independent audit’ is described as providing reasonable assurance that published audited financial reports are free from material misstatement and are in accordance with legislation and relevant accounting standards
  - (A) True
  - (B) Independent audit is performed by independent accountants
  - (C) False
  - (D) Once the auditor issues his opinion, the audit is independent
  - (E) Independent audit is conducted once in a while
  
2. In the conduct of any audit of financial statements, auditors should comply with the ethical guidance issued by their relevant professional bodies
  - (A) It is not mandatory to comply with ethical codes
  - (B) Since monitoring is slow, the auditor should not bother
  - (C) Auditors should comply with ethical guidance issued by their professional bodies
  - (D) Paying fines makes complying unnecessary
  - (E) False
  
3. An audit of the financial statements of an entity does not relieve the directors of any of their responsibilities on the financial statements
  - (A) The directors are absolved of their responsibility because the company law states as such
  - (B) The directors at the board meeting resolved as such
  - (C) A clean audit report relieves the directors of their responsibilities on the financial statements
  - (D) True
  - (E) False
  
4. “Documentation” means the material (working papers) prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit.
  - (A) Documentation is not necessary nowadays
  - (B) True
  - (C) False
  - (D) Electronic data is disputed by the courts
  - (E) Documentation and working papers are not the same.
  
5. The concept of “true and fair view” is central to financial reporting.
  - (A) False
  - (B) True and fair view is no longer in vogue
  - (C) The concept of true and fair view has been outlawed
  - (D) True
  - (E) True and fair view is at the bottom of financial reporting.

**1.7.2 SHORT ANSWER QUESTIONS**

- (1) Mention the fundamental principles of independent auditing contained in the ethical code for professional accountants.
- (2) State the matters which the auditor should consider in determining the scope of the audit work.

- (3) List matters contained in the ethical principles which govern auditors' professional responsibilities.
- (4) What do you understand by 'independence of mind' in relation to ethical conduct of a professional accountant?
- (5) When is there a professional duty or right to disclose information which the auditor obtained in the course of an audit?

*Refer to Suggested Solutions in Appendix I on page 301.*



## ***REGULATORY AND ETHICAL ISSUES***

### **2.0 LEARNING OBJECTIVES**

After studying this chapter, readers will be able to:

- ◆ Know the scope and terms of engagement of auditors as provided in: Companies and Allied Matters Act CAP C20, 2004; Banks and Other Financial Institutions Act 25 of 1991; Insurance Act of 2007; Pension Act 2004.
- ◆ Know the instruments establishing various organisations such as Securities and Exchange Commission (SEC), Nigeria Deposit Insurance Corporation (NDIC) etc.
- ◆ Understand the professional pronouncements and their applications, i.e. guidelines and standards of the Institute and other international bodies.
- ◆ Understand supervision and monitoring of auditors: Quality control, working papers, peer review; Functions and responsibility; Threat to auditors' independence and their resolutions; Conflicts of interest, beneficial shareholding, financial involvement with or in the affairs of clients, personal relationships, audit fee etc.

The regulatory provisions and issues may be discussed, as follows:

### **2.1 COMPANIES AND ALLIED MATTERS ACT (CAMA) CAP C20, 2004**

The Companies and Allied Matters Act, (CAMA) CAP C20, LFN 2004 is the principal law which sets the tone for the incorporation and conduct of business in Nigeria.

#### **Appointment of auditors**

Section 357 of the Companies and Allied Matters Act provides for the appointment of auditors. The section states as follows:

- (a) Every company shall at each annual general meeting appoint an auditor or auditors to audit the financial statements of the company, and to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.
- (b) At any annual general meeting a retiring auditor, however appointed, shall be reappointed without any resolution being passed unless:
  - (i) he is not qualified for re-appointment;
  - (ii) a resolution has been passed at that meeting appointing some other person instead of him or providing expressly that he shall not be re-appointed; and

- (iii) he has given the company notice in writing of his unwillingness to be re-appointed.

Where notice is given of an intended resolution to appoint some other person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that other person or of all those other persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be automatically re-appointed by virtue of this sub-section.

Where at an annual general meeting, no auditors are appointed or re-appointed, the directors may appoint a person to fill the vacancy:

- (a) The company shall, within one week of the power of the directors becoming exercisable, give notice of that fact to the Corporate Affairs Commission; and if a company fails to give required notice the company and every officer of the company who is in default shall be guilty of an offence and liable to a fine of ₦100 for every day during which the default continues;
- (b) The first auditors of a company may be appointed by the directors at any time before the company is entitled to commence business and auditors so appointed shall hold office until the conclusion of the next annual general meeting:

Provided that:

- (i) the company may at a general meeting remove any such auditors and appoint in their place any other person who has been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than 14 days before the date of the meeting; and
- (c) The company may, in a general meeting convened for that purpose, appoint the first auditors and thereupon the said powers of the directors shall cease.

The directors may fill any casual vacancy in the office of auditor but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

### **Qualification of auditors**

The provisions of the Institute of Chartered Accountants of Nigeria Act 1965 shall have effect in relation to any investigation or audit for the purpose of this Act so however that none of the following persons shall be qualified for appointment as auditor of a company, that is

- (a) an officer or servant of the company;
- (b) a person who is a partner of or in the employment of an officer or servant of the company; or
- (c) a body corporate,

The disqualification shall extend and apply to persons who in respect of any period of an audit were in the employment of the company or were otherwise connected therewith in any manner.

A person shall also not qualify for appointment as an auditor of a company if he is disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

A firm is qualified for appointment as auditor of a company if, but only if, all the partners are qualified for appointment as auditors of it.

No person shall act as auditor of a company at a time when he knows that he is disqualified for appointment to that office and if an auditor of a company to his knowledge becomes so disqualified during his term of office, he shall thereupon vacate his office and give notice in writing to the company that he has vacated it by reason of that disqualification.

A person who acts as auditor in contravention or fails without reasonable excuse to give notice of vacating his office shall be guilty of an offence and liable to a fine of 500 and, for continued contravention, to a daily default fine of 50, (Section 358).

### **Auditors' Report**

The auditors of a company shall make a report to its members on the accounts examined by them, and on every balance sheet and profit and loss account, and on all group financial statements, copies of which are to be laid before the company in a general meeting during the auditors' tenure of office.

The auditors' report shall state the matters set out in the Sixth Schedule to the Companies and Allied Matters Act as follows:

- (a) Basis of preparation of the entity's financial statements (i.e. that the financial statements have been prepared on the basis of the entity's accounting policies);
- (b) Respective responsibilities of the directors and the auditors;
- (c) Basis of the auditors' opinion;
- (d) Whether proper books of account have been kept;
- (e) Compliance with the provisions of the Companies and Allied Matters Act, Cap. C 20 LFN 2004; and
- (f) Compliance with the statements of accounting standards issued by the Nigerian Accounting Standards Board.

The Companies and Allied Matters Act, CAP C20, LFN 2004 further provides that:

- (a) It shall be the duty of the company's auditors, in preparing their report to carry out such investigations as may enable them to form an opinion as to the following matters whether;

- (i) proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them; and
  - (ii) the company's balance sheet and (if not consolidated) its profit and loss account are in agreement with the accounting records and returns.
- (b) If the auditors are of the opinion that proper accounting records have not been received from branches not visited by them, or if the balance sheet and (if not consolidated) the profit and loss account are not in agreement with the accounting records and returns, the auditors shall state that fact in their report.
- (c) Where certain requirements (i.e. Part V and VI of the Third Schedule and Parts I to III of the Fourth Schedule) of the Companies and Allied Matters Act are not complied with in the accounts, it shall be the auditors' duty to include such matters in their report, so far as they are reasonably able to do so, a statement giving the required particulars.
- (d) It shall be the auditors' duty to consider whether the information given in the directors' report for the year for which the accounts are prepared is consistent with those accounts; and if they are of opinion that it is not, they shall state that fact in their report, (Section 359).

### **Audit Committee**

The Companies and Allied Matters Act, CAP C20, LFN 2004 provides that:

- (a) In addition to the auditors report made to the members on the entity's financial statements, the auditor shall in the case of a public company also make a report to an audit committee which shall be established by the public company.
- (b) The audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members) and shall examine the auditors' report and make recommendations thereon to the annual general meeting as it may think fit, provided, however, that such member of the audit committee shall not be entitled to remuneration and shall be subject to re-election annually.
- (c) Any member may nominate a shareholder as a member of the audit committee by giving notice in writing of such nomination to the secretary of the company at least 21 days before the annual general meeting.
- (d) Subject to such other additional functions and powers that the company's articles of association may stipulate, the objectives and functions of the audit committee shall be to:
  - (i) ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
  - (ii) review the scope and planning of audit requirements;

- (iii) review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- (iv) keep under review the effectiveness of the company's system of accounting and internal control;
- (v) make recommendations to the Board with regard to the appointment, removal and remuneration of the external auditors of the company; and
- (vi) authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee, (Section 359).

### **Auditors' Duties and Powers**

- (a) It shall be the duty of the company's auditors, in preparing their report to carry out such investigations as may enable them to form an opinion as to the following matters whether:
  - (i) proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them; and
  - (ii) the company's balance sheet and (if not consolidated) its profit and loss account are in agreement with the accounting records and returns.
- (b) Every auditor of a company shall have a right of access at all times to the company's books, accounts and vouchers, and be entitled to require from the company's office such information and explanations as he thinks necessary for the performance of the auditor's duties.
- (c) It shall be the auditors' duty to consider whether the information given in the directors' report for the year for which the accounts are prepared is consistent with those accounts (Section 360).

### **Remuneration of Auditors**

- (a) The remuneration of the auditors of a company-
  - (i) in the case of an auditor appointed by the directors, may be fixed by the directors if the general meeting empowers the directors to do so; or
  - (ii) shall be fixed by the company in general meeting.
- (b) "Remuneration" includes sums paid by the company in respect of the auditors' expenses. (Section 361).

### **Removal of Auditors**

- (a) A company may by ordinary resolution remove an auditor before the expiration of his term of office, notwithstanding anything in any agreement between it and him.

Where a resolution removing an auditor is passed at a general meeting of a company, the company shall within 14 days give notice of that fact in the prescribed form to the Corporate Affairs Commission and if a

company fails to give the required notice the company and every officer of it who is in default shall be guilty of an offence and liable to a daily default fine of 100.

- (b) Nothing shall be taken as depriving the auditor removed of compensation or damages payable to him in respect of the termination of his appointment as auditor or of any appointment terminating with that as auditor. (Section 362).

### **Auditors' Right to Attend Company's Meetings**

- (a) A company's auditors shall be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which a member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditor.
- (b) An auditor of a company who has been removed shall be entitled to attend:
  - (i) the general meeting at which his term of office would otherwise have expired; and
  - (ii) any general meeting at which it is proposed to fill the vacancy caused by his removal, and to receive all notices of, and other communications relating to, and such meeting which any member of the company is entitled to receive, and to be heard at any such meeting which he attends on any part of the business of the meeting which concerns him as former auditor of the company. (Section 363)

### **Supplementary provisions relating to auditors**

- (a) A special notice shall be required for a resolution at a general meeting of a company:
  - (i) appointing as auditor a person other than a retiring auditor;
  - (ii) filling a casual vacancy in the office of auditor;
  - (iii) re-appointing as auditor a retiring auditor who was appointed by the directors to fill a casual vacancy; and
  - (iv) removing an auditor before the expiration of his term of office.
- (b) On receipt of notice of such an intended resolution the company shall forthwith send a copy of it:
  - (i) to the person proposed to be appointed or removed, as the case may be;
  - (ii) to the retiring auditors; and
  - (iii) where the casual vacancy was caused by the resignation of an auditor who resigned.

- (c) Where notice is given of such a resolution the retiring auditor (or, as case may be, the auditor proposed to be removed) makes with respect to the intended resolution representations in writing to the company not exceeding a reasonable length, and requests their notification to members of the company, the company shall (unless the representations are received by it too late for it to do so:
  - (i) in any notice of the resolution given to members of the company, state the fact of the representations having been made; and
  - (ii) send a copy of the representations to every member of the company to whom notice of the meeting is or has been made;
- (d) If a copy of any such representations is not sent out as required because they were received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representations shall be read out at the meeting; and
- (e) Copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person claiming to be aggrieved, the court is satisfied that the rights conferred are being abused to secure needless publicity for defamatory matter; and the court may order the company's costs on the application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application. (Section 364)

### **Resignation of Auditors**

- (a) An auditor of a company may resign his office by depositing a notice in writing to that effect at the company's registered office; and any such notice shall operate to bring his term of office to an end on the date of which the notice is deposited, or on such later date as may be specified in it.
- (b) An auditor's notice of resignation shall not be effective unless it contains either:
  - (i) a statement to the effect that there are no circumstances connected with his resignation which he considers should be brought to the notice of the members or creditors of the company; or
  - (ii) a statement of any such circumstances as are mentioned above.
- (c) Where a notice under this section is deposited at a company's registered office, the company shall within 14 days send a copy of the notice-
  - (i) to the Corporate Affairs Commission; and
  - (ii) if the notice contained a statement, to every person who is entitled to be sent copies of the financial statements.
- (d) The company or any person claiming to be aggrieved may, within 14 days of the receipt by the company of a notice containing a statement, apply to the court for an order.

- (e) If in such an application the court is satisfied that the auditor is using the notice to secure needless publicity for defamatory matter, it may, by order, direct that copies of the notice need not be sent out; and the court may further direct the company's costs on the application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.
- (f) The company shall, within 14 days of the court's decision, send to the persons mentioned:
  - (i) if the court makes an order a statement setting out the effect of the order; and
  - (ii) if not, a copy of the notice containing the statement.
- (g) If default is made in complying with certain provisions the company and every officer of it who is in default shall be guilty of an offence and liable to a daily default fine of 100. (Section 365)

#### **Right of Resigning Auditor to Requisition for Company Meeting**

- (a) Where an auditor's notice of resignation contains a statement, there may be deposited with the notice a requisition signed by the auditor calling on the directors of the company forthwith to duly convene an extra-ordinary general meeting of the company for the purpose of receiving and considering such explanation of the circumstances connected with his resignation as he may wish to place before the meeting.
- (b) Where an auditor's notice of resignation contains such a statement, the auditor may request the company to circulate to its members before:
  - (i) the general meeting at which his term of office would otherwise have expired; or
  - (ii) any general meeting at which it is proposed to fill the vacancy caused by his resignation or convened on his requisition, a statement in writing (not exceeding a reasonable length) of the circumstances connected with his resignation.
- (c) If a resigning auditor requests the circulation of a statement the company shall (unless the statement is received by it too late for it to comply):
  - (i) in any notice of the meeting given to members of the company, state the fact of the statement having been made; and
  - (ii) send a copy of the statement to every member of the company to whom notice of the meeting is or has been sent.
- (d) If the directors do not within 21 days from the date of the deposit of a requisition under this section proceed duly to convene a meeting for a day not more than 28 days after the date on which the notice convening the meeting is given, every director who fails to take all reasonable steps to ensure that a meeting is convened as mentioned above shall be guilty of an offence and liable to a fine of 500.

- (e) If a copy of the statement is not sent out as required because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the statement be read out at the meeting.
- (f) Copies of a statement need not be sent out and the statement need not be read out at the meeting if, on the application, either of the company or of any other person who claims to be aggrieved, the court is satisfied that the rights conferred are being abused to secure needless publicity for defamatory matter; and the court may order the company's costs on such an application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.
- (g) An auditor who has resigned his office shall be entitled to attend any such meeting and to receive all notices of and other communications relating to any such meeting which any member of the company is entitled to receive, and to be heard at any such meeting which concerns him as former auditor of the company. (Section 366).

#### **Powers of Auditors in Relation to Subsidiaries**

- (a) Where a company has a subsidiary, then-
  - (i) if the subsidiary is a body corporate incorporated in Nigeria it shall be the duty of the subsidiaries and its auditors to give the auditors of the holding company such information and explanation as those auditors may reasonably require for the purposes of their duties as auditors of the holding company;
  - (ii) in any other case, it shall be the duty of the holding company, if required by its auditors to do so, to take all such steps as are reasonably open to it to obtain from the subsidiary such information and explanation as are mentioned above.
- (b) if a subsidiary or holding company fails to comply with the provisions, the subsidiary or holding company, and every officer of it who is in default, shall be guilty of an offence and liable to a fine; and if an auditor fails without reasonable excuse to comply he shall be guilty of an offence and so liable. (Section 367).

#### **Liability of Auditors for Negligence**

- (a) A company's auditor shall in the performance of his duties, exercise all such care, diligence and skill as is reasonably necessary in each particular circumstance.
- (b) Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him the auditor shall be liable for negligence and the directors may institute an action for negligence against him in the court.
- (c) If the directors fail to institute an action against the auditor, any member may do so after the expiration of 30 days' notice to the company, of his intention to institute such action, (Section 368).

### **False Statements to Auditors**

- (a) An officer of a company commits an offence if he knowingly or recklessly makes to a company's auditors a statement (whether written or oral) which:
  - (i) conveys or purports to convey to the auditors any such information or explanation which the auditors require, or are entitled to require, as auditors of the company; and
  - (ii) is misleading, false or deceptive in a material particular.
- (c) A person guilty of an offence shall be liable to imprisonment for one year or to a fine of 500 or both, (Section 369).

## **2.2 BANKS AND OTHER FINANCIAL INSTITUTIONS ACT 25 OF 1991**

The Banks and Other Financial Institutions Act 1991(BOFIA) regulates the operations of banks and other financial institutions in Nigeria.

### **Publication of annual accounts of banks**

- (a) Subject to the prior approval in writing of the Central Bank, a bank, shall not later than four months after the end of its financial year:
  - (i) cause to be published in a daily newspaper printed in and circulating in Nigeria and approved by the Central Bank;
  - (ii) exhibit in a conspicuous position in each of its offices and branches in Nigeria; and
- (b) Forward to the Central Bank, copies of the bank's balance sheet and profit and loss account duly signed and containing the full and correct names of the directors of the bank.
- (c) Every published account of a bank shall disclose, in detail, penalties paid as a result of contravention of the provisions of this Act and provisions of any policy guidelines in force during the financial year in question and the auditor's report shall reflect such contravention;
- (d) The balance sheet and profit and loss account of a bank shall bear on their face the report of an approved auditor and shall contain statements on such matters as may be specified by the Bank, from time to time;
- (e) For the purpose of subsection (3) of this section, an "approved auditor" shall be an auditor approved for the purpose of section 29 of this Act; and
- (f) Any bank which fails to comply with any of the requirements of this section is in respect of each such failure guilty of an offence and liable on conviction to a fine of ₦10,000 each day during which the offence continues. (Section 27).

### **Contents and form of accounts**

- (a) Every balance sheet and every profit and loss account of a bank shall give a true and fair view of the state of affairs of the bank as at the end of the reporting period;

- (b) Every balance sheet and every profit and loss account of a bank forwarded to the Bank shall comply with the requirements of any circular which has been issued by the Central Bank thereon; and
- (c) Any person being a director of any bank who fails to take all reasonable steps to secure compliance with any of the prescribed provisions in respect of any account is guilty of an offence and liable to pay to the Bank a fine of ₦1,000 or to imprisonment for five years or to both such fine and imprisonment. (Section 28).

### **Appointment, power and report of approved auditor**

- (a) Every bank shall appoint annually a person approved by the Central Bank, referred to as “approved auditor”, whose duties shall be to make to the shareholders a report upon the annual balance sheet and profit and loss account of the bank and every such report shall contain statements as to the matters and such other information as may be prescribed, from time to time, by the Central Bank;
- (b) For the purpose of this section, the approved auditor shall be an auditor who is:
  - (a) a member of one of the professional bodies recognised in Nigeria;
  - (b) approved by the Central Bank;
  - (c) resident in Nigeria; and
  - (d) carrying on in Nigeria professional practice as accountant and auditor.
- (c) Any person:
  - (i) having any interest in a bank otherwise than as a depositor;
  - (ii) who is a director, officer or agent of a bank;
  - (iii) which is a firm in which a director of a bank has any interest as partner or director;
  - (iv) who is indebted to a bank, shall not be eligible for appointment as the approved auditor for that bank; and
  - (v) a person appointed as such auditor who subsequently:
    - ◆ acquires such interest; or
    - ◆ becomes a director, officer or agent of the bank; or
    - ◆ becomes indebted to a partner in a firm in which a director of a bank is interested as partner or director, shall cease to be such auditor.
- (d) If any bank fails to appoint an approved auditor, the Central Bank shall appoint a suitable person for that purpose and shall fix the remuneration to be paid by the bank to such auditor;
- (e) Any approved auditor who acts in contravention of or fails deliberately or negligently to comply with any of the required provisions is guilty of an offence and liable on conviction to pay to the Central Bank a fine of not less than ₦200,000 and not exceeding ₦500,000;

- (f) The report of the approved auditor shall be read together with the report of the board of directors at the annual general meeting of the shareholders of the bank and two copies of each report with the auditor's analysis of bad and doubtful advances in a form specified, from time to time, by the Central Bank shall be sent to the Central Bank.
- (g) If an auditor appointed under this section, in the course of his duties as an auditor of a bank, is satisfied that:
  - (i) there has been a contravention of this Act, or that an offence under any other law has been committed by the bank or any other person; or
  - (ii) losses have been incurred by the bank which substantially reduce its capital funds; or
  - (iii) any irregularity which jeopardises the interest of depositors or creditors of the bank, or any other irregularity has occurred; or
  - (iv) he is unable to confirm that the claims of depositors or creditors are covered by the assets of the bank, and he shall immediately report the matter to the Central Bank.
- (h) The approved auditor shall forward to the Central Bank two copies of the domestic report on the bank's activities not later than three months after the end of the bank's financial year.
- (i) Any approved auditor who acts in contravention of or fails deliberately or negligently to comply with any of the required provisions is guilty of an offence and liable on conviction to a fine not exceeding 500,000 and where the approved auditor is a firm, the individual partner or partners shall in addition be liable on conviction to imprisonment for a term not exceeding five years and to the fine required to be paid by the firm.
- (j) The appointment of an approved auditor shall not be determined without prior approval of the Central Bank. (Section 29).

### **2.3 INSURANCE ACT 2007**

#### Classification of insurance business

- (a) The Act provides for two main classes of insurance as follows:
  - (i) Life insurance business; and
  - (ii) General insurance business.
- (b) In the case of life insurance, there shall be three categories:
  - (i) individual life insurance business;
  - (ii) group life insurance and pension business; and
  - (iii) health insurance business.
- (c) In the case of general insurance, there shall be eight categories:
  - (i) fire insurance business;
  - (ii) general accident insurance business;

- (iii) motor vehicle insurance business
- (iv) marine and aviation insurance business;
- (v) oil and gas insurance business;
- (vi) engineering insurance business;
- (vii) bonds credit guarantee and suretyship insurance business; and
- (viii) miscellaneous insurance business. (Section 2).

### **Minimum paid-up share capital**

No insurer shall carry on insurance in Nigeria unless the insurer has and maintained, while carrying on that business, a paid-up share capital of the following amounts as the case may require, in the case of:

- (a) Life insurance business, not less than ₦150,000,000;
- (b) General insurance, not less than ₦200,000,000;
- (c) Composite insurance business, not less than ₦350,000,000; or
- (d) Reinsurance business, not less than ₦350,000,000 (Section 9).

### **Records to be kept by insurer**

- (a) An insurer shall keep and maintain at its principal office the following-
  - (i) the Memorandum and Articles of Association or other evidence of the constitution of the insurer;
  - (ii) a record containing the names and addresses of the owners of the insurance business whether known as or called shareholders or otherwise;
- (b) the minutes of any meeting of the owners and of the policy-making executive (whether known as or called the Board of Directors or otherwise);
- (c) a register of all policies in which shall be entered in respect of every policy issued, the names and address of the policy-holder, the date when the policy was effected and a record or any transfer, assignment or nomination of which the insurer has notice;
- (d) a register of claims in which shall be entered every claim made together with the date of claim, the name and address of the claimant and the date on which the claim was settled, or in the case of a claim which is repudiated, the date of repudiation and the grounds for the rejection or in the case of litigation, the particulars of the litigation and the decision of the court in the matter;
- (e) a register of investment showing those which are attributable to the insurance funds and those which are not, and also any alteration in their values from time to time;
- (f) a register of its assets;
- (g) a register of reinsurance ceded in showing separately those ceded in Nigeria and those ceded outside Nigeria;
- (h) a cash book;
- (i) a current account book;
- (j) a register of open policies in respect of marine insurance transactions;
- (k) management report by external auditors; and

- (l) An insurer shall in respect of its life insurance business maintain and keep the following additional record, that is
  - (i) a register of assured under group policies;
  - (ii) a register of loans on policies;
  - (iii) a register of cash surrendered values; and
  - (iv) a register of lapsed and expired policies (Section 17).

#### **Records to be Kept by Re-insurer**

- (a) A re-insurer shall keep and maintain at its principal office the following:
  - (i) the Memorandum and Articles of Association or other evidence of the constitution of the reinsure;
  - (ii) records containing the names and address of the owners of the re-insurer (whether known as or called shareholders or otherwise);
  - (iii) minutes of any meeting of the owners and of the policy-making executive (whether known as the Board of Directors or otherwise);
  - (iv) a register of all treaties, in which shall be entered in respect of every treaty issued, the name of the cedant, and the date when the treaty was effected;
  - (v) a register of all claims, in which shall be entered every claim made together with the date of claim, the name of the cedant or insured, their proportionate share and the date the claim is settled;
  - (vi) a register of events showing those which are attributable to the insurance funds and those which are not also any alteration in value from time to time;
  - (vii) a register of assets;
  - (viii) a register of business or retrocession, showing separately those ceded within and outside Nigeria;
  - (ix) a register of new and existing clients;
  - (x) a cash book; and
  - (xi) domestic or management report prepared by external auditors.
- (b) A life re-insurer shall keep the following additional records:
  - (i) a register of assured under group policies;
  - (ii) a register of cancelled, lapsed and expired policies; and
- (c) a register of claims showing the name of the cedant and when the claim is settled. (Section 18).

#### **Separation of Accounts and Reserve Funds**

- (a) Where an insurer carries on the two classes of insurance business, all the receipts of each of those classes of insurance business shall be entered in a separate and distinct account and shall be carried to and form a separate insurance fund with the appropriate name so that in case of life insurance there shall be:
  - (i) the individual life insurance business fund;
  - (ii) the group life insurance business and pension fund; and
  - (iii) health insurance business.

- (b) Each insurance fund shall represent the liabilities in respect of all contracts of insurance of that particular class and shall consist:
  - (i) in the case of life insurance business, the life business funds shall be a sum not less than the mathematical reserve; and
  - (ii) in the case of general insurance business of the provisions for unexpired risk and provisions estimated to provide for the expenses of adjustment or settlement of such claims.
- (c) The insurance fund of each particular class shall:
  - (i) be absolutely the security of the policy holders of that class as though it belonged to an insurer carrying on other business than insurance business of that class;
  - (ii) not be liable for any contract of the insurer for which it would not have been liable had the business of the insurer been only that of particular insurance class; and
  - (iii) not be applied, directly or indirectly, for any purposes other than those of the class of business to which the fund is applicable. (Section 19).

#### **Provisions for Unexpired Risks and Claims**

- (a) An insurer shall in respect of its general business, establish and maintain the following provisions applicable in respect of each class of insurance business:
  - (i) provisions for unexpired risks which shall be calculated on a time apportionment basis of the risks accepted in the year;
  - (ii) provision for outstanding claims which shall be credited with an amount equal to the total estimated amount of all outstanding claims with a further amount representing 10 per centum of the estimated figure for outstanding claims in respect of claims incurred but not reported at the end of the year under review; and
  - (iii) provision for outstanding claims (Section 20).

#### **Contingency Reserves**

- (a) An insurer shall establish and maintain contingency reserves to cover fluctuations in securities and variation in statistical estimates.
- (b) The contingency reserves shall be credited with an amount not less than 3 per centum of the total premium or 20 per centum of the net profits (whichever is greater) and the amount shall accumulate until it reaches the amount of the minimum paid-up capital or 50 per centum of the net premiums (whichever is greater). (Section 21).

#### **Reserve for Life Insurance Business**

An insurer shall in respect of its life insurance business maintain the following reserve:

- (a) A general reserve fund which shall be credited with an amount equal to the net liabilities on policies in force at the time of the actuarial valuation

and an additional 25 per cent of net premium for every year between valuation date; and

- (b) A contingency reserve fund which shall be credited with an amount equal to 1 per cent of the gross premiums or 10 percent of the profits (whichever is greater) and accumulated until it reached the amount of the minimum paid-up capital. (Section 22).

### **Reserve of Re-insurers**

A re-insurer shall establish a general reserve fund which shall be credited with an amount:

- (a) Not less than 50 per centum of his insurer's gross profit for the year where the fund is less than the authorised capital of the insurer; and
- (b) Not less than 25 per centum of the re-insurer gross profit for the year where the fund is equal to or exceed the authorised capital of the re-insurer. (Section 23).

### **Solvency Margin**

- (a) An insurer shall in respect of its business other than its life insurance business, maintain at all times a margin of solvency being the excess of the value of its admissible assets in Nigeria over its liabilities in Nigeria consisting of:
  - (i) Provisions for unexpired risks;
  - (ii) Provision for outstanding claims;
  - (iii) Provisions for claims incurred but not yet reported; and
  - (iv) Funds to meet other liabilities.
- (b) The solvency margin referred to in subsection (1) of this section shall not be less than 15 per centum of the gross premium income less reinsurance premium paid out during the year review or the minimum paid-up capital which ever is greater;
- (c) For the purpose of calculating the solvency margin, all monies owned by policy holders, brokers or agents by way of premiums due to but not received by the insurer as at the end of the relevant year shall not count as admissible assets or be included in determining qualifying liabilities;
- (d) Any amount due as liability to re-insurers which are attributable to outstanding premium in respect of the current year excluded under the above shall be excluded from liabilities;
- (e) An auditor who audits a balance sheet profit and loss and revenue account of an insurer under section 28 of this Act shall insure a certification stating the extent to which the insurer has satisfied the margin of solvency required under this section;
- (f) If the Commission is not satisfied with a certification issued under this section, it may conduct an independent investigation on the matter with a view to determining what action to take against the insurer or the auditor;

- (g) Where an investigation conducted discloses a false certification by an auditor, the Commission may make a report on the auditor to the appropriate professional body for necessary disciplinary action;
- (h) Where an insurer or reinsurance company fails to account of its being insolvent, any auditor or official of the Commission who in the 3 previous years certifies the said company as being solvent shall be held liable;
- (i) In this section - “admissible assets” means assets designated as admissible assets consisting of the following:
  - (i) Cash and bank balance;
  - (ii) Quoted investment at market value;
  - (iii) Unquoted stock at cost;
  - (iv) Land and building;
  - (v) Furniture and fittings;
  - (vi) Office equipment;
  - (vii) Motor vehicles;
  - (viii) Prepaid expenses made to member of staff;
  - (ix) Amount due from retrocession;
  - (x) Staff loans and advance; and
  - (xi) Claims receivable. (Section 23).

### **Investment**

- (a) An insurer shall at all times in respect of the insurance transacted by it in Nigeria, invest and hold invested in Nigeria assets equivalent to not less than the amount of policy holder’s funds in such accounts of the insurer;
- (b) The policy-holder’s funds shall not be invested in property and securities except:
  - (i) shares of limited liability companies;
  - (ii) shares in other securities of a co-operative society registered under a law relating to co-operative societies;
  - (iii) loans to building societies approved by the Commission;
  - (iv) loans on real property, machinery and plant in Nigeria;
  - (v) loans on life policies within their surrender values;
  - (vi) cash deposit in or bills of exchange accepted by licensed banks; and
  - (vii) such investments as may be prescribed by the Commission.
- (c) No insurer shall:
  - (i) in respect of its general insurance business, invest more than 35 per centum of its assets as defined in subsection (1) of this section in real property; or
  - (ii) in contract of its life insurance business, invest more than 35 per centum of its assets as defined in subsection (1) of this section in real property.

- (d) An insurer which contravenes the provisions of this section commits an offence and is liable on conviction to a fine of ₦50,000. (Section 25).

**Statements of Accounts, etc.**

- (a) An insurer shall not later than 30 June of each year submit in writing to the Commission the following:
  - (i) a balance sheet duly audited showing the financial position of the insurance business of the insurer and its subsidiaries at the close of that year together with a copy of the relevant profit and loss account which the insurer is to present to its shareholders at its annual general meeting;
  - (ii) a revenue account applicable to each class of insurance business for which the insurer is required to keep separate account of receipts and payment; and
  - (iii) a statement of investments representing the insurance funds.
- (b) The returns and accounts required to be submitted under subsection (1) (a) and (b) of this section shall be in such form as may be approved by the Commission;
- (c) An insurer which fails, neglects or refuses to file the returns and accounts under this section commits an offence and is liable on conviction to a fine of ₦5,000 per day for each day of default.
- (d) An insurer shall in each year after receipt of the approval of the Commission, publish its general annual balance sheet together with its profit and loss accounts in at least one newspaper having wide circulation in Nigeria.
- (e) No insurer shall distribute any dividends until the Commission has approved the annual returns of the insurer within 30 days of its submission to the Commission. (Section 26).

**Life Insurance accounts**

- (a) An insurer transacting life insurance business shall submit to the Commission every three years in the prescribed form, the following:
  - (i) an abstract of the report if an actuary and valuation report of the life insurance business;
  - (ii) a summary and valuation of the life policies;
  - (iii) a table showing premium, policy reserve values and guaranteed surrender values together with the relationship between premium paid and such guaranteed surrender values; and
  - (iv) a certificate of solvency signed by an actuary stating that the value of the assets representing the funds maintained by the insurer in respect of the life insurance business exceeds the value of the liabilities.
- (b) The commission may require an insurer transacting business to:

- (i) cause the person who is for the time being the actuary of the insurer to make an investigation into its financial condition (including evaluation of its liabilities) in respect of that business as at a specified date;
  - (ii) cause an abstract of that person's report of the investigation to be made and submitted to it;
  - (iii) prepare and submit to it a statement of its life insurance business or part thereof as at the date of the request; and
  - (iv) show sufficient evidence that not more than 40 per centum of the actuarial surplus declared is appropriated for shareholders.
- (c) An insurer transacting life insurance shall at the expiration of each year:
- (i) prepare with reference to that year in the prescribed form a statement and exhibit of the life policies; and
  - (ii) submit the statement and exhibit together with such other document and information relating to the relevant accounts and balance sheet (including copies of reports on the affairs of the insurer for the year as submitted to the policy-holders of the insurer as the Commission may from time to time require.
- (d) On receipt of the documents mentioned in subsections (2) and (3) of this section, the Commission shall, if it appears to it that the statement furnished by an insurer under any of those subsections is inaccurate or is prepared in the prescribed form, or is defective in any material particular:
- (i) require from the insurer such further information as it may consider necessary;
  - (ii) call on the insurer to submit for its examination any book of account, register or any other document;
  - (iii) require the insurer to confirm on oath or by or a sworn declaration the authenticity of any statement submitted by the insurer;
  - (iv) refuse to approve the insurer's annual statement unless or until the inaccuracies have been supplied.
- (e) An insurer who fails, neglects or refuses to file the required returns or accounts under this section is guilty of an offence and liable on conviction to a fine of ₦5,000 per day for every day of default.
- (f) An insurer shall in each year after receipt of the approval of the Commission publish its general annual balance sheet together with its profit and loss account in at least one newspaper having wide circulation in Nigeria. (Section 27).

### **Audits**

- (a) The balance sheet profit and loss account and revenue account of an insurer in respect of the insurance business transacted by the insurer, shall be audited annually by an external auditor.

- (b) At the conclusion of the audit, the auditor shall issue certificate signed by him stating whether in his opinion:
  - (i) He has obtained adequate information from the books and records of the insurer;
  - (ii) The books of the insurer have been properly kept and the affairs and transactions of the insurer have been properly recorded;
  - (iii) The accounts and balance sheet of the insurer are in accordance with the information given to him for the purpose of his audit;
  - (iv) The accounts and balance sheet are in accordance with the applicable provisions of this Part of this Act; and
  - (v) The balance sheet of the insurer and the profit and loss account respectively gives a true and fair view of the financial position of the insurer. (Section 28).

### **Actuarial Valuation**

- (a) An insurer transacting life insurance business shall in respect of its life insurance business once in every period of three years, cause an investigation to be made into its financial position by an actuary appointed or secured by the insurer;
- (b) An investigation under subsection (1) of this section shall include:
  - (i) a valuation of the assets and liabilities of the insurer; and
  - (ii) a determination of any excess over those liabilities of the assets representing the funds maintained by the insurer.
- (c) For the purpose of an investigation under this section, the value of any asset and the amount of liability shall be determined in accordance with applicable valuation regulations. (Section 29).

## **2.4 PENSION REFORM ACT, 2004**

### **Objective of the Act**

The objectives of the Scheme shall be to:

- (a) ensure that every person who worked in either the Public Service of the Federation, Federal Capital Territory or Private Sector receives his retirement benefits as and when due;
- (b) assist improvident individuals by ensuring that they save in order to cater for their livelihood during old age; and
- (c) establish a uniform set of rules, regulations and standards for the administration and payments of retirement benefits for the Public Service of the Federation, Federal Capital Territory and the Private Sector.

### **Establishment of the Commission**

There is established a body to be known as the National Pension Commission.

The Commission:

- (a) shall be a body corporate with perpetual succession and a common seal; and
- (b) may sue and be sued in its corporate name.

The Commission may acquire, hold or dispose of any moveable or immovable property for the purpose of its function.

### **Objectives of the Commission**

The principal object of the Commission shall be to regulate, supervise and ensure the effective administration of pension matters in Nigeria.

### **Composition of the Commission**

The Commission shall consist of:

- (a) a part-time chairman who shall possess a university degree or its equivalence with not less than 20 years experience;
- (b) a Director-General who shall:
  - (i) be the Chief Executive Officer responsible for the day-to-day administration of the Commission;
  - (ii) possess professional skill and with not less than twenty years cognate experience relating to pension matters and or Insurance, Actuarial Science or other related field; and
  - (iii) be a fit and proper person;
- (c) four full-time Commissioners who shall each:
  - (i) possess professional and cognate experience in Finance and Investment, or Accounting or Pension Management or Actuarial Science or Business Administration or other related field; and
  - (ii) be fit and proper persons,
- (d) part-time members of the Commission who shall be representatives each of:
  - (i) The Head of the Civil Service of the Federation,
  - (ii) The Federal Ministry of Finance,
  - (iii) The Nigeria Labour Congress,
  - (iv) The Nigeria Union of Pensioners,
  - (v) The Nigeria Employers' Consultative Association,
  - (vi) The Central Bank of Nigeria; and
  - (vii) the Securities and Exchange Commission.

There shall be 4 specialised departments of the Commission, namely:

- (a) Technical;
- (b) Administration;
- (c) Inspectorate; and
- (d) Finance and Investment to be headed by 4 Commissioners.

The Chairman, the Director-General and other members of the Commission other than ex-officio members shall be appointed by the President, one each from the six geo-political zones of Nigeria, subject to the confirmation of the Senate.

The Commission's Secretary and Legal Adviser shall be appointed by the Commission and his terms of employment shall be as stipulated by the Commission.

The Chairman, the Director-General and the Commissioners shall hold office for a term of 4 years and may be re-appointed a further term of 4 years. In the event of a vacancy, the President shall appoint a new member from the appropriate zone to complete the tenure of his successor.

### **Functions and Powers of the Commission**

The Commission shall:

- (a) regulate and supervise the Scheme established under this Act;
- (b) issue guidelines for the investment of pension funds;
- (c) approve, licence, regulate and supervise pension fund administrators, custodians and other institutions relating to pension matters as the Commission may, from time to time, determine;
- (d) establish standards, rules and guidelines for the management of the pension funds under this Act;
- (e) ensure the maintenance of a National Data Bank on all pension matters;
- (f) carry out public awareness and education on the establishment and management of the Scheme;
- (g) promote capacity building and institutional strengthening of pension fund administrators and custodians;
- (h) receive and investigate complaints of impropriety levelled against any pension fund administrator, custodian or employer or any of their staff or agent; and
- (i) perform such other duties which, in the opinion of the Commission, are necessary or expedient for the discharge of its functions under this Act.

The Commission shall have the power to:

- (a) formulate, direct and oversee, the overall policy on pension matters in Nigeria;
- (b) fix the terms and conditions of service including remuneration of the employees of the Commission;
- (c) request or call for information from any employer or pension administrator or custodian or any other person or institution on matters relating to retirement benefit;
- (d) charge and collect such fees, levy or penalties, as may be specified by the Commission;
- (e) establish and acquire offices and other premises for the use of the Commission in such locations as it may deem necessary, for the proper performance of its functions under this Act;
- (f) establish standards, rules and regulations for the management of the pension funds under this Act;
- (g) investigate any pension fund administrator, custodian or other party involved in the management of pension funds;
- (h) impose administrative sanctions or fines on erring employers or pension fund administrators or custodians;
- (i) order the transfer of management or custody, of all pension funds or assets being managed by a pension fund administrator, or held by a

- custodian whose licence has been revoked under this Act, or subject to insolvency proceedings to another pension fund administrator or custodian, as the case may be; and
- (j) do such other things which in its opinion are necessary to ensure, the efficient performance of the functions of the Commission under this Act.

### **Funds of the Commission**

The Commission shall establish and maintain a fund from which all its expenses will be defrayed. The fund established shall consist of:

- (a) the initial take-off grant from the Federal Government;
- (b) annual subvention from the Federal Government;
- (c) fees, fines and commissions charged by the Commission;
- (d) income from any investments of the Commission; and
- (e) all sums of money or income accruing to the Commission by way of testamentary dispositions and endowments.

### **Estimates, Accounts and Audit of the Commission**

The Commission shall cause to be prepared, not later than the thirtieth day of September in each year, an estimate of its income and of expenditure for the succeeding year.

The Commission shall cause to be kept proper accounts and records in relation thereto. Such account shall, not later than 4 months after the end of each year, be audited by auditors appointed by the Commission from the list and in accordance with the guidelines supplied by the Auditor-General for the Federation.

The Commission shall not later than 6 months after the end of each year submit to the President and the Public Account Committee of the National Assembly a report on the activities and administration of the Commission during the immediately preceding year and shall include in such report the audited accounts of the Commission and the auditors report thereon.

## **2.5 NIGERIAN ACCOUNTING STANDARDS BOARD ACT 2003**

### **Establishment of the Nigerian Accounting Standards Board**

The Nigerian Accounting Standards Board Act, 2003 states as follows:

There is established a Board to be known as the Nigerian Accounting Standards Board. The Board shall be:

- (a) a body corporate with perpetual succession and a common seal; and
- (b) may sue and be sued in its corporate name.

The Board may acquire, hold or dispose any property movable or immovable for the purpose of carrying out its functions.

### **Membership of the Board**

There is established for the Board, a Governing Council which shall have overall control of the Board.

The Council shall consist of:

- (a) a Chairman who shall be a professional accountant with considerable professional experience in accounting practices;
- (b) two representatives each of the following:
  - (i) Institute of Chartered Accountants of Nigeria; and
  - (ii) Association of National Accountants of Nigeria
- (c) a representative each of the following:
  - (i) Federal Ministry of Commerce;
  - (ii) Federal Ministry of Finance;
  - (iii) Central Bank of Nigeria
  - (iv) Corporate Affairs Commission;
  - (v) Federal Inland Revenue Service;
  - (vi) Nigeria Deposit Insurance Corporation;
  - (vii) Securities and Exchange Commission;
  - (viii) Auditor-General for the Federation;
  - (ix) Accountant-General of the Federation;
  - (x) Chartered Institute of Taxation of Nigeria;
  - (xi) Nigerian Association of Chambers of Commerce, Industries, Mines and Agriculture.
- (d) the Executive Secretary of the Board

The Chairman and other members of the Council, other than ex-officio members, shall be appointed by the President, on the recommendation of the Minister.

The Chairman and other members of the Council, other than ex-officio members shall each hold office:

- (a) for a term of 4 years in the first instance and may be reappointed for a further term of 4 and no more; and
- (b) on such terms and conditions as may be specified in their letters of appointment.

### **Functions of the Board**

The Board shall:

- (a) develop and publish in the public interest accounting standards to be observed in the preparation of financial statements;
- (b) promote the general acceptance and adoption of such standards by preparers and users of financial statements;
- (c) promote and enforce compliance with the accounting standards developed or reviewed by the Board;
- (d) review from time-to-time the accounting standards developed in line with the prevalent social, economic and political environment;
- (e) receive from time to time notices of non-compliance with its standards from the prepare, user or auditor of an account;
- (f) receive copies of all qualified reports together with detailed explanations for such qualifications from auditors of the accounts within a period of 60 days from the date of such qualification;

- (g) advise the Minister on the making of regulations under Section 356 of the Companies and Allied Matters Act, Cap. C 20, LFN 2004;
- (h) advise the Federal Government on matters relating to accounting standards; and
- (i) perform such other duties which in the opinion of the Council, are necessary or expedient to ensure the efficient performance of the functions of the Board under the Act.

### **Powers of the Board**

The Board shall have powers to:

- (a) identify accounting statements which require standardisation and establish the order of priority for addressing them;
- (b) determine the scope and objectives of each standards;
- (c) prescribe the methods and procedure for the productions of standards;
- (d) prescribe the time table for the production of each standards;
- (e) approve discussion papers, exposure drafts and standards;
- (f) enforce and approve enforcement of compliance with accounting standards in Nigeria; and
- (g) exercise such powers as are necessary or expedient for giving effect to the provisions of this Act.

### **Development of Statements of Accounting Standards**

The Board shall observe the following procedure in the development of statement of accounting standards:

- (a) choice of a topic for standardisation;
- (b) prepare and publish exposure draft;
- (c) conduct a public hearing where necessary; and
- (d) issue a statement of accounting standards.

Know the instruments establishing various organisations such as SEC, NDIC, etc.

### **The Nigerian Accounting Standards Board (NASB)**

Section 344 of Companies and Allied Matters Act, CAP C20, 2004 provides that the directors of every company shall in respect of each year of the company; prepare financial statements for the year to contain the necessary details as provided in the Act.

Section 355 (1) CAMA states as follows:” The Financial statements of a company prepared under section 344 of the Act, shall comply with the requirements of schedule 2 to the Act with respect to their form and content, and with the accounting standards laid down in the Statements of Accounting Standards issued from time to time by the Nigerian Accounting Standards Board to be constituted by the Minister after due consultation with such accounting bodies as he may deem fit in the circumstances for this purpose provided that such accounting standards do not conflict with the provisions of this Act”

Following the above provision, the Nigerian Accounting Standards Board (NASB) was reconstituted with the following members:

- (a) Central Bank of Nigeria (CBN);
- (b) Federal Ministry of Finance;
- (c) Nigerian Accounting Teachers Association;
- (d) Nigeria Association of Chambers of Commerce, Industry, Mines and Agriculture;
- (e) Nigeria Stock Exchange;
- (f) Securities and Exchange Commission;
- (g) The Chartered Institute of Bankers of Nigeria;
- (h) Federal Ministry of Commerce and Tourism;
- (i) Federal Inland Revenue Service Board;
- (j) Nigeria Deposit Insurance Corporation;
- (k) The Office of the Auditor-General for the Federal;
- (l) Corporate Affairs Commission;
- (m) The Institute of Chartered Accountants of Nigeria;
- (n) Chartered Institute of Taxation of Nigeria; and
- (o) Association of National Accountants of Nigeria.

The Board from time to time issues Statements of Accounting Standards (SAS) which seek to provide a guide for accounting policies and accounting methods that should be followed by companies in the preparation of their financial statements relative to income recognition, loss recognition, balance sheet classification and many other provisions. The Board since inauguration has issued twenty-one consecutive Statements of Accounting Standards (SAS) to date.

The Nigerian Accounting Standards Board (NASB) is charged with the responsibility for developing and publishing accounting standards to be observed in the preparation of financial statements in Nigeria. The Companies and Allied Matters Act makes it mandatory for auditors to ensure that financial statements prepared in Nigeria comply with accounting standards issued by the NASB.

The Nigerian Accounting Standards Board Act 2003 further seeks to promote and enforce compliance with the accounting standards to be observed in the preparation of financial statements. NASB Act 2003 prescribes stiff penalties for non-compliance with accounting standards issued by the NASB. These include:

- (a) Fines at the discretion of the Board
- (b) ₦5 million fine
- (c) One year imprisonment, or both, on conviction
- (d) Proscription or de-listing of the firm of accountants.

## 2.6 SECURITIES AND EXCHANGE COMMISSION (SEC)

In 1962, a year after the establishment of the Lagos Stock Exchange, an ad-hoc consultative and advisory body known as the Capital Issues Committee was established under the aegis of the Central Bank of Nigeria (CBN). Its mandate was to examine applications from companies seeking to raise capital from the market and to recommend the timing of such issues. The Committee, however, had no legal backing, but operated non-officially as a capital market consultative and advisory body within the Central Bank of Nigeria.

An increase in the level of economic activities, and consequently capital market activities after cessation of the civil war hostilities, coupled with the promulgation of the Nigerian Enterprises Promotion Decree in 1972, necessitated the creation of another body, the Capital Issues Commission in March, 1973 to take over the activities of the Capital Issues Committee.

The new body statutorily backed by the Capital Issues Commission Decree of 1973 which established a board of nine members, including a representative of the Central Bank of Nigeria, serving as Chairman, while the other eight members were drawn from some Federal Ministries, the industrial and finance sectors.

Following the acceptance of the recommendations of the Financial System Reviewing Committee in 1976, the Federal Government endorsed the establishment of the Securities and Exchange Commission to supersede the Capital Issues Commission. Consequently, the Securities and Exchange Commission Decree No. 71 of 1979 was promulgated, effective retrospectively from April 1, 1978, thus establishing the Commission and vesting wider power on it to regulate and develop the Nigerian capital market, in addition to determining the prices of issues and setting the basis of allotment of securities. Unlike its two predecessors, the Commission at this stage was excised from the CBN, although it continued to receive further funding from the apex bank. It also had an enlarged 12-member board with a CBN representative as its Chairman. Other members were drawn from the Ministries of Finance, Trade and Industries, The Nigerian Stock Exchange and the Nigerian Enterprises Promotion Board; other members were nominated on basis of personal merit.

The Commission, however, took off effectively on January 1, 1980 with a staff of fifty one; seven of them were on secondment (for a period of three years) from the Central Bank of Nigeria (CBN), while others were newly recruited. Nine years after the establishment of the Securities and Exchange Commission, the enabling law, Decree No. 7 of 1979 was re-enacted as Securities and Exchange Commission Decree No. 29 of 1988 with additional provisions to address observed lapses in the previous arrangement and to enable the Commission pursue its functions more effectively.

To further enhance the Commission's pursuit of its objects of investor protection and capital market, another review was carried out in 1996 by a 7-man panel

headed by Chief Dennis Odife. A new Act known as “The Investment and Securities Act No. 45 of 1999” was promulgated on May 26, 1999 based on the panel’s recommendations. The Act repealed the SEC Act of 1988. The new Act is expected to promote a more efficient and virile capital market, pivotal to meeting the nation’s economic and developmental aspirations.

Part II Section 8 of the Act stipulated twenty five functions in the previous Act. New roles were added to the existing roles of the Securities and Exchange Commission. Among the various new roles of the Commission are to:

- (a) Register and regulate Securities Exchange; Capital Trade Points; Futures, Options and Derivatives Exchanges; Commodity Exchanges and any other recognised Investment Exchange;
- (b) Prepare adequate guidelines and organised training programmes and disseminate information necessary for the establishment of securities exchange and capital trade points;
- (c) Funds, Capital Trade Points, Futures, Options and Derivatives as well as other intermediaries and self-regulatory organisations in the securities industry;
- (d) Keep and maintain separate registers of foreign direct investment and foreign portfolio investments;
- (e) Promote investors’ education and the training of categories of intermediaries in the security industry. In addition, the Act empowers the Commission to establish specialised departments for the purpose of regulating:
  - (i) Securities Exchange; Capital Trade Points; Options and Commodity Exchange;
  - (ii) Capital market operators including corporate members securities exchange and individuals; professional firms, that is, accountants, solicitors, surveyors, engineers and other professionals who undertake investment business either as investment advisers or consultants;
  - (iii) Collective investments including all collective investment schemes such as unit trusts, esusu schemes, pension funds and other such schemes; and
  - (iv) Mergers, acquisitions, takeover and other forms of business combinations under the Act.

Another major new provision is the establishment of Investors’ Protection Fund. The Act provides that a Securities Exchange or Capital Trade Point shall establish and maintain the fund to be administered by their individual governing councils respectively.

The Securities and Exchange Commission is also a member of International Organisation of Securities Commission (IOSCO).

## 2.7 NIGERIA DEPOSIT INSURANCE CORPORATION

The Nigeria Deposit Insurance Corporation (NDIC), was established as part of the reform measures taken to strengthen the safety net for the banking sector following the introduction in 1986 of a major economic reform programme, the Structural Adjustment Programme (SAP) by government to correct the observed imbalances in the economy. The establishment of NDIC became imperative given the rapid growth in the number of licensed banks in the late 80s' and early 90s' and the financial sector reforms that subsequently followed the Structural Adjustment Programme.

In addition to this, there was also the long-term need to create and sustain an enabling environment that will engender banking stability by protecting the banking sector against destructive runs, protecting bank depositors and to ensure fair play amongst the competing banks. These considerations were informed by the lessons of history of bank failures in Nigeria in the 50s, the experience of other countries where deposit insurance schemes are being operated and the prevailing distressed financial conditions of the banks in particular and other financial intermediaries in the financial sector in general, among others. The NDIC was formally established by Decree No. 22 of 1988 and commenced operations in 1989.

Section 5 of the Decree No 22 of 1988 establishing NDIC provides the following functions for the Corporation:

- (a) Insuring all deposit liabilities of licensed banks and such other financial institutions operating in Nigeria within the meaning of sections 20 and 26 of this Decree so as to engender confidence in the Nigerian Banking system;
- (b) Giving assistance in the interest of depositors, in case of imminent or actual financial difficulties of banks particularly where suspension of payments is threatened: and avoiding damage to public confidence in the banking system;
- (c) Guaranteeing payments to depositors, in case of imminent or actual suspension of payments by insured banks or financial institutions up to the maximum amount as provided for in section 26 of this Decree;
- (d) Assisting monetary authorities in the formulation and implementation of banking policy so as to ensure sound banking practice and fair competition among banks in the country;
- (e) Pursuing any other measures necessary to achieve the functions of the Corporation provided such measures and actions are not repugnant to the functions of the Corporation.

## 2.8 CENTRAL BANK OF NIGERIA

The Central Bank of Nigeria Act of 1991 provides for the continuance of the Central Bank of Nigeria (CBN) and its overall control and administration of the monetary and banking policies of the Federal Government of Nigeria both within and outside Nigeria. It simply establishes the Central Bank of Nigeria as the Apex Financial Regulatory Institution in Nigeria.

### **Principal objects of the Central Bank**

The principal objects of the Central Bank are:

- (a) Issue legal tender currency in Nigeria;
- (b) Maintain external reserves to safeguard the international value of the legal tender currency;
- (c) Promote monetary stability and a sound financial system in Nigeria; and
- (d) Act as banker and financial adviser to the Federal Government.

The Central Bank has powers to:

- (a) Issue demand drafts;
- (b) Purchase and sell gold coins or bullion;
- (c) Open accounts for and accept deposits from Federal, State and local governments and parastatals;
- (d) Purchase, sell, discount and rediscount inland bills of exchange and promissory notes;
- (e) Purchase, sell, discount and rediscount treasury bills, treasury certificates and project-tied bonds issued by State Governments, local governments and parastatals;
- (f) Purchase and sell securities of the Federal Government;
- (g) Grant advances for fixed deposits not exceeding three months against publicly issued treasury bills;
- (h) Determine exchange rate of the Naira;
- (i) Sole right of issuing notes and coins;
- (j) Power to print notes and mint coins;
- (k) Denominate currency notes and coins;
- (l) Buy and sell Nigerian currency;
- (m) Maintain accounts with central banks and other banks outside Nigeria
- (n) Act as correspondent, banker or agent for any central bank or other monetary authority;
- (o) Promote the establishment of bank clearing systems;
- (p) Grant temporary advances to commercial banks;
- (q) Act as clearing house for banks to facilitate the clearing of cheques and credit instruments;
- (r) Banker to other bankers;
- (s) Carry out open market operations for the purpose of maintaining monetary stability in the Nigerian economy;
- (t) Sell or place by allocation to each bank any stabilisation securities issued;
- (u) Issue and manage Federal Government loans;
- (v) Act as banker to State and local governments;
- (w) Power to issue directives on cash reserves; and
- (x) Publish minimum re-discount rate

### **Prohibited Activities**

The Central Bank shall not:

- (a) Engage in trade or otherwise have a direct interest in any commercial, agricultural or industrial undertaking except for the purpose of its business, provided that all such interest so acquired shall be disposed of at the earliest suitable time;
- (b) Grant loan upon the security of any shares;
- (c) Purchase, acquire or lease real property except for the provision of business premises for the Central Bank and its agencies and residences for the Governor, Deputy Governors and officers and other employees of the Central Bank;
- (d) Draw or accept bills payable otherwise than on demand;
- (e) Pay interest on deposits except deposits in respect of cash reserve and special deposits made by various banks to the Central Bank, to maintain the required ratio of the deposit liabilities;
- (f) Accept for discount or as security for an advance made by the Central bills or notes signed by members of the Board or by officers and other employees of the Bank; and
- (g) Open accounts for or accept deposits from persons other than Federal, State, local governments, institutions and corporations of all such governments, banks and other credit or financial institutions, central banks and other banks outside Nigeria.

### **Audit**

The accounts of the Central Bank shall be audited by an auditor or auditors appointed by the Board.

- (a) The President may direct that the Auditor-General of the Federation to conduct an examination of the accounts of the Central Bank.
- (b) Publication of annual accounts and reports:  
The Central Bank shall within two months after the close of each financial year, transmit to the President a copy of its annual accounts certified by the auditor.
- (c) The Central Bank shall within four months from the close of each financial year, submit to the President a report on its operations during the year.
- (d) Any report required to be submitted to the President shall be published by the Central Bank in such a manner as the Governor of Central Bank may direct.
- (e) The Board of Central Bank shall ensure that accounts submitted be published in the Gazette.
- (f) The Central bank shall publish a monthly return of its assets and liabilities.
- (g) A copy of the return shall be forwarded to the President and shall be published in the Gazette.
- (h) The gold tranche position at the International Monetary Fund shall form part of the external reserve assets of the Bank.

### **Exemption from Stamp Duty**

The Central Bank shall not be liable for the payment of any stamp duty under the Stamp Duties Act in respect of its notes issued as currency.

### **Exemption from Income Tax**

The Central Bank of Nigeria shall be exempted from the payment of tax under the Companies Income Tax Act.

### **Exemption from Companies and Allied Matters Act**

The provisions of the Companies and Allied Matters Act shall not apply to the Central Bank.

## **2.9 BUREAU OF PUBLIC ENTERPRISES**

The Bureau of Public Enterprises (BPE) is the Secretariat of the National Council on Privatisation (NCP) and is charged with the overall responsibility of implementing the policies and decisions of the Council. The functions of the Bureau as provided for in the Act include:

- (a) Implementing the Council's policy on privatisation and commercialisation;
- (b) Preparing public enterprises approved by the Council for privatisation and commercialisation;
- (c) Advising Council on further public enterprises that may be privatised or commercialised;
- (d) Advising Council on capital restructuring needs of the public enterprises to be privatised;
- (e) Ensuring the update of accounts of all commercialised enterprises for financial discipline;
- (f) Making recommendations to the Council on the appointment of Consultants, advisers, investment bankers, issuing houses stockbrokers, solicitors, trustees, accountants and other professionals required for the purpose of either privatisation or commercialisation;
- (g) Ensuring the success of the privatisation and commercialisation exercise through effective post transactional performance monitoring and evaluation; and
- (h) Providing secretarial support to the Council and carrying out such other duties and responsibilities as may be assigned to it from time to time by the Council and its committees.

### **The Rationale**

Experience worldwide has shown that Public Enterprises have failed to live up to expectations. They tend to consume a large proportion of national resources without discharging the responsibilities thrust upon them. More importantly, they fail to allocate these resources efficiently. Public enterprises consume about ₦200 billion of national resources annually, by way of grants, subsidies, import duty waivers, tax exemptions, and the like.

The current move towards economic liberalisation, competition and privatisation is partly informed by the gross failure of public enterprises to live up to expectation. In the case of Nigeria, it is clear that Nigeria cannot afford to spend or subsidise a few public enterprises with resources equal to more than twice the nation's capital expenditure budget.

Furthermore, donors and creditors expect Nigeria to direct her scarce resources to alleviate poverty through investment in health, education and rural development - social programmes that will benefit millions of Nigerians. There is virtually no public enterprise in Nigeria today that functions well.

While they were created to alleviate the shortcomings of the private sector and spearhead the development of Nigeria, many of them have stifled entrepreneurial development and fostered economic stagnation. NITEL, NEPA and the Nigerian National Petroleum Corporation (NNPC) are the best examples of these. Public enterprises have served as platforms for patronage and the promotion of political objectives, and consequently suffer from operational interference by civil servants and political appointees.

Public Commissions and Study Groups have undertaken various studies on the performance of public enterprises in Nigeria. Adebo (1969), Udoji (1973), Onosode (1981) and Al-Hakim (1984) chaired these commissions.

The findings of the studies were consistent in establishing that public enterprises were infested with problems such as:

- (a) Abuse of monopoly powers;
- (b) Defective capital structures resulting in heavy dependence on the treasury for funding;
- (c) Bureaucratic bottlenecks;
- (d) Mismanagement;
- (e) Corruption; and
- (f) Nepotism.

The scope of the Privatisation Programme, which commenced in 1999, includes the partial or total divestment of the shares owned by the Federal Government, its parastatals and other agencies in public enterprises active or dominant in at least thirteen key sectors. The cumulative value of investment to be transferred from the public sector is in excess of \$100 billion.

Clearly then, there is abundant evidence that public enterprises have not served their customers, their employees, or the taxpayers well. The simple fact is that when the government owns, nobody owns; and when nobody owns, nobody cares. The experience in the last thirty years has been one in which the public enterprises have:

- (a) Created economic inefficiency;
- (b) Incurred huge financial losses;
- (c) Absorbed disproportionate share of credit especially in the form of Paris and London club loans, as well as domestic loans and advances; and
- (d) Contributed to consistent fiscal deficits.

Over time, political and personal considerations have proved to be significant influences on numerous public enterprises policy matters (including investment, tendering, pricing, choice of machinery, employment levels, and management appointments). All have been unsustainable, and achieved at significant cost to the Treasury.

The benefits of privatisation are immense, and the sooner these are realised, the better. Privatisation, in whatever forms chosen, will:

- (a) Reduce corruption;
- (b) Modernise technology;
- (c) Strengthen domestic capital markets;
- (d) Dismantle monopolies and open markets;
- (e) Promote efficiency and better management;
- (f) Reduce debt burden and fiscal deficits;
- (g) Resolve massive pension funding problems;
- (h) Broaden base of ownership;
- (i) Generate funds for the Treasury;
- (j) Promote corporate governance;
- (k) Attract foreign investment; and
- (l) Reverse capital flight.

## 2.10 PROFESSIONAL PRONOUNCEMENTS AND THEIR APPLICATIONS

Guidelines and standards of the Institute and other International Bodies.

### **Ethics**

- (a) Ethics refers to a system or code of conduct based on moral duties, values and obligations that indicates how we should behave within a constituted body or society.
- (b) Professionalism refers to the conduct, aims, or qualities that characterise or mark a profession or professional person in the context of the professional body to which the person belongs.
- (c) Without independence, the user will place little reliance on the report of the auditors.

### **Code of Ethics Issued by the Institute of Chartered Accountants of Nigeria**

In Nigeria, the auditor must comply with the 'Rules of Professional Conduct for Members' issued by the Institute of Chartered Accountants of Nigeria and accounting standards issued by the Nigerian Accounting Standards Board. The Ethical Code covers the following matters:

- (a) fundamental principles;
- (b) integrity, objectivity and independence;
- (c) conflicts of interest;
- (d) confidentiality;
- (e) changes in professional appointment;
- (f) consultancy;

- (g) association with non-members;
- (h) fees;
- (i) obtaining professional work;
- (j) the names and letterheads of practicing firms;
- (k) second and other opinions;
- (l) members in business; and
- (m) enforcement of ethical standards.

### **Professional conduct for the members of the Institute of Chartered Accountants of Nigeria**

The following guidelines on professional conduct are issued by the Institute to guide its members in the efficient discharge of their professional duties. The contents of the 'Rules of Professional Conduct for Members' serve as a guide to members of the Institute which require strict observance of these rules of conduct as condition for its membership. If a member cannot find the guidance he or she requires either in the Institute of Chartered Accountants of Nigeria Act, in the Rules and Regulations of the Institute or in official statements by the Council he or she is always free to seek further advice through the Registrar/Chief Executive of the Institute. The decision as to whether or not a particular situation constitutes a breach lies entirely with the Investigating Panel, after due consideration of representation(s) if any by the member committing the alleged breach. The Accountants' Disciplinary Tribunal deals with deserving cases recommended by the Investigating Panel.

### **Fundamental principles**

- (a) A member should behave with integrity in all professional and business relationships. Integrity implies not mere honesty but fair dealing and truthfulness;
- (b) A member should strive for objectivity in all professional and business judgements. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other;
- (c) A member should not accept or perform work which he or she is not competent to undertake unless he or she obtains such advice and assistance as will enable him or her competently carry out the work;
- (d) A member should carry out his or her professional work with due skill, care, diligence and expedition and with proper regard for technical and professional standards expected of him or her as a member; and
- (e) A member should conduct himself or herself with courtesy and consideration towards all with whom he comes into contact during the course of performing his or her work.

### **Integrity, Objectivity and Independence**

- (a) Integrity: A member should behave with integrity in all professional, business and financial relationships. Integrity implies not mere honesty but fair dealing and truthfulness.

- (b) **Objectivity:** Objectivity is essential for any professional person exercising professional judgement. It is as essential for members in business as for practicing members. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other. It is sometimes described as 'independence of mind'. The need for objectivity is particularly evident in the case of a practicing accountant carrying out an audit or some other reporting role where his or her professional opinion is likely to affect rights between parties and the decisions they take.
- (c) **Independence:** A member must exercise objectivity and independence required of an auditor. He or she must have both independence of mind and independence in appearance.
- (d) An accountant should always act with integrity, honesty and probity, and maintain a professional attitude in the performance of his responsibilities. He should, if in public practice, not follow any other occupation which is inconsistent with his professional duties.
- (g) A member should exercise his profession with independence and objectivity. He must be in a position to give an honest and unbiased opinion. Under no circumstances must a member knowingly allow his name to be associated with a financial statement that is misleading. Pursuant to the above and, in order to exercise his independence, an accountant, in public practice, must not:
  - (i) possess any direct and/or indirect beneficial interest in any Company for which he or his firm acts as auditors;
  - (ii) accept fees, the amount of which is based on the success of an assignment, except where this cannot be avoided because of legislation or agreement to which he is not a party;
  - (iii) accept fees, the amount of which is based on the turnover of the company for which he is acting as auditor;
  - (iv) act for any two opposing parties in respect of a negotiation, claim or settlement unless appointed as an arbitrator under due process of law;
  - (v) carry out the work as an auditor concurrently with carrying out work for the client in an executive capacity.

**Note:** "Indirect beneficial interest" means interest through a nominee.

### **Conflicts of Interest**

- (a) A member should not accept or continue an engagement in which there is or likely to be a significant conflict of interests between the firm and its client.
- (b) There is, on the face of it, nothing improper in a firm having two or more clients whose interests may be in conflict. In such a case, however, the work of the firm should be so managed as to avoid the interests of one client adversely affecting those of another. Where the acceptance or

continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued, or one of the appointments should be discontinued.

### **Confidentiality**

- (a) Information confidential to a client or employer acquired in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper source, or where there is legal right or duty to disclose; and
- (b) Where a legal right or duty of disclosure does exist, the client or employer should normally be notified in advance of the disclosure being made.

A member should respect the confidentiality of information entrusted to him by his employer or his client, and should not disclose any such information to a third party without the specific authority of his employer or client unless:

- (i) He knows or suspects his clients to have committed the offence of treason or treasonable felony. The duty to disclose is obligatory in this case;
- (ii) The disclosure is reasonably necessary to protect the interest of members e.g. to enable the member to sue for his fees or to defend an action for (say) negligence;
- (iii) He is required to disclose by due legal process or in the interest of the public.

When a member is required to provide information about a client's affairs by the Police, the Inland Revenue or any other authority, he should decline to give the information unless and until he is satisfied that there is statutory authority for demanding the information. He should seek the advice of his solicitor where necessary.

A member should not voluntarily appear in Court as a witness against a client or former client unless served with a subpoena or any other form or witness summons. He could refuse particular questions which he is not obliged to answer. He must produce any documents in his ownership or possession if the Court so directs.

A member should not make improper use of any knowledge he may gain in the course of his work. He should ensure that the staff under his control also observes this requirement.

### **Changes in a professional appointment**

Recurring Work: Clients have the right to choose their auditors and other professional advisers, and to change to others if they so desire.

Nevertheless, it is necessary - in the interests of the public, the existing auditor or adviser and prospective auditor or adviser - for a member who is asked to act by a prospective client in respect of an audit or recurring reporting assignment, or the provision of recurring accounting services and taxation work

of a compliance nature, to communicate with the existing auditor or adviser, and for the latter to reply promptly as to any considerations which might affect the prospective auditor or adviser's decision whether or not to accept appointment.

- (a) **Statutory Provisions:** Firms must adhere to the statutory provisions relating to any change in an audit appointment, in particular those contained in sections 362 to 366 of the Companies and Allied Matters Act 2004, and in particular the proposed auditor should ensure that the previous auditor has validly vacated office.
- (b) **Unpaid fees:** A member in public practice should not accept an audit hitherto carried out by another member, without first ensuring that the other member has been properly removed from office as auditor and that all outstanding fees due to the other member have been fully paid.
- (c) **Confidentiality:** The prospective auditor or adviser should ordinarily treat in confidence any information provided by the existing auditor or adviser. However, it may be essential to the fulfilment of a prospective auditor's or adviser' obligations that he should disclose such information. It may, for example, be unavoidable for the prospective auditor or adviser to disclose to officers or employees of the client matters brought to his attention by the predecessor firm which needed to be properly investigated. Such disclosure should be no wider than is necessary.
- (d) **Defamation:** It is likely that an existing auditor or adviser who communicates to a prospective successor matters damaging to the client or to any individuals concerned with the client's business will have a strong measure of protection were any action for defamation to be brought against him, in that the communication will be protected by qualified privilege. This means that he should not be liable to pay damages for defamatory statements even if they turn out to be untrue, provided that they are made without malice. The chances of an incumbent being held to have acted maliciously are remote provided that:
  - (i) he states only what he sincerely believes to be true; and
  - (ii) he does not make reckless imputations against a client or individuals connected with it which he can have no reason for believing to be true.
- (e) **Joint auditor:** A member whose firm is nominated as a joint auditor should communicate with all existing auditors and be guided by similar principles to those set out in relation to nomination as an auditor. Where it is proposed that a joint audit appointment becomes sole appointment, the surviving auditor should communicate formally with the other joint auditor as though for a new appointment.
- (f) **Vacancy:** A member whose firm is invited to accept nomination on the death of a sole practitioner auditor should endeavour to obtain such information as he may need from the latter's alternate (where appropriate), the administrators of the estate or other source.

- (g) **Transfer of Books and Papers:** A replaced auditor or adviser should transfer promptly to the client, or to his successor after the latter has been duly appointed, all books and papers which are in his possession and which belong to the client unless he is exercising a lien thereon for unpaid fees. Members should be aware that the courts have held that no lien can exist over books or documents of a registered company which, either by statute or by article of association of the company have to be available for public inspection.
- (h) **Co-operation with a Successor:** The incoming auditor or adviser often needs to ask his predecessor for information as to the client's affairs, lack of which might prejudice the client's interests. Such information should be promptly given and, unless there is good reason to the contrary, such as a significant amount of work involved, no charge should be made.
- (i) **Additional work:** A member invited to undertake recurring or non-recurring work which is additional to and related to continuing work carried out by another professional adviser should normally notify that other professional adviser of the work he has been asked to undertake.
- (j) **Consultancy:** If a member in practice (the practitioner) obtains the advice of a member (consultant) on a consultancy basis on behalf of a client, the consultant or any practicing firm with which he or his consultancy organisation is associated should not, without the consent of the practitioner, accept from that client within one year of completion of the consultancy assignment any work which was, at the time the consultant was first retained in relation to that client's affairs, being carried out by the practitioner;
- (k) The same considerations apply where a practitioner introduces one of his clients to the consultant for the purposes of consultancy.

### **Association With Non-Members**

- (a) **Mixed Accountancy Practices:** A member engaged in public practice with a non-member partner or fellow director of a company is responsible for ensuring that the non-member conforms to the ethical standards governing the provision by members of public accountancy services;
- (b) **Use of Offices, Name, etc:** A member should so conduct his or her firm that a client or potential client cannot mistake it for any other firm or business and cannot mistake any other associated firm business for his;
- (c) **Work for or obtained through Non-members:** A member should not enter into arrangements to provide public accountancy services to clients of another firm or to clients introduced by another firm of public accountants not controlled by chartered accountants (the requesting firm) unless he or she has satisfied himself or herself that the requesting firm's professional work is obtained in accordance with ethical standards governing the provision by members of public accountancy services.

## **Fees**

Members are expected to charge fees for the service rendered to clients. The Institute has advised that a member is entitled to charge for his or her services:

- (a) Such specific fee as he or she has agreed with the client; or
- (b) A fee calculated in accordance with any agreement with the client; or
- (c) In the absence of an agreement, a fee calculated by reference to the custom of the profession or in accordance with regulations of the Institute in force, at the time the fees were charged.

In the last event it is customary, where the basis of the fee has not been agreed with a client that a member should charge a fee, which is fair and reasonable having regards to:

- (a) the seniority and professional expertise of the persons necessarily engaged on the work;
- (b) the time expended by each;
- (c) the degree of risk and responsibility which the work entails; and
- (d) the priority and importance of the work to the client together with any expenses properly incurred.

The Institute's minimum charge-out rates in respect of fees for professional services are intended to set a benchmark for such fees below which members are not ordinarily expected to charge. A member in public practice must not charge or accept fees for acting as auditor, the amount of which is below any minimum fee chargeable under any scheme approved by the Institute.

## **Fee Quotation and Estimates**

A member should inform a client in writing prior to commencement of any engagement of the basis upon which any fee he proposes to charge that client for his services will be calculated and, on request and where practicable, the level of fees likely to be charged for any assignment.

## **Audit Work**

Firms should not quote for new work, a level of fees which is lower than that charged by an existing auditor or quote by tender levels of fees which they have reason to believe are significantly lower than those quoted by other tendering firms as their objectivity could in those circumstances be threatened. Such firms should ensure that their work complies with Auditing Standards and Guidelines and, in particular, quality control procedures. In the event of a complaint being made to the Institute (which might have arisen as a result of a Professional Practice Monitoring Committee's inspection), where fees were a feature in obtaining or retaining the work, firms should be prepared to demonstrate that the work done was in accordance with Auditing Standards; and the client was not misled as to the basis on which fees for the current year and the subsequent years were to be determined.

### **Fee Information and Disputes**

A member should furnish, either in the fee account or subsequently on request, and without further charge, such details as are reasonable to enable the client to understand the basis on which the fee account has been prepared.

### **Percentage and Contingent Fees**

Unless the circumstances dictate otherwise or the client clearly objects, fees should normally be charged on time rates in respect of audit work, reporting assignment and similar non-audit roles. In all circumstances, a member in public practice should refrain from quoting or charging fees for audit work, reporting assignment and similar non-audit roles using criteria other than the basis or bases approved by the Institute.

## **OBTAINING PROFESSIONAL WORK**

### **Practice Promotion**

Subject to the guidance which follows, a member may seek publicity for his or her services achievements and products and may advertise his services, achievements and products in any way consistent with the dignity of the profession in that he should not project an image inconsistent with that of a professional person bound by high ethical and technical standards.

### **Advertising**

Advertisements must comply with the law and should be legal, decent, clear, honest and truthful. An advertisement should be clearly distinguishable as such. The preceding considerations are of equal application to letterheads, invoices and similar practice documents.

### **Fees**

If reference is made in promotional material to fees, the basis on which fees are calculated, or to hourly or other charging rates, the greatest care should be taken to ensure that such reference does not mislead as to the precise range of services and time commitment that the reference is intended to cover. Members should not make comparisons in such material between their fees and of other accounting practices, whether members or not.

The danger of giving a misleading impression is particularly pronounced when constraints of space limit the amount of information which can be given. For this reason, it will seldom be appropriate to include information about fees in short advertisements. A member may be offered a free consultation at which levels of fees will be discussed.

### **Disparaging Statements**

Promotional material may contain any factual statement the truth of which a member is able to justify, but should not make disparaging references to or disparaging comparisons with the services of others.

Particular care is needed in claims of size or quality. For example, it is impossible to know whether a claim to be 'the largest firm' in an area is a reference to the number of partners or staff, the number of offices or the amount of fee income. A claim to be 'the best firm' is subjective and cannot be substantiated.

### **Harassment**

A member should, under no circumstances, promote or seek to promote his or her services, or the services of another member, in such a way or to such an extent as to amount to harassment of a prospective client.

### **Cold Calling**

- (a) In relation to audit or other financial reporting work, a member should not make an unsolicited personal visit or telephone call to a person who is not a client with a view to obtaining professional work from the non-client.
- (b) Promotional or technical material may be sent to non-client by mail or other means, subject to certain conditions. Such a distribution should not, in the case of audit or other financial reporting work, be followed by a personal visit or telephone call except at the specific request of the recipient.
- (c) The same constraints apply to direct mail as to other promotional or technical material.
- (d) Unsolicited promotional or technical material should not be sent to a non-client by facsimile transmission or other electronic means.

A member may send a letter introducing his or her firm and its range of services to another professional adviser, such as a solicitor or banker, and follow it up by a telephone call or visit. Such a follow-up should not be made in respect of audit or other financial reporting needs of the professional adviser.

### **Introductions**

A member should not give or offer any commission, fee or reward to a third party, not being either his or her employee or another public accountant governed by ethical standards comparable to those observed by members in return for the introduction of a client.

### **Responsibility for Promotional Activities**

Promotional activities carried out in the name of a firm should be construed as promotional activities carried out by the individual principals of that practice, whether carried out personally or through agents. The names and letterheads of practising firms

### **Names**

- (a) 'Firm' includes partnership, a corporation and a sole practitioner, the main business of which is the provision of services customarily provided by chartered accountants, while the term 'letterhead' means any part of the firm's notepaper and documents used by the firm for communicating with clients or other parties.

- (b) Public practice should refrain from practising in or under a name which does not comprise proper name(s) only, such name(s) being that or those of one or more of the current or former proprietor(s) and/or partner(s) of the Firm.
- (c) A practice name should be consistent with the dignity of the profession in the sense that it should not project an image inconsistent with that of a professional practice bound to high ethical and technical standards. A practice name should not be misleading.
- (d) Use of the description 'Chartered Accountants' is governed by the law establishing the Institute.
- (e) Firms entitled to use the description 'Chartered Accountants' are encouraged to do so, on their letterheads, in advertisements and generally. A firm which describes itself as 'Chartered Accountants' on its notepaper may include a list of the services it particularly wishes to offer. However, it should not incorporate any of that list of services into the general description of the firm (e.g. 'Chartered accountants and Tax Advisers') lest, this should suggest that these services are not offered by other chartered accountants.
- (f) Principals in a firm describing itself as 'Chartered Accountants' should adopt a distinguishing name for any separate firm of public accountants in which they may practise which is not itself entitled to the description 'Chartered Accountants'.

### **Persons Named on Letterheads**

- (a) It should be clear from the letterhead of a practice whether any person named thereon, or other persons named only in the name of the firm, is a partner of the practice, a sole practitioner or, in the case of a corporate practice, a director.
- (b) Firms should distinguish chartered accountants mentioned on the letterhead of a practice from persons not entitled to be so described by the use of designatory letters or otherwise.
- (c) No person named on the letterhead of a practice should be described by a title, description or designatory letters to which he or she is not entitled.

## **SECOND AND OTHER OPINIONS**

### **Specific Circumstances**

Where the opinion of a member, whether in practice or otherwise, is sought on the application of accounting standards or principles to specific circumstances or transactions, either completed or contemplated of an entity with which the member does not have an ongoing professional relationship to provide audit services, he should be alert to the possibility of his opinion creating undue pressure on the judgement and objectivity of the auditor. Accordingly, he should seek to minimise the risk of giving inappropriate guidance by ensuring that he has access to all relevant information.

### **General Circumstances**

A member giving an opinion on the application of accounting standards or principles, relating to a hypothetical situation and not based on the specific facts or circumstances of a particular organisation, should ensure that the nature of the opinion is made clear.

## **MEMBERS IN BUSINESS**

### **Employed member**

'Employed member' includes reference to members, whether employed or not, who are engaged in work relevant to their qualification as a member otherwise than in a practicing office.

An employed member owes certain legal duties towards his or her employer. Additionally, he or she has ethical duties towards his Institute, and, in particular, he should observe the same code of ethics and the same standards of behaviour and competence as apply to all other members of the Institute.

### **Financial and Other Involvement**

An employed member should recognise the problems which may be created by financial involvement or personal relationships which, whether sanctioned by his or her contract of employment or not, could nevertheless by reason of their nature or degree threaten his or her objectivity. Where any doubt exists, the involvement or relationship should be disclosed.

### **Professional and Technical Standards**

- (a) A member is required to carry out his or her professional work with proper regard for the technical and professional standards expected of him as a member. The standards include Statements of Accounting Standards issued by the Nigerian Accounting Standards Board and, where appropriate, the rules and regulations of the Securities and Exchange Commission and requirements of the Companies and Allied Matters Act 2004. However, an employed member who, in the performance of his professional work, may be subject to contrary directions from his employers may be faced with a conflict of loyalties in seeking to apply the fundamental principle. The difficulty is of particular importance where the outcome of the work is to be published.
- (b) Where a member has sole responsibility for the preparation and approval of information, including management information, which is to be made public or is to become available, on however restricted a basis, outside the organisation to which it refers, he or she should ensure that such information complies with the applicable standards, and relevant statutes and regulation or, if it does not so comply, that the reasons for non-compliance are stated truthfully, unambiguously and fairly.

### **Enforcement of ethical standards**

- (a) The power of the Institute to enforce ethical standards is by the Institute of Chartered Accountants of Nigeria Act conferred on the Accountants Disciplinary Tribunal which is in respect of this power independent of the Council.

### **CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS ISSUED BY THE INTERNATIONAL FEDERATION OF ACCOUNTANTS**

The auditor should comply with the Code of Ethics for Professional Accountants issued by the International Federation of Accountants. The Code states that “in order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles”.

The fundamental principles are:

- (a) **Integrity**  
A professional accountant should be straight-forward and honest in performing professional services.
- (b) **Objectivity**  
A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.
- (c) **Professional Competence and Due Care**  
A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.
- (d) **Confidentiality**  
A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.
- (e) **Professional Behaviour**  
A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from any conduct which might bring disrepute to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to clients, third parties, other members of the accountancy profession, staff, employers, and the general public.

**(f) Technical Standards**

A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and, in the case of professional accountants in public practice, independence.

In addition, they should conform to the technical and professional standards issue by:

- (i) IFAC (e.g. International Standards on Auditing);
- (ii) International Accounting Standards Board;
- (iii) The member's professional body or other regulatory body; and
- (iv) Relevant legislation.

**2.11 ACCOUNTING STANDARDS AND GUIDELINES**

The following sections deal with accounting standards and guidelines issued by the Institute of Chartered Accountants of Nigeria, International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

**Accounting Standards and Guidelines**

The practice of Accountancy worldwide is governed by sets of rules and guidelines. These rules and guidelines are compiled into standards. There are two sets of standards governing accounting practice in Nigeria. They are:

- (a) International Standards:
  - (i) IAS: International Accounting Standards
  - (ii) SIC: Standing Interpretations Committee.
- (b) Local Standards:
  - (i) SAS: Statement of Accounting Standards
  - (ii) AG: Auditing Guidelines

**(a) International Accounting Standards (IAS)**

Each standard discusses the Accounting treatment of a particular item or group of items. A summary of the international standards are as follows:

- IAS 1 - Presentation of Financial Statement.
- IAS 2 - Inventories.
- IAS 3 - (Superseded by IAS 27 and IAS 28).
- IAS 4 - (Superseded by IAS 16, IAS 22 and IAS 38).
- IAS 5 - (Superseded by IAS 1).
- IAS 6 - (Superseded by IAS 15).
- IAS 7 - Cash flow Statements.
- IAS 8 - Net profit or loss for the Period, Fundamental Errors and changes in Accounting Policies.
- IAS 9 - (Superseded by IAS 38).
- IAS 10 - Events after the Balance Sheet date.

- IAS 11 - Construction Contracts.
- IAS 12 - Income Taxes.
- IAS 13 - (Superseded by IAS 1).
- IAS 14 - Segment Reporting.
- IAS 15 - Information Reflecting the Effects of Changing Prices.
- IAS 16 - Property, Plant and Equipment.
- IAS 17 - Leases.
- IAS 18 - Revenue.
- IAS 19 - Employee Benefits.
- IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance.
- IAS 21 - The Effects of Changes on Foreign Exchange in Rates.
- IAS 22 - Business Combinations.
- IAS 23 - Borrowing Costs.
- IAS 24 - Related Party Disclosures.
- IAS 25 - (Superseded by IAS 39 and IAS 40).
- IAS 26 - Accounting and Reporting by Retirement benefit Plans
- IAS 27 - Consolidated Financial Statements and Accounting for Investments in Subsidiaries.
- IAS 28 - Accounting for Investments in Associates.
- IAS 29 - Financial Reporting in Hyperinflationary Economics.
- IAS 30 - Disclosures in the Financial Statements of Bank and Similar Financial Institutions.
- IAS 31 - Financial Reporting of Interests in Joint Ventures.
- IAS 32 - Financial Instruments: Disclosure and Presentation
- IAS 33 - Earnings Per Share.
- IAS 34 - Interim Financial Reporting.
- IAS 35 - Discontinuing Operations.
- IAS 36 - Impairment of Assets.
- IAS 37 - Provisions, Contingent Liabilities and Contingent Assets.
- IAS 38 - Intangible Assets.
- IAS 39 - Financial Instruments: Recognition and Measurement.
- IAS 40 - Investment property.
- IAS 41 - Agriculture (effective January 1, 2003).

(b) **Standard Interpretations Committee (SIC)**

These contain the interpretations of International Accounting Standards.

- SIC 1 - Consistency - Different cost formulas for inventories (IAS 2).
- SIC 2 - Consistency - Capitalisation of Borrowing Costs (IAS 23).
- SIC 3 - Elimination of Unrealised Profits and Losses on Transactions with Associates (IAS 28).
- SIC 5 - Classification of Financial Instruments Contingent Settlement Provisions (IAS32).
- SIC 6 - Costs of Modifying Business Software (Framework).
- SIC 7 - Introduction of the Euro (IAS 21).
- SIC 8 - First-Time Application of IAS as the Primary Basis of Accounting (IAS 1).

- SIC 9 - Business Combinations - Classification either as Acquisitions or Uniting of Interests (IAS 22).
- SIC 10 - Government Assistance No specific Relation to Operating Activities (IAS 20).
- SIC 11 - Foreign Exchange - Capitalisation of Losses Resulting from Severe Currency Devaluations (IAS 21).
- SIC 12 - Consolidation - Special Purpose Entities (IAS 27).
- SIC 13 - Jointly controlled Entities - Non-Monetary Contributions by Ventures (IAS 31).
- SIC 14 - Property, Plant and Equipment or Loss of Items (IAS 16)
- SIC 15 - Operating leases - Incentives (IAS 17)
- SIC 16 - Share Capital - Reacquired own Equity Instruments (Treasury Shares) IAS 32.
- SIC 17 - Equity - Costs of an Equity Transaction (IAS 32)
- SIC 18 - Consistency - Alternative Methods (IAS 1)
- SIC 19 - Reporting Currency - Measurement and Presentation of Financial Statements under (IAS 21 and IAS 29).
- SIC 20 - Equity Accounting Methods - Recognition of Losses (IAS 27)
- SIC 21 - Income Taxes - Recovery of Revalue Combinations- Subsequent Adjustment of fair Values and Goodwill Initially Reported (IAS 22).
- SIC 22 - Business combinations- Subsequent adjustments of fair values and goodwill initially reported (IAS 22).
- SIC 23 - Property, Plant and Equipment - Major Inspection or overhaul Costs (IAS 16).
- SIC 24 - Earnings per share - financial Instruments and other contract that may be settled in shares (IAS 33).
- SIC 25 - Income Taxes - changes in the Tax status of an enterprise or it's shareholders (IAS 12).

**Note:** No SIC Interpretation was issued as SIC 4. Draft interpretation SIC D4, Classification of Financial Instruments Issuer's settlement option, was withdrawn.

(c) **Statement Of Accounting Standards**

The publications of Nigerian Accounting Standards Board (NASB) are as follows:

- SAS 1 - Disclosure of Accounting Policies
- SAS 2 - Information to be disclosed in Financial Statements
- SAS 3 - Accounting for Property, Plant and Equipment
- SAS 4 - Stocks
- SAS 5 - Construction Contracts
- SAS 6 - Extraordinary items and Prior Year Adjustments.
- SAS 7 - Foreign Currency Conversions and Translations
- SAS 8 - Accounting for Employees' Retirement Benefits
- SAS 9 - Accounting for Depreciation

- SAS 10 - Accounting by Banks and Non-Bank Financial Institutions (Part I).
- SAS 11 - Leases
- SAS 12 - Accounting for Deferred Taxes
- SAS 13 - Accounting for Investments
- SAS 14 - Accounting in the Petroleum Industry: Upstream Activities
- SAS 15 - Accounting by Banks and Non-Bank Financial Institutions (Part II).
- SAS 16 - Accounting for Insurance Business
- SAS 17 - Accounting in the Petroleum Industry: Downstream Activities.
- SAS 18 - Statement of Cash Flows
- SAS 19 - Accounting for taxes
- SAS 20 - Abridged Financial Statements
- SAS 21 - Earnings per share
- SAS 22 - On Research and Development Cost
- SAS 23 - On Provisions, Contingent Liabilities and Contingent Assets
- SAS 24 - Segment Reporting, Added: 2007-04-20
- SAS 25 - Telecommunications Activities Added: 2008-02-11
- SAS 26 - Business Combinations Added: 2008-02-11
- SAS 27 - Consolidated and Separate Financial Statements Added: 2008-02-11
- SAS 28 - Investments in Associates Added: 2008-02-11
- SAS 29 - Interests in Joint Ventures Added: 2008-02-11
- SAS 30 - Interim Financial Reporting Added: 2008-02-11

(d) **Auditing Standards and Guidelines (AG)**

These are the publications of Auditing Standards Committee (ASC) of ICAN.

AG 1 - Auditing Guideline on Engagement Letters

AG 2 - Auditing Guideline: Prospectus and Reporting Accountant

(e) **Adaptation of International Standards on Auditing (IS) as Nigerian Standards On Auditing (NS)**

The Institute of Chartered Accountants of Nigeria (ICAN) as a member of the International Federation of Accountants (IFAC) is committed to the Federation's broad mission of the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide "services of consistent high quality in the public interest".

As a condition of its membership, The Institute of Chartered Accountants of Nigeria is obliged to support the work of IFAC by informing its members of pronouncements developed by IFAC and by using its best endeavours, to work towards implementation, when and to the extent possible under local circumstances, of those pronouncements and specifically to incorporate the principles on which they are based.

IFAC's International Standards on Auditing (ISAs) in Nigerian auditing pronouncements.

IFAC to date has issued over thirty International Standards on Auditing (ISA) and one International Standard on Quality Control, some of which are listed below:

**Name Of Standard**

ISQC1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements. The Nigerian equivalent is NSQC1 as adopted.
ISA 200	Objective and general principles governing an audit of financial statements. The Nigerian equivalent is NSA 200 (Nigerian Standards on Auditing) as adopted.
NSA 210	Terms of audit engagements.
NSA 220	Quality control for audits of historical financial (Revised) information.
NSA 230	Documentation.
NSA 240	The auditor's responsibility to consider fraud in an audit of financial statements.
NSA 250	Consideration of laws and regulations in an audit of financial statements.
NSA 260	Communication of audit matters with those charged with governance.
NSA 300	Planning an audit of financial statements.
NSA 315	Understanding the entity and its environment and assessing the risks of material misstatement.
NSA 320	Audit materiality.

**Key**

- ISQC International Standards on Quality Control
- ISA International Standards on Auditing

**Members' Education and Training**

ICAN has a 'Members' Education and Training Unit' which is responsible for the training of members of the Institute and non-members through the under listed training programmes.

- (a) Mandatory Continuing Professional Education (MCPE) strictly for ICAN members only;
- (b) Executive Mandatory Continuing Profession Education (EMCPE) this is for ICAN members in senior management positions in organisations;
- (c) Continuing Professional Education (CPE) for ICAN members and non-members;

- (d) In-house: this is organised by the Institute for ICAN members in organisations who desire that the MCPE be held in their chosen location (i.e. in-plant).

A member of the Institute is expected to earn minimum of thirty credit hours in a year. A member earns fifteen credit hours at every seminar attended. The four courses listed above are termed (“structured”). Other activities/events of the Institute and courses attended by members outside the ones organised by the Institute (unstructured) attract credit hours, but such courses must be accredited by the Institute.

### **Sanctions for Non-Compliance:**

Every member is expected to obtain a minimum of sixty credit hours within a 2-year cycle. A member in default would be suspended from membership at the end of 2 years for six months in the first instance and thereafter expunged from membership list if he/she fails to make up the deficiencies in credit hours.

Those Exempted:

- (i) Members who are sixty years and above and who have indicated in writing to the Institute their intention to retire from practising the accountancy profession;
- (ii) Members who are certified as medically unfit;
- (iii) Traditional Rulers;
- (iv) Members on special national or state engagements.

### **Programme for the Year**

The Unit publishes an annual programme of its training courses.

### **International Financial Reporting Standards (IFRS)**

The International Accounting Standards Committee (IASC) issued International Accounting Standards (IAS) from 1973 to 2000. The International Accounting Standards Board (IASB) replaced the IASC in 2001. Since 2001, the IASB amended some international accounting standards and has proposed to amend or replace some international accounting standards with new International Financial Reporting Standards (IFRS). The IASB has adopted or proposed certain new IFRSs on topics for which there were no previous international accounting standards. Interpretations of Standards have also been issued on the standards.

To date, the following IFRS's have been issued:

Preface to International Financial Reporting Standards May 2002

- |        |   |
|--------|---|
| IFRS 1 | First-time Adoption of International Financial Reporting Standards<br>June 2003 |
| IFRS 2 | Share-based Payment - February 2004   |
| IFRS 3 | Business Combinations - March 2004  |
| IFRS 4 | Insurance Contracts - March 2004  |
| IFRS 5 | Non-current Assets Held for Sale and Discontinued Operations -<br>March 2004    |

IFRS 6	Exploration for and Evaluation of Mineral Assets - December 2004
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments

## 2.12 QUALITY CONTROL, WORKING PAPERS, PEER REVIEW

### Introduction

APB statement of auditing standard 240 deals with “Quality Control for audit work”. It takes Quality Control to be of paramount importance to the independent audit function.

The standard describes quality control policy and processes as those “designed to provide reasonable assurance as to the appropriateness of the auditors’ report and of adherence to auditing standards, ethical and other regulatory requirements.

Many quality assurance frameworks take a holistic approach to quality, encompassing a wide range of business considerations including; client and employee satisfaction, and commercial performance. Firms are encouraged to embed procedures to meet the requirements of the statement of auditing standards on quality control into a wider quality assurance framework”. (Chitty, 2004).

Wider quality assurance objectives may be achieved by the auditors by discussing audit performance with boards of directors, audit committees (where they exist) and senior management.

### Small firms

In order to satisfy quality control requirements,

- (a) Firms should develop different policies and processes on various matters pertaining to the practice.
- (b) The nature, timing and extent of those policies and processes will depend on many factors, including the size and nature of the firm.
- (c) The policies and processes adopted by small firms need not be complex or time consuming to be effective.
- (d) Quality control encompasses several different roles and functions within the audit firm, including responsibilities for quality control policy and processes and monitoring.
- (e) For small firms and sole practitioners, a single individual may perform some of these roles and functions but in some circumstances they may wish to use the services of a suitably qualified external consultant.

### Quality Drivers

Compliance with quality control standard in setting quality drivers for the purpose of complying with quality control standard, the following matters should be considered:

- (a) distinction of individual responsibilities and the collective responsibilities of the firm;

- (b) personal accountability and team working;
- (c) building quality into processes and monitoring the results;
- (d) Individual responsibilities and the collective responsibilities of the firm; and
- (e) involvement of all members of an audit team who should feel responsible for the performance of their work in accordance with professional standards.

The audit engagement partner has an especially important role in promoting a quality culture within the audit team. The appointment of a suitably senior audit partner within the firm to take overall responsibility for quality control policy and processes will assist this process.

### **Personal Accountability and Team Working**

- (a) Personal accountability can provide an important motive for ensuring that quality control policy and processes are applied in practice while it is important to clarify responsibilities within the firm and the audit team; and
- (b) It is also necessary that consultation takes place to ensure that the collective wisdom of, first the team, and then the firm, is applied in resolving difficult or contentious matters.

### **Building quality into processes and monitoring the results**

- (a) Quality processes are aimed at 'getting it right first time' as well as monitoring performance after the event.
- (b) Monitoring provides the stimulus for performance as well as important information on the application of quality control and processes which can be used to improve them.

### **Definitions**

The APB Statement of Auditing Standard 240 on 'Quality Control for audit work provides the following definitions:

- (a) 'audit engagement partner' - the partner or other person in the firm who assumes responsibility for the conduct of the audit and for issuing an auditors' report on the financial statements on behalf of the firm.
- (b) 'audit staff' - the personnel involved in an individual audit, including experts employed by the auditors, other than the audit engagement partner.
- (c) 'client service partner' - a partner who takes primary responsibility for coordinating the range of services provided to an audit client.
- (d) 'competencies' - the knowledge, skills and abilities of audit engagement partners and audit staff.
- (e) 'firm' - sole practitioners, partnerships, limited liability partnerships and other corporate entities engaged in the provision of auditing services.
- (f) 'independent partner' - a partner with sufficient experience and authority to perform an 'independent review', other than the audit engagement partner, who is not engaged in the performance of the audit or the

- provision of other services and who is free of all other responsibilities for the audited entity and any entities in the same group of entities.
- (g) 'independent review' - an objective, independent assessment of the quality of the audit undertaken before the issue of the auditors' report.
  - (h) 'listed companies' - entities whose capital instruments are listed or publicly traded on a stock exchange or market, including domestic and foreign exchange and markets, and markets other than main markets.
  - (i) 'monitoring' - periodic reviews of working papers for completed audits by, wherever possible, reviewers independent of those who performed the audit.
  - (j) 'partner' - sole practitioners, partners in partnerships and limited liability partnerships and directors of other corporate entities engaged in the provision of auditing services.
  - (k) 'quality control policy and processes' - policy and processes designed to provide reasonable assurance as to the appropriateness of the auditors' report, and of adherence to auditing standards, ethical and other regulatory requirements.
  - (l) 'suitably qualified external consultant' - another registered auditor or an employee (with appropriate experience) of either a professional accountancy body whose members may register as auditors or a specialist organisation, such as a training consortium, which provides review services.

### **Senior audit partner responsible for quality control**

Considering the importance of audit quality, the development, documentation and communication of quality control and processes should be made the responsibility of a senior audit partner. Where a firm operates in more than one office, the firm may appoint several individuals to undertake quality control activities in their local offices but one senior audit partner should take ultimate responsibility for quality control matters within the firm.

The senior audit partner with overall responsibility for quality control has the experience, seniority and authority necessary to fulfil the role, and the influence to help ensure that the quality of audit engagements conducted by the firm is never compromised by commercial considerations.

Partners having concerns on quality control issues should discuss their concerns, and agree appropriate actions, with the senior audit partner responsible for establishing quality control policy and processes.

### **Establishment of policy and processes**

The establishment of quality control policy and processes within a firm involves:

- (a) setting a framework within which all relevant requirements, including the requirements of auditing standards and ethics, can be met.
- (b) size and nature of the practice and its organisation.

**Communication**

Communication of quality control involves:

- (a) communication of quality control policy and processes to all audit staff and audit;
- (b) engagement partners for effective implementation;
- (c) use of internal training, electronic and paper circulars, and staff manuals to communicate quality control policy and processes.

**Documentation**

Appropriate documentation of quality control policy and processes normally includes:

- (a) a description of the policy and processes and the objectives they are designed to achieve.
- (b) Records of amendments to policies and processes
- (c) A record of how policy and processes and changes to them have been communicated.

**Acceptance and continuance of audit engagements**

Before accepting a new audit engagement firms, should ensure that they:

- (a) are competent to undertake the work;
- (b) consider carefully whether there are threats to their independence and objectivity and, if so, whether adequate safeguards can be established;
- (c) assess the integrity of the owners, directors and management of the entity; and comply with the ethical requirements of the professional accountancy bodies in relation to changes in appointment.

The firm should regularly reconsider the above matters whether the firm should continue in office as auditor. The following matters should be considered in deciding whether to continue in office as auditors:

- (a) the identity of those who control the entity, its owners, directors and managers (or their equivalents),
- (b) the nature of the entity's activities;
- (c) the reasons for the proposed appointment and the reasons for the retirement or removal of any incumbent or predecessor auditors.
- (d) potential audit risks associated with the engagement.

**Professional clearance**

- (a) Before accepting a new engagement, the prospective auditor should communicate in writing with the incumbent auditors
- (b) ascertain whether the incumbent auditors have information which the prospective auditors should be aware, before deciding whether or not to accept the appointment.
- (c) The responsibility for the decision to accept or decline an audit appointment rests solely with the prospective auditors, regardless of the outcome of these enquiries.

## **Resources**

Resource considerations should take into account the following:

- (a) require resources to be developed and implemented by a firm and periodically review plans for recruitment;
- (b) have available adequate number of audit engagement partners and audits staff with the competencies necessary to meet their needs;
- (c) project personnel needs in order to establish number and characteristics of the individuals required; and
- (d) have recruitment processes including procedures to help determine whether recruits are individuals of integrity and have the capacity to develop the competencies necessary to perform the firm's work.

Competencies are developed through:

- (a) professional education and development (including technical and management training, in-house courses and external training);
- (b) work experience and coaching by other members of the audit team; and
- (c) development and maintenance of technical competencies by the provision of technical circulars, libraries and technical departments.

## **Assignment of Personnel to Audit Engagements**

- (a) Each audit engagement should have an engagement partner who should take responsibility for the engagement on behalf of the firm;
- (b) Audit engagement partners are responsible for the conduct of the audits to which they have been appointed, ethical and other regulatory requirements, and for the issue of the auditors' report on behalf of the firm;
- (c) Firms should assign audit staff with the competencies necessary to perform the audit work expected of them to individual audit engagements;
- (d) firms should establish processes to assess individuals' knowledge, skills and abilities;
- (e) Firms should 'develop policies and processes to provide reasonable assurance that:
  - (i) audit engagement partners have the competencies necessary to perform their role;
  - (ii) audit engagement partners' responsibilities are clearly defined and communicated to them;
  - (iii) the identity and role of the audit engagement partner is known to the directors and senior management of the audited entity;
  - (iv) audit engagement partners have appropriate support (e.g. another partner), where necessary, at meetings with the directors and senior management of the audited entity that will involve matters that are, or may be, material to the auditors' report; and
  - (v) audit engagement partners have sufficient time to discharge their responsibilities' ( Chitty, 2004).

Competencies which a firm must consider include:

- (a) understanding and practical experience of auditing (through participation in audit engagements and appropriate training);
- (b) Understanding applicable accounting, auditing, ethical and other technical standards;
- (c) Knowledge of specific industries;
- (d) Professional judgement;
- (e) Understanding the firm's quality control policy and processes; and
- (f) Drive and career path.

### **Consultation**

Firms should establish procedures to:

- (a) facilitate consultation and to ensure that sufficient resources are available to enable appropriate consultation to take place in relation to difficult or contentious matters;
- (b) Document results of consultation that are relevant to audit conclusions;
- (c) Deal with difficult or contentious matters; and
- (d) Resolve conflicts.

Firms establish the likely circumstances in which consultation is encouraged or required, and who is to be consulted. Consultation may be:

- (a) on technical matters from the firm's technical department or from an expert within the firm; and
- (b) necessary in relation to ethical matters affecting either the firm or individual partners and others within it.

Consultation procedures are designed to ensure that individuals of appropriate seniority and experience within the firm are consulted on all difficult or contentious issues and that the results of consultations relevant to audit conclusions are properly documented.

## **THE AUDIT ENGAGEMENT PARTNER**

### **Leadership and Responsibilities**

- (a) Audit engagement partners should, in all cases, take responsibility on behalf of the audit firm, for the quality of the audit engagements to which they are assigned; and
- (b) Audit engagement partners are responsible for finalising and signing the auditors' report on behalf of the firm and for applying the firm's quality control policy and processes to individual audit engagements in an appropriate manner.

### **Direction, Supervision and Review**

Audit engagement partners should ensure that audit work is directed, supervised and reviewed in a manner that provides reasonable assurance that the work has been performed competently.

Direction of audit staff involves:

- (a) Being informed of their responsibilities, the nature of the entity's business, accounting or auditing problems that may arise, and the overall audit plan;
- (b) Being encouraged to raise any questions they may have with more experienced team members;
- (c) Understanding the objectives of the work to avoid drawing inappropriate conclusions as a result of misunderstandings; and
- (d) Being educated on appropriate team-working and training.

Supervision is closely linked to both direction and review and includes:

- (a) considering the progress of the audit;
- (b) considering whether audit staff have the competencies necessary to perform the audit work expected of them and sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the overall audit plan and audit programme;
- (c) Addressing significant accounting and auditing questions raised during the audit, assessing their significance and modifying the overall audit plan and audit programme as appropriate; and
- (d) Identifying matters for further consideration during the audit.

Work performed by audit staff is reviewed by other more senior audit staff or the audit engagement partner. Reviewers should consider whether:

- (a) the work has been performed in accordance with the firm's procedures and in accordance with the audit programme;
- (b) The work performed is adequate in light of the results obtained and has been adequately documented;
- (c) Significant audit matters have been raised for further consideration;
- (d) Appropriate consultations have taken place and the results of such consultations have been documented;
- (e) The objectives of the audit procedures have been achieved; and
- (f) The conclusions are consistent with the results of the work performed.

Audit engagement partners perform an overall review of working papers. The review is sufficient for them to be satisfied that the working papers contain sufficient appropriate evidence to support the conclusions reached and for the auditors' report to be issued. Although the review may not cover all working papers, it covers:

- (a) all critical areas of judgement, especially any relating to difficult or contentious matters identified during the audit.
- (b) audit evidence relating to high risk areas; and
- (c) any other areas which the audit engagement partner considers important.

Audit engagement partners document the extent of their review and its timing so as to demonstrate that it was completed before the auditors' report was signed.

The audit engagement partner reads the auditors' report, the financial statements and the information issued with the financial statements" (Chitty, 2004).

Review notes recording questions or points raised in the course of the audit need not be retained at the end of the audit provided that the working papers have been updated thereto and, in particular, record the reasoning on all significant matters which require the exercise of judgement.

### 2.13 INDEPENDENT REVIEW

Firms should ensure that:

- (a) an independent review is undertaken for all audit engagements where the audited entity is a listed company;
- (b) policies setting out the circumstances in which an independent review should be performed for other audit engagements, whether on the grounds of the public interest or audit risk, are established;
- (c) independent review should take place before the issue of the auditors' report in order to provide an objective, independent assessment of the quality of the audit;
- (d) Firms' policies should set out in detail the manner in which this objective is to be achieved; and
- (e) The independent review is performed by one or more independent partners having sufficient experience and authority to fulfil the role on the particular engagement.

"The independent review involves consideration of the following matters in order to assess the quality of the audit:

- (i) the objectivity of the audit engagement partner and key audit staff and the independence of the firm. This normally includes a review of the summary of factors that could be perceived as threatening either, the audit team's objectivity or the independence of the firm;
- (ii) The rigour of the planning process including the analysis of the key components of audit risk identified by the audit team and the adequacy of the planned responses to those risks;
- (iii) The results of audit work and the appropriateness of the key judgements made, particularly in high risk areas;
- (iv) The significance of any potential changes to the financial statements that the firm is aware of but which the management of the audited entity has declined to make;
- (v) Whether all matters which may reasonably be judged by the auditors to be important and relevant to the directors, identified during the course of the audit, have been considered for reporting to the board of directors and/or the audit committee (or their equivalents); and
- (vi) The appropriateness of the draft auditors' report" (Chitty, 2004).

The independent review:

- (a) Does not necessarily involve a detailed review of all audit working papers, nor does it affect the responsibilities of the audit engagement partner;
- (b) Its purpose is to provide an independent assessment of the quality of the audit, including the key decisions and significant judgements made;
- (c) The extent of the review depends on the complexity of the engagement, the risks associated with the audit and the experience of the audit;
- (d) engagement partner and the audit staff;
- (e) The independent review partner is involved sufficiently early to allow for all material matters identified during the review process to be dealt with properly;
- (f) Towards the end of the audit the independent partner considers the adequacy of proposed disclosures in the financial statements relating to significant matters identified during the course of the audit;
- (g) In all cases, the independent review is complete before the issue of the auditors' report; and
- (h) The scope and conclusions of the independent review are documented.

Monitoring

- (a) Firms should appoint a senior audit partner to take responsibility for monitoring the quality of audits carried out by the firm.
- (b) The responsibility for monitoring the quality of audit performance is different from the responsibility for the establishment of quality control policy and processes. Wherever possible, the two responsibilities are undertaken by different senior audit partners.
- (c) The objective of monitoring reviews is to provide an independent assessment of:
  - (i) the appropriateness of the auditors' report, and the conduct of the audit in accordance with auditing standards, ethical and other regulatory requirements;
  - (ii) whether the firm's own quality control policy and processes have been applied in practice and appropriate consultation has taken place in relation to difficult or contentious issues' (Chitty, 2004).

The senior audit partner responsible for the monitoring process should:

- (a) Develop procedures for the systematic review of the conduct of a sample of completed audit engagements. The review is undertaken by competent individuals who, wherever possible, are independent of those performing the audit.
- (b) Develop appropriate course of action where failures are identified. Courses of action may involve communication of the findings within the firm, additional training and professional development.
- (c) Ensure changes to the firm's policies and procedures and disciplinary action against those who repeatedly fail to comply with the firm's standards.

**Appendix - Summary of Key Roles Described**

Partner who takes responsibility for establishing quality control policy and processes:

Must be: a senior audit partner of the firm

Cannot be: an external consultant

Partner who takes responsibility for monitoring the quality of audits:

Must be: a senior audit partner (wherever possible a different partner to the partner responsible for establishing quality control policy and processes).

Cannot be: an external consultant Audit engagement partner.

Must be: a partner or other person in the firm who is authorised to issue an auditors' report on behalf of the firm.

Cannot be: the 'independent partner' for the audited entity or any other entities in the same group of entities.

Individual who performs an 'independent review':

Must be: an 'independent partner' with sufficient experience and authority to fulfil the role; or a suitably qualified external consultant

Cannot be: a partner engaged in the performance of the audit or the provision of other services or with any other responsibilities for the audited entity or any entities within the same group of entities

*(Source: ACCA Auditing Handbook 2004/2005)*

**2.14 SUPERVISION AND MONITORING OF AUDITORS****Functions and Responsibility**

Audit engagement partners should ensure that audit work is directed, supervised and reviewed in a manner that provides reasonable assurance that the work has been performed competently.

**Direction and Supervision**

Direction of audit staff involves:

- (a) Being informed of their responsibilities, the nature of the entity's business, accounting or auditing problems that may arise, and the overall audit plan;
- (b) Being encouraged to raise any questions they may have with more experienced team members;
- (c) Understanding the objectives of the work to avoid drawing inappropriate conclusions as a result of misunderstandings; and
- (d) Being educated on appropriate team-working and training.

Supervision is closely linked to 'both direction and review and includes:

- (a) Considering the progress of the audit;
- (b) Considering whether audit staff have the competencies necessary to perform the audit work expected of them and sufficient time to carry out their work, whether they understand their instructions and whether the

- work is being carried out in accordance with the overall audit plan and audit programme;
- (c) Addressing significant accounting and auditing questions raised during the audit, assessing their significance and modifying the overall audit plan and audit programme as appropriate; and
  - (d) Identifying matters for further consideration during the audit.

Work performed by audit staff is reviewed by other more senior audit staff or the audit engagement partner. Reviewers consider whether:

- (a) The work has been performed in accordance with the firm's procedures and in accordance with the audit programme;
- (b) The work performed is adequate in light of the results obtained and has been adequately documented;
- (c) Significant audit matters have been raised for further consideration;
- (d) Appropriate consultations have taken place and the results of such consultations have been documented;
- (e) The objectives of the audit procedures have been achieved; and
- (f) The conclusions are consistent with the results of the work performed.

Audit engagement partners perform an overall review of working papers. The review is sufficient for them to be satisfied that the working papers contain sufficient appropriate evidence to support the conclusions reached and for the auditors' report to be issued. Although the review may not cover all working papers, it covers:

- (a) All critical areas of judgement, especially any relating to difficult or contentious matters identified during the audit;
- (b) Audit evidence relating to high risk areas; and
- (c) Any other areas which the audit engagement partner considers important.

Audit engagement partners document the extent of their review and its timing so as to demonstrate that it was completed before the auditors' report was signed.

The audit engagement partner reads the auditors' report, the financial statements and the information issued with the financial statements' (Chitty, 2004).

Review notes, recording questions or points raised in the course of the audit need not be retained at the end of the audit provided that the working papers have been updated thereto and, in particular, record the reasoning on all significant matters which require the exercise of judgement.

### **Monitoring**

Firms should appoint a senior audit partner to take responsibility for monitoring the quality of audits carried out by the firm.

The responsibility for monitoring the quality of audit performance is different from the responsibility for the establishment of quality control policy and processes. Wherever possible, the two responsibilities are undertaken by different senior audit partners.

The objective of monitoring reviews is to provide an independent assessment of:

- (a) The appropriateness of the auditors' report, and the conduct of the audit in accordance with auditing standards, ethical and other regulatory requirements; and
- (b) Whether the firm's own quality control policy and processes have been applied in practice and appropriate consultation has taken place in relation to difficult or contentious issues.

The senior audit partner responsible for the monitoring process:

- (a) Develops procedures for the systematic review of the conduct of a sample of completed audit engagements. The review is undertaken by competent individuals who, wherever possible, are independent of those performing the audit;
- (b) Develops appropriate course of action where failures are identified. Courses of action may involve communication of the findings within the firm, additional training and professional development; and
- (c) Ensures changes to the firm's policies and procedures and disciplinary action against those who repeatedly fail to comply with the firm's standards.

## **2.15 THREAT TO AUDITORS' INDEPENDENCE AND THEIR RESOLUTIONS**

The IFAC Code of Ethics for Professional Accountants gives a comprehensive coverage of threats to auditors' independence and their resolution. The Rules of Professional Conduct for Members also cover the same topic. Excerpts of the sections in the IFAC Code are adapted or reproduced in the following sections:

### **Threats to Independence**

Independence is potentially affected by:

- (a) self-interest,
- (b) self-review,
- (c) advocacy,
- (d) familiarity and
- (e) intimidation threats.

"Self-Interest Threat" refers to when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.

Examples of circumstances that may create self-interest threat include:

- (a) A direct financial interest or material indirect financial interest in an assurance client;

- (b) A loan or guarantee to or from an assurance client or any of its directors or officers;
- (c) Undue dependence on total fees from an assurance client;
- (d) Concern about the possibility of losing the engagement
- (e) Having a close business relationship with an assurance client;
- (f) Potential employment with an assurance client; and
- (g) Contingent fees relating to assurance engagements.

“Self-Review Threat” occurs when:

- (a) any product or judgement of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement; or
- (b) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

Examples of circumstances that may create self-review threat include:

- (a) A member of the assurance team being, or having recently been, a director or officer of the assurance client;
- (b) A member of the assurance team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (c) Performing services for an assurance client that directly affect the subject matter of the assurance engagement; and
- (d) Preparation of original data used to generate financial statements or preparation of other records that are the subject matter of the assurance engagement.

“Advocacy Threat” occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client’s position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgement to that of the client.

Examples of circumstances that may create advocacy threat include:

- (a) Dealing in, or being a promoter of, shares or other securities in an assurance client; and
- (b) Acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties. “Familiarity Threat” occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client’s interests.

Examples of circumstances that may create familiarity threat include:

- (a) A member of the assurance team having an immediate family member or close family member who is a director or officer of the assurance client;

- (b) A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (c) A former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- (d) Long association of a senior member of the assurance team with the assurance client; and
- (e) Acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.

“Intimidation Threat” occurs when a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

Examples of circumstances that may create intimidation threat include:

- (a) Threat of replacement over a disagreement on the application of an accounting principle; and
- (b) Pressure to reduce inappropriately the extent of work performed in order to reduce fees.

### **Safeguards**

The firm and members of the assurance team have a responsibility to remain independent by taking into account the context in which they practice the threats to independence and the safeguards available to eliminate the threats or reduce them to an acceptable level.

When threats are identified:

- (a) Appropriate safeguards should be identified and applied to eliminate the threats or reduce them to an acceptable level;
- (b) This decision should be documented;
- (c) The nature of the safeguards to be applied will vary depending upon the circumstances;
- (d) Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information; including safeguards applied, and would reasonably conclude to be unacceptable; and
- (e) The consideration will be affected by matters such as the significance of the threat, the nature of the assurance engagement, the intended users of the assurance report and the structure of the firm.

Safeguards fall into three broad categories:

- (a) Safeguards created by the profession, legislation or regulation;
- (b) Safeguards within the assurance client; and
- (c) Safeguards within the firm’s own systems and procedures.

The firm and the members of the assurance team should select appropriate safeguards to eliminate or reduce threats to independence, other than those that are clearly insignificant, to an acceptable level.

Safeguards created by the profession, legislation or regulation, include the following:

- (a) Educational, training and experience requirements for entry into the profession;
- (b) Continuing education requirements;
- (c) Professional standards and monitoring and disciplinary processes;
- (d) External review of a firm's quality control system; and
- (e) Legislation governing the independence requirements of the firm.

Safeguards within the assurance client include the following:

- (a) When the assurance client's management appoints the firm, persons other than management ratify or approve the appointment;
- (b) The assurance client has competent employees to make managerial decisions;
- (c) Policies and procedures that emphasise the assurance client's commitment to fair financial reporting;
- (d) Internal procedures that ensure objective choices in commissioning non-assurance engagements; and
- (e) A corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.

Audit committees have an important corporate governance role when they are independent of client management and, in performing their statutory role, assist the board of directors in satisfying themselves that a firm of auditors is independent in carrying out its audit role.

There should be regular communication between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities, in the course of the audit, regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.

The Companies and Allied Matters Act makes provision for the establishment of audit committees and stipulates their functions. The audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members) and shall examine the auditors' report and make recommendations thereon to the annual general meeting as it may think fit.

Firms should establish policies and procedures relating to independence, communications with audit committees, or others charged with governance.

Safeguards within the firm's own systems and procedures may include firm-wide safeguards such as the following:

- (a) Firm leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;
- (b) Policies and procedures to implement and monitor quality control of assurance engagements;
- (c) Documented independence policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the identification and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant to an acceptable level;
- (d) Internal policies and procedures to monitor compliance with firm policies and procedures as they relate to independence;
- (e) Policies and procedures that will enable the identification of interests or relationships between the firm or members of the assurance team and assurance clients;
- (f) Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single assurance client;
- (g) using different partners and teams with separate reporting lines for the provision of non-assurance services to an assurance client;
- (h) Policies and procedures to prohibit individuals who are not members of the assurance team from influencing the outcome of the assurance engagement;
- (i) Timely communication of a firm's policies and procedures, and any changes thereto, to all partners and professional staff, including appropriate training and education thereon;
- (j) Designating a member of senior management as responsible for overseeing the adequate functioning of the safeguarding system;
- (k) Means of advising partners and professional staff of those assurance clients and related entities from which they must be independent;
- (l) A disciplinary mechanism to promote compliance with policies and procedures; and
- (m) Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them; this includes informing staff of the procedures open to them.
- (n) Safeguards within the firm's own systems and procedures may include engagement specific safeguards such as the following:
- (o) Involving an additional professional accountant to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm, or someone within the firm or network firm who was not otherwise associated with the assurance team;
- (p) Consulting a third party, such as a committee of independent directors, a professional regulatory body or another professional accountant;
- (q) Rotation of senior personnel;
- (r) Discussing independence issues with the audit committee or others charged with governance;
- (s) Disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;

- (t) Policies and procedures to ensure members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client;
- (u) Involving another firm to perform or re-perform part of the assurance engagement;
- (v) Involving another firm to re-perform the non-assurance service to the extent necessary to enable it to take responsibility for that service; and
- (w) Removing an individual from the assurance team, when that individual's financial interests or relationships create a threat to independence.

When the safeguards available, such as those described above, are insufficient to eliminate the threats to independence or to reduce them to an acceptable level, or when a firm chooses not to eliminate the activities or interests creating the threat, the only course of action available will be the refusal to perform, or withdrawal from, the assurance engagement.

## **2.16 CONFLICTS OF INTEREST, BENEFICIAL SHAREHOLDING, FINANCIAL INVOLVEMENT WITH OR IN THE AFFAIRS OF CLIENTS, PERSONAL RELATIONSHIPS, AUDIT FEE, ETC.**

The IFAC Code of Ethics for Professional Accountants gives a comprehensive coverage of conflicts of interest. The Rules of Professional Conduct for Members also cover the same topic. Excerpts of the sections in the IFAC Code are adapted or reproduced in the following sections for clarity.

### **Loans and Guarantees**

Ordinarily, banks and other financial institutions grant loans and advances to their varied customers as part of their normal business. Members of the assurance teams who are customers of such banks and other financial institutions may be granted loans and advances in the ordinary course of business. Loans and advances granted in the ordinary course of business may not necessarily constitute a threat to the independence of the auditors, but there are circumstances whereby such facilities granted may constitute a threat to independence.

#### **Loan to the Firm**

A loan from, or a guarantee thereof, by an assurance client, that is, a bank or a similar institution to the firm would not create a threat to independence, provided:

- (a) The loan is made under normal lending procedures, terms and requirements; and
- (b) The loan is immaterial to both the firm and the assurance client.

If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include:

- (a) Involving an additional professional accountant from outside the firm;  
or
- (b) Network firm, to review the work performed.

### **Loan to a Member of the Assurance Team**

A loan from, or a guarantee thereof, by an assurance client, that is, a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements. Examples of such loans include:

- (a) home mortgages;
- (b) bank overdrafts;
- (c) car loans; and
- (d) credit card balances.

Deposits and brokerage accounts of a firm or member of the assurance team with an assurance client.

In the same vein, deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution would not create a threat to independence provided the deposit or account is held under normal commercial terms.

Examples of self-interest threat created that would be so significant that no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm and the member of the assurance team and the assurance client, are:

- (a) If the firm, or a member of the assurance team, makes a loan to an assurance client that is not a bank or similar institution, or guarantees such an assurance client's borrowing.
- (b) if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution.

### **Close Business Relationships with Assurance Clients**

The Code of Ethics for Professional Accountants issued by the International Federation of Accountants provides that:

“A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and an audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats”.

The following are examples of such relationships:

- (a) Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client;

- (b) Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties; and
- (c) Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

#### **Case of an Audit Client**

In the case of an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level.

#### **Case of Assurance Client which is not an Audit Client**

In the case of an assurance client that is not an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level.

Consequently, in both these cases the only possible courses of action are to:

- (a) Terminate the business relationship;
- (b) Reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or
- (c) Refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

#### **Case Involving an Interest Held by the firm or Member of the Assurance Team or Their Immediate Family**

In the case of an audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or their immediate family in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

- (a) The relationship is clearly insignificant to the firm, the network firm and the audit client;
- (b) The interest held is immaterial to the investor, or group of investors; and
- (c) The interest does not give the investor, or group of investors, the ability to control the closely held entity.

#### **Purchase of Goods and Services from an Assurance Client by the Firm or a Member of the Assurance Team**

The purchase of goods and services from an assurance client by the firm (or from an audit client by a network firm) or a member of the assurance team would not generally create a threat to independence provided the transaction

is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- (a) Eliminating or reducing the magnitude of the transaction;
- (b) Removing the individual from the assurance team; or
- (c) Discussing the issue with those charged with governance, such as the audit committee.

### **Family and Personal Relationships**

The Code of Ethics for Professional Accountants issued by the International Federation of Accountants further provides that:

“Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level as discussed below”.

When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, or in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level.

If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence on the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.

When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- (a) The position, the close family member holds with the client; and
- (b) The role of the professional accountant on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- (a) Removing the individual from the assurance team;
- (b) Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- (c) Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or close family member of a member of the assurance team, has a close relationship with the member of the assurance team and is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement.

Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level, will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.

Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the assurance team, the position held within the firm, and the role of the individual within the assurance client.

An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:

- (a) The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;
- (b) Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and
- (c) Additional care is given to reviewing the work of the professional.

When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- (a) Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- (b) Excluding the individual from any substantive decision-making concerning the assurance engagement.

### **Employment with Assurance Clients**

“A firm or a member of the assurance team’s independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team’s independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is or may, join the assurance client some time in the future”. If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

- (a) The position the individual has taken at the assurance client;
- (b) The amount of any involvement the individual will have with the assurance team;
- (c) The length of time that has passed since the individual was a member of the assurance team or firm; and
- (d) The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- (a) Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement; or
- (b) Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client.

In the course of their work, auditors may provide advice on sources of capital that meet the client specifications or criteria, and provide structuring advice and assist a client in analysing the accounting effects of proposed transactions.

Safeguards that should be considered include:

- (a) Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- (b) Using professionals who are not members of the assurance team to provide the services; and
- (c) Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

## **FEES AND PRICING**

### **Fees - Relative Size**

When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat".

The significance of the threat will depend upon factors such as:

- (a) The structure of the firm; and
- (b) Whether the firm is well established or newly created.
- (c) The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
  - (i) Discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
  - (ii) Taking steps to reduce dependency on the client;
  - (iii) External quality control reviews; and
  - (iii) Consulting a third party, such as a professional regulatory body or another professional accountant.

A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

Such safeguards might include:

- (a) Policies and procedures to monitor and implement quality control of assurance engagements; and

- (b) Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary.

### **Fees - Overdue**

“A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year.

Generally the payment of such fees should be required before the report is issued”. The following safeguards may be applicable:

- (a) Discussing the level of outstanding fees with the audit committee, or others charged with governance;
- (b) Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed; and
- (c) The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

### **Pricing**

When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:

- (a) The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and
- (b) All applicable assurance standards, guidelines and quality control procedures are being complied with.

### **Contingent Fees**

“Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard.

Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client, may also create self-interest and advocacy threats.

If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard.

Accordingly, the only acceptable action is not to accept such arrangements”. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- (a) The range of possible fee amounts;
- (b) The degree of variability;
- (c) The basis on which the fee is to be determined;
- (d) Whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- (e) The effect of the event or transaction on the assurance engagement.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- (a) Disclosing to the audit committee, or others charged with governance, the nature and extent of fees charged;
- (b) Review or determination of the final fee by an unrelated third party; or
- (c) Quality and control policies and procedures.

### **Gifts and Hospitality**

“Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality”.

### **Actual or Threatened Litigation**

“When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created.

The relationship between client management and the members of the assurance team must be characterised by complete candor and full disclosure regarding all aspects of a client’s business operations. The firm and the client’s management may be placed in adversarial positions by litigation, affecting management’s willingness to make complete disclosures and the firm may face a self-interest threat”. The significance of the threat created will depend upon such factors as:

- (a) The materiality of the litigation;
- (b) The nature of the assurance engagement; and
- (c) Whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated, the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

- (a) Disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;
- (b) If the litigation involves a member of the assurance team, removing that individual from the assurance team; or
- (c) Involving an additional professional accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

### **Resolution of Ethical Conflicts**

From time to time professional accountants encounter situations which give rise to conflicts of interest. Such conflicts may arise in a wide variety of ways, ranging from the relatively trivial dilemma to the extreme case of fraud and similar illegal activities. The professional accountant should be constantly conscious of and be alert to factors which give rise to conflicts of interest. It should be noted that an honest difference of opinion between professional accountant and another party is not in itself an ethical issue. However, the facts and circumstances of each case need investigation by the parties concerned.

It is recognised, however, that there can be particular factors which occur when the responsibilities of a professional accountant may conflict with internal or external demands of one type or another. Hence:

- (a) There may be the danger of pressure from an overbearing supervisor, manager, director or partner; or when there are family or personal relationships which can give rise to the possibility or pressures being exerted upon them. Indeed, relationship or interests which could adversely influence, impair or threaten a professional accountant's integrity should be discouraged;
- (b) A professional accountant may be asked to act contrary to technical and/or professional standards;
- (c) A question of divided loyalty as between the professional accountant's superior and the required professional standards of conduct could occur; and
- (d) Conflict could arise when misleading information is published which may be to the advantage of the employer or client and which may not benefit the professional accountant as a result of such publication.

“In applying standards of ethical conduct professional accountants may encounter problems in identifying unethical behaviour or in resolving an ethical conflict. When faced with significant ethical, professional accountants should follow the established policies of the employing organisation to seek a resolution of such conflict”.

If those policies do not resolve the ethical conflict, the following should be considered:

- (a) Review the conflict problem with the immediate superior. If the problem is not resolved with the immediate superior and the professional accountant determines to go to the next managerial level, the immediate superior should be notified of the decision. If it appears that the superior is involved in the conflict problem, the professional accountant should raise the issue with the next higher level of management. When the immediate is the Chief Executive Officer (or equivalent) the next higher reviewing level may be the Executive Committee, Board of Directors, Non-Executive Directors, Trustee, Partners' Management Committee or Shareholders;
- (b) Seek counselling and advice on a confidential basis with an independent advisor or the applicable professional accountancy body to obtain an understanding of possible courses of action; and
- (c) If the ethical conflict still exists fully exhausting all levels of internal review, the professional accountant as a last resort may have no other recourse on significant matters (e.g. fraud) resign and submit an information memorandum to an appropriate representative of that organisation.

In Nigeria, the banking laws and regulations require cases of fraud to be reported to the regulatory authorities.

Any professional accountant in a senior position should endeavour to ensure that policies are established within his or her employing organisation to seek resolution of conflicts.

The professional bodies should provide confidential counselling and advice to members who experience ethical conflicts. The Institute of Chartered Accountants of Nigeria requires a member who is in doubt as to his or her ethical position in any matter to seek advice of the Institute through the Registrar/Chief Executive.

## **2.17 SUMMARY AND CONCLUSIONS**

This Chapter extensively dealt with provisions of the Companies and Allied Matters Act 2004 on auditors' appointment, duties, remuneration, rights and obligations, etc; Provisions of Insurance, Pension Reforms, Nigerian Accounting Standards Board, Securities and Exchange Commission, Nigeria Deposit Insurance Corporation and Central Bank of Nigeria Acts which are relevant to the auditor on the conduct of an audit exercise.

The various professional pronouncements in respect of guidelines, standards, code of ethics, and general conduct for Professional Accountants issued by the Institute of Chartered Accountants of Nigeria (ICAN) and the International Federation of Accountants (IFAC) were fully discussed.

Readers are also provided with the opportunity of familiarising themselves with an up-to-date Local and International Auditing Standards/Guidelines to be followed while carrying out an audit assignment.

The need for quality control as regards Working Papers, Audit Personnel's supervision/monitoring, independent and peer review were also treated.

Finally, the chapter is concluded with discussions on issues on threats to auditors independence and their resolutions, conflict of interest including beneficial shareholding and financial involvement of an auditor in client's affairs.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

## **2.18 REVISION QUESTIONS**

### **2.18.1 MULTIPLE CHOICE QUESTIONS**

1. The Companies and Allied Matters Act provides that every company shall at each annual general meeting appoint an auditor or auditors to audit the financial statements of the company, and to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.
  - (A) The auditor should hold office in perpetuity
  - (B) The auditor should participate in the tendering process annually
  - (C) True
  - (D) False
  - (E) The provision has recently been repealed.
  
2. The Banks and Other Financial Institutions Act provides that a bank shall not later than four months after the end of its financial year cause to be published in a daily newspaper printed in and circulating in Nigeria and approved by the Central Bank; copies of the bank's balance sheet and profit and loss account duly signed
  - (A) True
  - (B) Untrue
  - (C) The accounts may be published any time before the end of the next financial year
  - (D) The provisions of the Companies and Allied Matters Act supersede those of the Banks and Other Financial Institutions Act, in this respect
  - (E) The accounting standards supersede the Banks and Other Financial Institutions Act.
  
3. The Nigeria Deposit Insurance Corporation (NDIC), was established as part of the reform measures taken to strengthen the safety net for the banking sector following the introduction in 1986 of a major economic reform programme, the Structural Adjustment Programme (SAP) by government to correct the observed imbalances in the economy.
  - (A) True
  - (B) Untrue
  - (C) SAP was approved by the National Assembly
  - (D) NDIC is a parastatal of the Nigerian Stock Exchange
  - (E) NDIC is a subsidiary of Central Bank of Nigeria.

4. Quality control policy and processes are designed to provide reasonable assurance as to the appropriateness of the auditors' report and of adherence to auditing standards, ethical and other regulatory requirements
  - (A) True
  - (B) Untrue
  - (C) Quality control is not required on audit of quoted companies.
  - (D) Regulatory authorities are responsible for quality control.
  - (E) Since financial statements are published, they pass the quality control test.
  
5. Wider quality assurance objectives may be achieved by the auditors by discussing audit performance with
  - (A) boards of directors,
  - (B) audit committees (where they exist)
  - (C) senior management
  - (D) regulatory authorities
  - (E) board of directors, audit committees and senior management.

### 2.18.2 SHORT ANSWER QUESTIONS

- (1) State the circumstances in which the remuneration of the auditors of a company may be fixed by the directors
  
- (2) Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him, what options are available under the Companies and Allied Matters Act to the directors?
  
- (3) In which circumstances shall a person not be eligible for appointment as the approved auditor of a bank under the Banks and Other Financial Institutions Act?
  
- (4) The Nigerian Accounting Standards Board Act 2003 seeks to promote and enforce compliance with the accounting standards to be observed in the preparation of financial statements. NASB Act 2003 prescribes stiff penalties for non-compliance with accounting standards issued by the NASB. State three penalties prescribed by the Act.
  
- (5) Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. State what the audit firm should do to reduce the threats to independence to an acceptable level.

*Refer to Suggested Solutions in Appendix I on page 301.*

# ***INTERNAL AUDIT AND CONTROL***

## **3.0 LEARNING OBJECTIVES**

After studying this chapter, readers should be able to:

- ◆ Understand the scope and objectives of internal audit.
- ◆ Review the relationship between external and internal audits.
- ◆ Understand Internal Control Systems.
- ◆ Explore the options, opportunities and challenges for outsourcing the internal audit function.

## **3.1 INTRODUCTION**

At the planning stage of an audit, the external auditors should consider the activities of internal audit and their effect, if any, on external audit procedures. This chapter considers the scope and objectives of internal audit. The scope and objectives of internal audit vary widely and depend on the size and structure of the entity and the requirements of its management and directors.

The student taking professional examinations of the Institute of Chartered Accountants of Nigeria should have understanding of the separate roles of internal audit and external audit, and how they are interrelated. It is important to know that the role of internal audit is determined by management and the directors who set its objectives. However, the external auditors are engaged to report independently on the financial statements; their role is statutory in nature.

The external auditors' primary concern is whether the financial statements are free of material misstatement. The internal audit function's objectives vary according to the requirements of management and the directors and, generally, less emphasis is placed on materiality consideration.

The means of achieving their respective objectives are often similar and thus certain of the work of internal auditors may be useful in determining the nature, and timing of external audit procedures. If an entity has an audit committee, monitoring the activities of the internal audit function and the relationship between the entity's internal and external auditors is often one of that committee's responsibilities.

As part of the planning of an audit, an auditor should have understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach.

The auditor should use professional judgement to assess the components of audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

Auditors are only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessment, enables auditors to:

- (a) assess the adequacy of the accounting system as a basis for preparing the financial statements;
- (b) identify the types of potential misstatements, that could occur in the financial statements;
- (c) Consider factors that affect the risk of misstatements; and
- (d) Design appropriate audit procedures.

The learning objectives of this chapter have been carefully considered in structuring the topics in this chapter. A careful study of this chapter will enable the reader to understand the scope and objectives of internal audit, understand the relationship between external and internal audits as well as internal control systems. At the end of this chapter, the reader should be able to answer typical examination questions on internal audit and control.

### **3.2 SCOPE AND OBJECTIVES OF INTERNAL AUDIT**

The APB statement of auditing standard 500 is titled “Considering the work of internal audit”

At the planning stage of an audit, the external auditors should consider the activities of internal audit and their effect, if any, on external audit procedures

The standard describes ‘Internal audit’ as an appraisal or monitoring activity established by management and the directors for the review of the accounting and internal control systems as a service to the entity. Internal audit functions by:

- (a) examining,
- (b) evaluating and reporting to management and the directors on the adequacy and effectiveness of components of the accounting and internal control systems.

The external auditors have sole responsibility for:

- (a) The audit opinion expressed;
- (b) Determining the nature, timing and extent of external audit procedures;
- (c) All judgements relating to the audit of the financial statements of the external auditors;
- (d) That responsibility is not reduced by any use, made of internal audit work; and
- (e) However, internal audit work may serve to provide external auditors with audit evidence.

“The scope and objectives of internal audit vary widely and depend on the size and structure of the entity and the requirements of its management and directors.

Generally, internal audit activities include one or more of the following:

- (a) Review of the accounting and internal control systems: the establishment of adequate accounting and internal control systems is a responsibility of management and the directors which demands proper attention on a continuous basis. Often internal audit is assigned specific responsibility for reviewing, the design of the systems, monitoring their operation and recommending improvements thereto;
- (b) Examination of financial and operating information: this may include review of the means used to identify, measure, classify and report such information and specific enquiry, into individual items including detailed testing of transactions, balances and procedures;
- (c) Review of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation;
- (d) Review of compliance with laws, regulations and other external requirements and with internal policies and directives and other requirements including appropriate authorisation of transactions; and
- (e) Special investigations into particular areas, for example suspected fraud” (Chitty, 2004).

### **3.3 REVIEW OF THE RELATIONSHIP BETWEEN EXTERNAL AND INTERNAL AUDITS**

#### **Roles of External Audit and Internal Audit**

The role of internal audit is determined by management and the directors who set its objectives. External auditors are engaged to report independently on the financial statements; their role is statutory. The external auditors’ primary concern is whether the financial statements are free of material misstatement.

The internal audit function’s objectives vary according to the requirements of management and the directors, and generally, less emphasis is placed on materiality consideration.

#### **Evaluating Specific Internal Audit Work**

APB SAS 500 on ‘Considering the work of internal audit’ further states that “when the external auditors use specific internal audit work to reduce the extent of their audit procedures, they should evaluate that work to confirm its adequacy for their purposes”.

‘The evaluation of specific internal audit work involves consideration of the adequacy of the scope of work and related audit programmes and whether the assessment of the internal audit function remains appropriate. This evaluation may include consideration of whether:

- (a) the work is performed by persons having adequate technical training and proficiency as internal auditors;
- (b) the work of assistants is properly supervised, reviewed and documented;
- (c) sufficient appropriate audit evidence is obtained to afford a reasonable basis for the conclusions reached;
- (d) the conclusions reached are appropriate in the circumstances;
- (e) any reports prepared by internal audit are consistent with the results of the work performed;
- (f) any exceptions or unusual matters disclosed by internal audit are properly resolved;
- (g) amendments to the external audit programme are required as result of matters identified by internal audit work; and
- (h) there is a need to test the work of internal audit to confirm its adequacy (Chitty, 2004).

The nature, timing and extent of the testing, if any, of the specific internal audit work which the external auditors consider necessary depends on:

- (a) Their judgement as to the risk and materiality of the area concerned;
- (b) The assessment of the internal audit function; and
- (c) The results of the other evaluation procedures.

Such tests may include examination of items already examined by internal audit, examination of other similar items and observation of internal audit procedures.

In the event that the external auditors conclude that the internal audit work is not adequate for their purposes:

- (a) They extend their procedures beyond those originally planned; and
- (b) Ensure that sufficient appropriate audit evidence, is obtained to support the conclusions reached.

### **3.4 ACCOUNTING AND INTERNAL CONTROL SYSTEMS AND AUDIT RISK ASSESSMENTS**

As part of the planning of an audit, an auditor should:

- (a) Obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach; and
- (b) Use professional judgement to assess the components of audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

The following definitions are contained in APB Statement of Auditing Standard 300 on 'Accounting and internal control systems and audit risk assessments':

**'Audit risk'** means the risk that auditors may give an inappropriate audit opinion on financial statements. Audit risk has three components: inherent risk, control risk and detection risk.

**'Inherent risk'** is the susceptibility of an account balance or class of transactions to material misstatement, either individual or when aggregated with misstatements in other balances or classes, irrespective of related internal controls.

**'Control risk'** is the risk that a misstatement could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, would not be prevented, or detected and corrected on a timely basis by the accounting and internal control systems.

**'Detection risk'** is the risk that auditors' substantive procedures (tests of details of transactions and balances or analytical procedures) do not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.

**'Accounting system'** means the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions and other events.

Internal control system comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and timely preparation of reliable financial information.

Internal controls may be incorporated within computerised accounting systems. However, the internal control system extends beyond those matters which relate directly to the accounting system.

Control environment means the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity.

The control environment encompasses the management style, and corporate culture and values shared by all employees. It provides the background against which the various other controls are operated. However, a strong control environment does not, by itself, ensure the effectiveness of the overall internal control system. Factors reflected in the control environment include:

- (a) The philosophy and operating style of the directors and management;
- (b) The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory controls); and

- (c) The directors' methods of imposing control, including the internal audit function, the functions of the board of directors and personnel policies and procedures.

Control procedures are those policies and procedures in addition to the control environment which are established to achieve the entity's specific objectives. They include, in particular procedures designed to prevent or to detect and correct errors. The latter may be a particular focus of high level controls in small or owner-managed entities. Specific control procedures include:

- (a) Approval and control of documents;
- (b) Controls over computerised system and the information technology environment;
- (c) Checking the arithmetical accuracy of the records;
- (d) Maintaining and reviewing control accounts and trial balances;
- (e) Reconciliations;
- (f) Comparing the results of cash, security and stock counts with accounting records;
- (g) Comparing internal data with external sources of information; and
- (h) Limiting direct physical access to assets and records.

Auditors are only concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessment enables auditors to:

- (a) Assess the adequacy of the accounting system as a basis for preparing the financial statements;
- (b) Identify the types of potential misstatements that could occur in the financial statements;
- (c) Consider factors that affect the risk of misstatements; and
- (d) Design appropriate audit procedures" (Chitty, 2004)

At the planning stage of the audit, the auditors should consider:

- (a) The likelihood of error in the light of inherent risk; and
- (b) The system of internal control (control risk) in order to determine the extent of work and hence the level of detection risk required; to satisfy themselves that the risk of error in the financial statements is sufficiently low.

### **Inherent risk**

APB SAS 300 on 'Accounting and internal control systems' states that "in developing the audit approach and the detailed procedures, auditors should assess inherent risk in relation to financial statement assertions, about material account balances and classes of transactions, taking account of factors relevant both to the entity as a whole and to the specific assertions".

In the absence of information to assess the inherent risk for a specific account balance, or class of transactions, the auditors should assume that the inherent risk is high. However, when an assessment results in the inherent risk not to be high, the auditors must document the reasons and are able to reduce the work which would otherwise have been carried out' (Chitty, 2004).

To assess inherent risk:

- (a) Auditors use their professional judgement to evaluate numerous factors having regard to their experience of the entity from previous audits;
- (b) Any controls established by management to compensate for a high level of inherent risk; and
- (c) Their knowledge of any significant changes which have taken place.

Examples of the factors are:

At the entity level

- (a) The integrity of directors and management;
- (b) Management experience and knowledge and changes in management during the period;
- (c) Unusual pressures on directors or management, such as tight reporting deadlines, market expectations or other circumstances that might predispose them to misstate the financial statements;
- (d) The nature of the entity's business;
- (e) Factors affecting the industry in which the entity operates.

At the account balance and class of transaction level:

- (a) Financial statement accounts likely to be susceptible to misstatements;
- (b) The complexity of underlying transactions and other events which might require the use of the work of an expert;
- (c) The degree of judgement involved in determining account balances;
- (d) Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash;
- (e) The quality of the accounting systems;
- (f) The completion of unusual and complex transactions, particularly at or near period end; and
- (g) Transactions not subjected to ordinary processing (Chitty, 2004).

### **Accounting System and Control Environment**

APB SAS 300 on 'Accounting and internal control systems' states that "in planning the audit, auditors should obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach".

Auditors obtain an understanding of the accounting system sufficient, to enable them to identify and understand by documenting:

- (a) major classes of transactions in the entity's operations;
- (b) how such transactions are initiated;

- (c) significant accounting records, supporting documents and accounts in the financial statements; and
- (d) the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.

In order to assess the likely effectiveness of control procedures, the auditor must have an understanding of the control environment.

A strong control environment, for example, one with strong budgetary controls and an effective internal audit function, increases the effectiveness of control procedures.

A small entity's control environment may be strengthened by the close involvement of the directors, including their review of financial information.

Based on their understanding of the accounting system and control environment:

- (i) Auditors can make a preliminary assessment of the adequacy of the system as a basis for the preparation of the financial statements; and
- (ii) The likely mix of tests of control and substantive procedures.

An auditor must obtain an understanding of the accounting system, control environment and control procedures (i.e. the systems) as one exercise. However, in order to design and select the appropriate audit tests, it may be necessary for them to undertake additional work to obtain a more detailed understanding of specific control procedures.

When seeking an understanding of the accounting systems and control environment, sufficient to plan the audit the auditors should:

- (a) Gain knowledge of the design and operation of the systems;
- (b) Understand and assess inherent risks; and
- (c) Perform 'walk-through tests' that is: tracing one or more transactions through the accounting system and observing the application of relevant aspects of the internal control system.

The nature, timing and extent of the procedures performed by auditors to obtain an understanding of the systems vary, because of:

- (a) Materiality considerations;
- (b) The size and complexity of the entity;
- (c) Their assessment of inherent risk;
- (d) The complexity of the entity's computer systems;
- (e) The type of internal controls involved; and
- (f) The nature of the entity's documentation of specific internal controls.

Usually, the auditors' understanding of the systems is obtained through previous experience with the entity updated as necessary by:

- (a) Enquiries of appropriate supervisory and other personnel at various organisational levels within the entity, together with reference to

documentation such as procedures manuals, job descriptions and systems descriptions;

- (b) Inspection of relevant documents and records produced by the systems; and
- (c) Observation of the entity's activities and operations, including the information technology function's organisation, personnel performing control procedures and the nature of transaction processing (Chitty, 2004).

### **Internal Controls and their Inherent Limitations**

Internal controls established by the directors relating to the accounting system are concerned with achieving objectives such as:

- (a) Transactions are executed in accordance with proper, general or specific authorisation;
- (b) All transactions and other events are promptly recorded at the correct amount, in the appropriate accounts and in the proper accounting period, so as to permit preparation of financial statements in accordance with the applicable reporting framework (e.g. relevant legislation and applicable accounting standards);
- (c) Access to assets is permitted only in accordance with proper authorisation; and
- (d) Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

An internal control system can only provide the directors with reasonable confidence that their objectives are reached because of inherent limitations such as:

- (a) The usual requirement that the cost of an internal control is not disproportionate to the potential loss which may result from its absence;
- (b) Most systematic internal controls tend to be directed at routine transactions rather than non-routine transactions;
- (c) The potential for human error due to carelessness, distraction, mistakes of judgement and the misunderstanding of instruction;
- (d) The possibility of circumvention of internal controls through collusion with parties outside or inside the entity;
- (e) The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example by overriding an internal control; and
- (f) The possibility that procedures may become inadequate due to changes in conditions or that compliance with procedures may deteriorate over time (Chitty, 2004).

These factors indicate why auditors cannot obtain all their evidence from tests of the system of internal control.

### **Control Risk in the Small Business**

Auditors must obtain an appropriate level of audit evidence to support their audit opinion regardless of the size of the entity.

However, many internal controls relevant to large entities are not practical in the small business; for example, in small businesses accounting procedures may be performed by few persons, who may have both operating and custodial responsibilities and, consequently, segregation of duties may be severely limited. Inadequate segregation of duties may, in some cases, be offset by other control procedures and close involvement of an owner or manager in strong supervisory controls where they have direct personal knowledge of the entity and involvement in transactions though, this in itself may introduce other risks. In circumstances where segregation of duties is limited and evidence of supervisory controls is lacking, the audit evidence necessary to support the auditors' opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures and any audit work carried out in the course of preparing the financial statements.

### **Control Risk**

If auditors, after obtaining an understanding of the accounting system and control environment, expect to be able to rely on their assessment of control risk to reduce the extent of their substantive procedures, they should make a preliminary assessment of control risk for material financial statement assertions, and should plan and perform tests of control to support that assessment.

If, as a result of their work on the accounting system and control environment, auditors decide it is likely to be inefficient or impossible to rely on any assessment of control risk to reduce their substantive procedures, no such assessment is necessary and control risk is assumed to be high. The auditors may adopt substantive procedures in such cases.

### **Preliminary Assessment of Control Risk**

The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing and correcting material misstatements. This entails consideration of the design of the accounting and internal control systems to assess their likely effectiveness. There is, however, always some control risk because of the inherent limitations of any internal control system. The more effective the entity's accounting and internal control systems are assessed to be, the lower the auditors' assessment of control risk.

Where auditors obtain satisfactory audit evidence from tests of control as to the effectiveness of the accounting and internal control systems, the extent of substantive procedures may be reduced.

Auditors may conclude that the accounting and internal control systems are not effective, or they may decide that it is likely to be inefficient to adopt an audit approach which relies on tests of control. In these circumstances they plan the audit approach on the basis that sufficient and appropriate audit evidence needs to be obtained entirely from substantive procedures and from any audit work carried out in the preparation of the financial statements.

**Relationship Between the Assessments of Inherent and Control Risks**

Management often react to situations where inherent risk is high by designing accounting and internal control systems to prevent and detect misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, the effects of inherent and control risk may be more appropriately determined by making a combined assessment” (Chitty, 2004).

**Documentation of Understanding and Assessment of Control Risk**

When control risk is assessed at less than high, auditors should document the basis for that conclusion in their working paper file.

Different techniques may be used to document information relating to accounting and internal control systems and the assessment of control risk. Selection of a particular technique is a matter for the auditors’ judgement.

Common techniques, used alone or in combination, are narrative descriptions, questionnaires, checklists and flow-charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity’s accounting and internal control systems.

Generally, the more complex the entity’s accounting and internal control systems are, the more extensive the auditors’ procedures, the more extensive the documentation needs to be.

**Test of Control**

Tests of control are performed to obtain audit evidence about the effective operation of the accounting and internal control systems - that is, that properly designed controls identified in the preliminary assessment exist in fact and have operated effectively throughout the relevant period. They include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk assessments.

In the process of obtaining the understanding of the accounting and internal control systems, some tests of control on one assertion may provide audit evidence about the effectiveness of the operation of internal controls relevant to another assertion and, consequently, serve as tests of control for the other assertion. For example, “in obtaining the understanding of the accounting and internal control systems pertaining to cash, auditors may obtain audit evidence about the effectiveness of the bank reconciliation process, through enquiry and observation.

In these circumstances, when auditors conclude that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the operating effectiveness of policies and procedures relevant to a particular financial statement assertion, they may use that evidence, on its own or (if not in itself sufficient) with other appropriate audit evidence, to support a control risk assessment at less than high.

Tests of control may include:

- (a) Corroborative enquiries about, and observation of, internal control functions;
- (b) Inspection of documents supporting controls or events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised or a reconciliation approved;
- (c) Examination of evidence of management reviews, for example minutes of management meetings at which financial results are reviewed and corrective action taken;
- (d) Re-performance of control procedures, for example reconciliation of bank accounts, to ensure they were correctly performed by the entity; and
- (e) Testing of the internal controls operating on specific computerised applications or over the overall information technology function, for example access or program change controls (Chitty, 2004).

When obtaining evidence about the effective operation of internal controls, relevant factors for auditors to consider are:

- (a) How they were applied;
- (b) The consistency with which they were applied during the period; and
- (c) By whom they were applied.

The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as:

- (a) Changes in key personnel;
- (b) Significant seasonal fluctuations in volume of transactions; and
- (c) Human error; in particular, staff changes in key internal control functions may increase control risk.

If there have been such changes in the period under review, auditors may need to modify their tests of control to confirm effective operation during and after the period of change.

In a computer environment, auditors may find it necessary, or may prefer to use computer-assisted audit techniques. The use of such techniques, for example file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system.

### **Quality and Timeliness of Audit Evidence**

Certain types of audit evidence obtained by auditors are more reliable than others. Usually, auditors' observations provide more reliable audit evidence than merely making enquiries. Audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied.

Auditors may decide to perform some tests of control at an interim audit visit advance of the period end. However, they cannot rely on the results of such test without considering the need to obtain further evidence relating to the remainder of the period. Factors to be considered include:

- (a) The results of the interim tests;
- (b) The length of the remaining period;
- (c) Whether any changes have occurred in the accounting and internal control systems during the remaining period;
- (d) The nature and amount of the transactions and other events and the balances involved;
- (e) The control environment; and
- (f) The nature, timing and extent of the substantive procedures which they plan to undertake (Chitty, 2004).

### **Final Assessment of Control Risk**

Having undertaken tests of control, auditors should evaluate whether the preliminary assessment of control risk is supported.

Whenever deviations are detected:

- (a) Auditors make specific enquiries in order to consider their implications;  
or
- (b) It may be that, in the circumstances, they can obtain sufficient appropriate audit evidence to conclude that, despite those deviations, their preliminary assessment is supported. On the other hand, if they conclude that the deviation rate is such that the preliminary assessment is not supported, they amend their assessment of control risk, unless audit evidence obtained from other tests of control supports that assessment.

If the evaluation of deviations results in auditors concluding that the assessed level of control risk needs to be revised, they should modify the nature, timing and extent of their planned substantive procedures.

### **Detection Risk**

APB SAS 300 on 'Accounting and internal control systems' states that "auditors should consider the assessed levels of inherent and control risk in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptable level". In this regard, the auditors should be aware that the level of detection risk relates to the auditors' substantive procedures (tests of details of transactions and balances and analytical procedures). It is primarily the consequence of the fact that auditors do not, and cannot, examine all available evidence; auditors seek reasonable confidence and so do not examine all items, not all evidence concerning any item that is examined. Moreover, as audit evidence is generally persuasive rather than conclusive, some detection risk is usually present even if they examine all evidence available of an account balance or an entire class of transactions.

### **Audit Opinion**

Auditors must obtain sufficient appropriate audit evidence as to whether the financial statements are free of material misstatement. Internal controls, even if fairly simple and unsophisticated, may contribute to this evidence.

The auditors' control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level.

Regardless of the assessed levels of inherent and control risks, auditors should perform some substantive procedures for financial statement assertions of material account balances and transaction classes. Substantive procedures may comprise only analytical procedures where such procedures provide sufficient appropriate evidence.

When both inherent and control risks are assessed as high, auditors consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. For example, they may not be able to obtain sufficient evidence about the completeness in income in the absence of some internal controls. When auditors determine that detection risk regarding a material financial statement assertion cannot be reduced to an acceptably low level, they consider the implications for their report (Chitty, 2004).

### **Communication of Weaknesses**

As a result of obtaining an understanding of the accounting and internal control systems and of performing audit procedures, auditors may become aware of weaknesses in the systems. This should be communicated to the directors or management using 'management reports'.

### **Risk Assessments and Internal Control**

International Standard on Auditing 400 titled 'Risk assessments and internal control' states as follows:

- (a) The auditors should obtain an understanding of the accounting system sufficient to identify and understand:
  - (i) Major classes of transactions in the entity's operations;
  - (ii) How such transactions are initiated;
  - (iii) Significant accounting records, supporting documents and accounts in the financial statements; and
  - (iv) The accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.
- (b) The auditor should obtain an understanding of the control environment sufficient to assess directors' and management's attitudes, awareness and actions regarding internal controls and their importance in the entity.
- (c) The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan.

- (d) The auditor should obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach.
- (e) The preliminary assessment of control risk for a financial statement assertion should be high, unless the auditor:
  - (i) Is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and
  - (ii) Plans to perform tests of control to support the assessment.

When auditors conclude that they do not wish to rely on tests of control, they plan the audit approach, on the basis that sufficient appropriate audit evidence, needs to be obtained entirely from substantive procedures, and from any audit work carried out in the preparation of the financial statements.

The auditor should document in the audit working papers:

- (a) The understanding obtained of the entity's accounting and internal control systems; and
- (b) The assessment of control risk.

The higher the assessment of inherent and control risk, the more evidence the auditor should obtain from the performance of substantive procedures.

When the auditor determines that; detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptably low level, the auditor should express a qualified opinion or disclaimer of opinion.

The auditor should make management aware, on a timely basis and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention" (Chitty, 2004).

### **3.5 CORPORATE GOVERNANCE**

Global interest in corporate governance has increased in recent times due to large scale corporate failures, resulting to huge loses to all stakeholders. The case of Enron, Worldcom, Pamalat and recent failures affecting financial industries is still fresh in the public mind. These issues have generated the need for regulations, stipulating standard rules regarded as best practices in corporate governance.

#### **Definition of Corporate Governance**

Corporate governance is defined as the system by which the affairs of companies are directed and controlled by those charged with the responsibility. It is an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders. This is achieved by directing and controlling management activities with good business shrewdness,

objectivity, accountability and integrity. Good corporate governance is reliant on a sound internal control system, existing legislation, and a healthy board culture which safeguards policies and processes.

### **Corporate Governance in Nigeria**

Realising the need to align with international best practices, in 2002 the Securities and Exchange Commission (SEC) in collaboration with the Corporate Affairs Commission (CAC) set up a committee with a mandate to identify weaknesses in the current corporate governance practices in Nigeria and come up with necessary recommendations that will improve corporate governance in Nigeria. The Committee was given the following terms of reference:

Identify weaknesses in the current corporate governance practices in Nigeria with respect to public companies;

- (a) Examine practices in other jurisdictions with a view to the adoption of international best practices in corporate governance in Nigeria;
- (b) Make recommendations on necessary changes in current practices; and
- (c) Examine any other issues relating to corporate governance in Nigeria.

The Committee's report known as Code of Best Practices on Corporate Governance in Nigeria, was approved by the Boards of the Securities and Exchange Commission (SEC) being the regulatory authority of the capital market and the Corporate Affairs Commission (CAC) being the regulatory authority of companies in Nigeria.

### **CODES OF BEST PRACTICES ON CORPORATE GOVERNANCE**

The code of best practices on Corporate Governance is treated under the following:

- (a) Board of Directors;
- (b) Shareholders; and
- (c) Audit Committee.

### **BOARD OF DIRECTORS**

This is further divided into the following sub-sections:

#### **Responsibilities of the Board of Directors**

The board of directors should be in control of the affairs of the company in lawful and efficient manner such that the company continuously improves on its value creation.

The board should, with due regard to the other stake-holder's interest, ensure that the value created is shared among the shareholders and employees.

The functions of the board should include but not limited to the following:

- (i) Strategic planning;
- (ii) Selection, performance appraisal and compensation of senior executive;
- (iii) Succession planning;

- (iv) Communication with shareholders;
- (v) Ensuring the integrity of financial controls and reports; and
- (vi) Ensuring that ethical standards are maintained and that the company complies with the laws of Nigeria.

The chairman's primary responsibility is to ensure effective operation of the board and he should as far as possible, maintain a distance from the day to day running of the company which should be the primary responsibility of the chief executive office and management team.

### **Composition of The Board of Directors**

The board should be composed in such a way as to ensure diversity of experience without compromising compatibility, integrity, availability and independence.

Membership of the board should possess the following attributes:

- (i) Upright personal characteristics;
- (ii) Relevant core competencies;
- (iii) Knowledge on board matters;
- (iv) Entrepreneurial bias; and
- (v) Sense of accountability integrity, commitment to the task of corporate and institutional building.

The position of the chairman and chief executive officer should ideally be separated and held by different persons.

There should be a strong non-executive independent director as vice-chairman of the board, where the position of the chairman and chief executive officer are combined in one individual.

### **Board of Directors**

The board should meet regularly at least once in a quarter with sufficient notices and a formal schedule of matters specifically reserved for its decision, in order to maintain effective control over the company and monitor the executive and management.

An agreed procedure should exist for directors to take independent professional advice; the cost of which should be borne by the company in furtherance of their duty, if necessary.

The advice and services of the company secretary who should be appointed by the board and is responsible for ensuring that board procedures are followed and that applicable rules and regulations are complied with, should be accessible to all directors. His removal should be decided by the board.

The advice and services of other professionals in areas where such advice will improve the quality of contribution of the directors to the overall decision making process should also be accessible to all directors.

### **Non-Executive Directors**

Non-executive directors should bring independent judgment to bear on issues such as integrity, performance, resources including key appointments and standard of conducts.

Shareholders approval is required where directors service contract is to exceed three years.

Other than their fees and allowances, non-executive directors should not be dependent on the company for their income. They should be independent and not be involved in business relationship with the company that could fetter or encumber their independent judgment.

They should neither participate in the company's share option scheme nor be pensionable by the company.

Appointment as non-executive director should be for a specified period and re-appointment should be dependent on performance.

It should be a matter for the entire board to decide the appointment of non-executive directors, which should be done through a defined formal selection process.

Skills mix of executive and non-directors should reflect the range of the competency needs of the company.

Proper company a board orientation should be undertaken by newly appointed directors, and where necessary formal training aimed at making them effective in the discharge of their duties should be given at the company's cost.

### **Executive Directors**

There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest paid director including pension contributions, stock options, where the earnings are in excess of ₦500,000.

In the determination of their remuneration, executive directors should not play an active role.

### **Compensation of Board Members**

The remuneration of executive directors should not be fixed in shareholders meeting but by the board.

The remuneration should be recommended by remuneration committees, wholly or mainly composed of non-executive independent directors and chaired by a non-executive director.

The following should be disclosed in relation to directors' remuneration:

- (a) Directors emoluments and that of the chairman and highest paid director;

- (b) Relevant information about stock options and any pension contribution; and
- (c) Future service contract.

### **Reporting and Control**

It is the duty of the board to present a balance, reasonable and transparent assessment of the company's position.

In financial and non-financial reporting, there is an overriding need to promote transparency.

It is the primary responsibility of the board to ensure good internal controls.

The board should ensure that an objective and professional relationship is maintained with the external auditors.

External auditors should not be involved in business relationships with the company.

An audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties should be established by the board.

A report on the effectiveness of the company's system of internal control should be presented by the directors in the annual report.

In compliance with the Companies and Allied Matters Act, the directors should report that, the business is a going concern with supporting assumptions or qualifications as necessary, with written terms of reference.

## **SHAREHOLDERS**

### **Shareholders' Rights and Privileges**

- (a) The company through the directors, should ensure that shareholders' statutory and general rights are protected at all times;
- (b) It should be the responsibility of shareholders to elect directors and approve the terms and conditions of their directorships;
- (c) The venue of the annual general meeting should be carefully chosen such that the majority of shareholders can attend and vote at the meeting and not be disenfranchised in terms of distance and cost;
- (d) Before the annual general meeting, notices should be sent at least 21 working days with such details as annual reports, audited financial statements and other information that will enable them vote properly on any issue;
- (e) A separate resolution should be proposed by the board at the general meeting on each substantial issue in such a way that they can be voted for in an organised manner;
- (f) The board should ensure that decisions reached at the general meetings are implemented;

- (g) There should be at least one director on the board to represent minority shareholders;
- (h) Unless they are in a competing business or have conflicts of interest, that warrant their exclusion, shareholders holding more than 20% of the total issued share capital of the company should have a representative on the board;
- (i) The board should ensure equal treatment of all shareholders such that none is given preferential treatment or superior access to information or other materials; and
- (j) The annual general meeting should be used by the board to communicate with the shareholders and encourage their participation.

### **Institutional Investors**

- (a) Shareholders' activism whether by institutional or by organised shareholders' group should not be discouraged by the board;
- (b) Institutional and non-institutional shareholders with larger holdings should act and influence the standard of corporate governance positively and thereby ensure optimisation of stakeholders' value; and
- (c) Information made available to institutional shareholders should also be made available to other shareholders at the same time in such a manner as to ensure that neither group enjoys preferential treatment.

### **Audit Committees**

- (a) Audit committees should be established by companies with the key objective of raising standard of corporate governance.
- (b) The committee should not be under the influence of any dominant personality on the main board, neither should they get in the way and obstruct executive management.
- (c) They should not act as a barrier between external auditors and the executive directors or encourage the main board to abdicate its responsibilities in reviewing and approving the financial statements.
- (d) Audit committees should be made up of strong and independent persons.

### **Composition of the Audit Committee**

- (a) Audit committee should be established in accordance with CAMA Section 359 (3), with not more than one executive director;
- (b) A majority of the non-executives serving on the committee should be independent of the company in terms of management or business or other relationship, which could materially interfere with the exercise of their independent judgement as committee members;
- (c) A non-executive director nominated by members of the audit committee should be the chairman of the committee;
- (d) Membership of the audit committee should be for a fixed tenure, however any member of the committee should be eligible for re-election after his tenure; and
- (e) The secretary of the audit committee should be the company secretary, auditor or such other person nominated by the committee.

### **Qualification and Experience of Members of Audit Committee**

- (a) Members of the audit committee should be capable of reading and understanding basic financial statements and make valuable contributions to the committee's deliberation;
- (b) Audit committee should review not only external auditor's reports but also, most importantly, the report of the internal auditor; and
- (c) Members of the committee should possess the following qualities:
  - (i) Integrity;
  - (ii) Dedication;
  - (iii) A thorough understanding of the business, its products and services;
  - (iv) A reasonable knowledge of the risks facing the company and the essential controls the company has in place;
  - (v) Inquisitiveness and dependable judgement; and
  - (vi) Ability to offer new or different perspective and constructive suggestions.

### **Terms of Reference for Audit Committee**

In line with Section 359 (6) (a-e) of the Companies and Allied Matters Act, Cap. C 20, LFN 2004, the committee should be given terms of reference.

The performance of the committee and its members should be evaluated periodically and the form of such evaluation should be decided by the company.

The committee should maintain a constructive dialogue between the external auditors and the board and enhance the credibility of the financial disclosures and the interest of the shareholders.

### **Meetings**

- (a) The number of members of the audit committee will determine the quorum for the meetings and it should be specified in the terms of reference of the committee.
- (b) The committee should meet at least three (3) times in a year.
- (c) The committee should hold a meeting with the external auditors at least once a year, without the presence of any executive member.

### **Enforcement and Compliance**

It has generally been argued that in this issue, voluntary compliance should be encouraged and where it becomes necessary and applicable, appropriate sanctions should be applied. This is the position adopted by Securities and Exchange Commission (SEC), and Corporate Affairs Commission (CAC) in the enforcement of compliance with corporate governance code of best practices in Nigeria.

SEC and CAC will give due consideration to the compliance or otherwise of the provisions of the code in the treatment of issues brought before them.

### 3.6 OUTSOURCING THE INTERNAL AUDIT FUNCTIONS

#### **Outsourcing**

Outsourcing involves the transfer of management's day-to-day execution of an entire business function to an external service provider. An outsourcing arrangement is a contract between an organisation and an outsourcing vendor to provide internal audit services. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vendor reports to him or her.

Entities often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing. Such uses are often referred to as internal audit assistance or audit co-sourcing. Some outsourcing arrangements are structured so that an outsourcing vendor performs virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit in the entity oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

#### **Internal Audit**

Effective internal control is a foundation for the safe and sound operation of any organisation. The board of directors and senior management of an entity are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties. An important element in assessing the effectiveness of the internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action.

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

In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms and other outside professionals (outsourcing vendors) in recent years to perform work that traditionally has been done by internal auditors. These arrangements are often called internal audit outsourcing, internal audit assistance, audit co-sourcing, or extended audit services.

### **Reasons for Outsourcing the Internal Audit Function**

The reasons for outsourcing the internal audit functions are:

(a) **Available Resources**

Appropriate internal audit resources may be scarce or unavailable in certain situations and for a number of reasons. Whether selected as a temporary alternative or permanent solution, outsourcing may be necessary to acquire timely, professional internal audit services and competent internal auditing staff.

(b) **Size of the Organisation**

Both large and small organisations may need to take advantage of outsourcing alternatives. Common reasons include temporary staff shortages, specialty skills, coverage of remote business locations, special project work, and supplemental staff to meet tight deadlines. Small organisations may also find it necessary to explore outsourcing due to the inability to hire permanent or full-time internal audit staff.

### **Types of Outsourcing Alternatives**

Organisations may need to define the types of outsourcing engagements or practices to be considered. Outsourcing alternatives include:

- (a) **Total outsourcing;** where 100 percent of the internal audit services are obtained from external sources, usually on an ongoing basis.
- (b) **Partial outsourcing;** where less than 100 percent of the internal audit services are obtained from external sources, usually on an ongoing basis.
- (c) **Co-sourcing;** where external resources participate on joint engagements with in-house internal audit staff. Engagements may be ongoing or for specific terms.
- (d) **Sub-contracting;** where a specific engagement or portion of some engagement is performed by an external party, typically for a limited time period. Management and oversight of the engagement is normally provided by in-house internal audit staff.

### **Advantages and Disadvantages of Outsourcing**

- (a) Outsourcing affords the client the luxury of having access to global expertise and cutting edge technology in internal auditing. Because internal audit is not a core experience area for many companies, many internal audit functions are not adequately equipped with either intellectual or human capital, to execute their mandate effectively. Outsourcing it to professionals provides the organisation with the best expertise in this area.

- (b) Due to the prohibitive cost involved; most organisations do not make sufficient investment to improve their internal audit functions and generally lack access to updated methodologies and technologies because of the prohibitive costs. This results in high staff turnover as they struggle to hire and retain talented personnel, who wish to make a career in internal auditing. Outsourcing saves the organisation this dilemma.

The following items, while not all-inclusive, should be considered when outsourcing the internal audit function:

- (a) Independence of the service providers;
- (b) Allegiance of in-house versus external service provide;
- (c) Professional standards followed by the service provider;
- (d) Qualifications of the service provider;
- (e) Staffing, training, turnover, rotation of staff, management;
- (f) Flexibility in staffing resources to meet engagement needs or special requests;
- (g) Availability of resources;
- (h) Retention of institutional knowledge for future assignments;
- (i) Access to best practice or insight to alternative approaches;
- (j) Culture of the organisation receptiveness to service providers;
- (k) Insight into the organisation by the service provider;
- (l) Coverage of remote locations;
- (m) Coordination with in-house internal audit services;
- (n) Coordination with external auditor;
- (o) Use of internal auditing as a training ground for internal promotions;
- (p) Retention, access to and ownership of working papers;
- (q) Acquisition and availability of specialty skills;
- (r) Cost considerations; and
- (s) Good standing membership in an appropriate professional organisation.

### 3.7 SUMMARY AND CONCLUSIONS

Internal audit and control is one of the key factors in audit and assurance services. In this chapter, adequate coverage of the nature of/and relationship between external and internal audit functions, has been given. The basis of internal audit work was also discussed. The concept of internal control, and corporate governance were also given adequate attention. Audit risks and related audit opinions with respect to external audit assurance were adequately treated. Issues regarding the Audit Committee of the Board (of corporate entities) and its composition as provided for in the statute, as well as its functions and relationships with the board, external and internal auditors, were given sufficient treatment.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

### 3.8 REVISION QUESTIONS

#### 3.8.1 MULTIPLE CHOICE QUESTIONS

1. 'Internal audit' as an appraisal or monitoring activity established by management and the directors for the review of the accounting and internal control systems as a service to the entity. Internal audit functions by
  - (A) examining
  - (B) evaluating
  - (C) reporting to management
  - (D) the directors on the adequacy and effectiveness of components of the accounting and internal control systems
  - (E) All the above four cases.
  
2. The role of internal audit is determined by management and the directors who set its objectives while the external auditors are engaged to report independently on the financial statements; the role of the external auditors is statutory
  - (A) True
  - (B) Untrue
  - (C) Internal auditors and the external auditors being chartered accountants do not have to document tests of internal control
  - (D) The need to state conclusions of tests conducted is done away with
  - (E) All the above four cases.
  
3. An effective internal audit function
  - (A) often allows a modification in the nature and timing
  - (B) a reduction in the extent, of procedures performed by the external auditors
  - (C) cannot eliminate the modification of the nature and timing of procedures entirely
  - (D) Dispenses of the need for external audit
  - (E) A - C above.
  
4. The effectiveness of the internal audit function may be an important factor in the external auditors' assessment of the control environment, and their related asset
  - (A) Not these days
  - (B) At times
  - (C) True
  - (D) Untrue
  - (E) Not applicable.
  
5. As part of the planning of an audit, an auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach
  - (A) Not these days
  - (B) At times
  - (C) True
  - (D) Untrue
  - (E) Not applicable.

### **3.8.2 SHORT ANSWER QUESTIONS**

1. The scope and objectives of internal audit vary widely and depend on the size and structure of the entity and the requirements of its management and directors. State four internal audit activities you have come across.
2. In what circumstances do the internal audit function's objectives vary?
3. In some cases, after considering the activities of internal audit, the external auditors may decide that internal audit work will have no effect on external audit procedures. What should the external auditor do when faced with such situation?
4. State five factors which the auditor may adopt in assessing inherent risk at the entity level.
5. State four matters which the auditor must consider in assessing control risk in small business

*Refer to Suggested Solution in Appendix I on page 301.*

# ***AUDIT PLANNING AND CONTROL PROCEDURE***

## **4.0 LEARNING OBJECTIVES**

After studying this chapter, readers should be able to:

- ◆ Understand the process of reviewing the client's operational background with regard to its financial, legal and personnel situations and the industry environment in which it operates.
- ◆ Know the allocation and supervision of work and responsibilities.
- ◆ Understand the designing the audit programme.
- ◆ Understand the impact of relevant legislations on the performance of an audit.
- ◆ Evaluate the quality of the audit and maintain adequate working papers.
- ◆ Understand planning, documenting and monitoring of time and costs.
- ◆ Establish procedures for obtaining audit evidence including balance and transaction testing, analytical procedures and management representation.
- ◆ Understand quality control and peer review.

## **4.1 INTRODUCTION**

Auditors should plan the audit work so as to perform the audit in an effective manner. Planning entails developing a focus and direction for the audit. This is done by the auditor in a document which contains a general strategy and a detailed approach for the expected nature, timing and extent of the audit.

The auditor develops the general audit strategy in an overall audit plan to set the direction for the audit and provide guidance for the development of the audit programme. The audit programme sets out the detailed procedures required to implement the strategy as part of planning for the audit.

Planning is necessary for audits of entities of all sizes. The objectives of planning the audit work, which takes place before the detailed audit work begins, include; ensuring that appropriate attention is devoted to the different areas of the audit; potential problems are identified; and facilitating review. The auditor needs to have a good understanding of the clients business to enable him or her prepare an audit plan. The process involves the review of the client's operational background with regard to its financial, legal and personnel situations and the industry environment in which it operates.

The functions and responsibility of the auditor when properly understood, enable the members of the audit team to, readily know the extent of their responsibility and how to go about conducting the audit work allocated to each member of the audit team. The functions and responsibility of the auditor under the law, are not diminished by relying on representations made by the directors.

This chapter examines the impact of relevant legislations on the performance of an audit. An understanding of the laws enables the auditor to test compliance or otherwise of his or her clients with the provisions of the laws. The auditor should recognise that non-compliance by the entity with law or regulations may materially affect the financial statements.

This chapter covers the evaluation of the quality of the audit and maintaining adequate working papers. Proper documentation enables the auditor to accomplish his or her statutory (or other) roles in a manner that leaves other professionals who may need to review or evaluate his working papers, in no doubt as to the nature of work done actually meeting professional standards and really supporting the audit opinion.

Planning, documenting and monitoring of time and costs are essential parts of an audit. The auditor should prepare time and cost estimate as part of the audit plan. It is necessary for audits of entities of all sizes. Planning of time and costs assist in the proper assignment of work to members of the audit team, and in briefing the members of the audit team.

Establishing procedures for obtaining audit evidence, including balance and transaction testing, analytical procedures and management representation, enable the auditor obtain, review and assess audit trail supporting his or her audit opinion. Obtaining management representation does not absolve the auditor from blame.

Analytical procedures are used by the auditor to assist in planning the nature, timing and extent of other audit procedures. They are used as substantive procedures when their use can be more effective or efficient than other procedures in reducing detection risk for specific financial statement assertions; and as part of the overall review of the financial statements when completing the audit.

The learning objectives of this chapter have been carefully considered in structuring the topics in this chapter. A careful study of this chapter will enable the reader to know the very essence of audit planning and control procedures.

At the end of this chapter, readers should be able to answer typical examination questions on audit planning and control procedures.

## **4.2 PLANNING**

APB statement of auditing standard 200 covers Planning. The standard requires the auditor to plan the audit work so as to perform the audit in an effective manner.

Planning involves:

- (a) Developing a general strategy; and
- (b) A detailed approach for the expected nature, timing and extent of the audit.

The auditor develops the general audit strategy in an overall audit plan to set the direction for the audit and provide guidance for the development of the audit programme.

The auditor also develops audit programme which sets out the detailed procedures required to implement the strategy as part of planning for the audit.

### **Planning the Work**

Planning is necessary for audits of entities of all sizes. The objectives of planning the audit work, which takes place before the detailed audit work begins, include:

- (a) Ensuring that appropriate attention is devoted to the different areas of the audit;
- (b) Ensuring that potential problems are identified; and
- (c) Facilitating review' (Chitty D, 2004).

Planning also assists:

- (i) In the proper assignment of work to members of the audit team and their briefing, and in the co-ordination of work done by other auditors and experts, so that the audit may be performed in an efficient and timely manner; and
- (ii) In obtaining an understanding of the entity's affairs and, all members of the audit team in understanding the nature and scope of the work they are to carry out before the audit field work starts.

Obtaining knowledge of the organisation's business is required as an important part of planning the work. The auditors' experience with the entity and knowledge of its business assist in the identification of events, transactions and practices which may have a material effect on the financial statements. Planning varies according to the size of the entity and the complexity of the audit. (Chitty, 2004).

Auditors need to discuss elements of the overall audit plan and certain audit procedures with:

- (a) The entity's management and staff; and
- (b) The audit committee (where such a committee is in place) in order to improve the effectiveness of the audit and to co-ordinate audit procedures with work of the entity's personnel, including internal auditors.

The overall audit plan and the detailed audit procedures to be performed, however, remain the auditors' responsibility. When such discussions occur, care is required not to compromise the independence and validity of the audit.

### **The Overall Audit Plan**

The standard requires the auditor to develop and document an overall audit plan describing the expected scope and conduct of the audit.

The amount of detail in the record of the overall audit plan is to be sufficient to guide the development of the detailed audit procedures to be performed. However, the precise form and content of the overall audit plan, and the formality with which it considers matters affecting the scope of the audit and the audit work to be undertaken, vary depending on the:

- (a) Size of the entity;
- (b) Complexity of the audit;
- (c) Need for member of the audit team to be briefed; and
- (d) Specific methodology and technology the auditors use.

Matters for auditors to consider in developing the overall audit plan may include:

### **Knowledge of the Entity's Business**

The following are to be considered:

- (a) General economic factors and industry conditions affecting the entity's business;
- (b) Important characteristics of the entity, its business, principal business strategies, its financial performance and its reporting requirements, including changes since the previous audit;
- (c) The operating style and control consciousness of directors and management; and
- (d) The auditors' cumulative knowledge of the accounting and internal control systems and any expected changes in the period.

### **Risk and Materiality**

The following are to be considered:

- (a) The setting of materiality for audit planning purposes;
- (b) The expected assessments of risks of error and the identification of significant audit areas;
- (c) Any indication, including the experience of past years, that misstatements that could have a material effect on the financial statements might arise because of fraud or for any other reason; and
- (d) The identification of complex accounting areas including those involving accounting estimates.

### **Nature, Timing and Extent of Procedures**

The following are to be considered:

- (a) The relative emphasis expected to be placed on tests of control and substantive procedures;
- (b) The effect on the audit of the use of information technology by the entity or the auditors;
- (c) The work of any internal audit function and its expected effect on external audit procedures;

- (d) Procedures which need to be carried out at or before the year end; and
- (e) The timing of significant phases of the preparation of the financial statements.

### **Co-ordination, Direction, Supervision and Review**

Auditors should note the following:

- (a) The involvement of other auditors, including other offices of the same firm, in the audit of components, for example, subsidiary undertakings, branches and divisions;
- (b) The involvement of, and communication with, experts, other third parties and internal auditors;
- (c) The number of locations; and
- (d) Staffing requirements.

### **Other matters include:**

- (a) Any regulatory requirements arising from the decision to retain the engagement;
- (b) The possibility that the going concern basis may be inappropriate;
- (c) The terms of the engagement and any statutory responsibilities; and
- (d) The nature and timing of reports or other communication with the entity that are expected under the engagement (Chitty, 2004).

### **Changes to the Audit Work Planned**

The audit work planned should be reviewed and, if necessary, revised during the course of the audit. That review should cover the following:

- (a) Changes in conditions, or unexpected results of audit procedures, may require changes to the overall audit plan or the planned audit procedures;
- (b) Changes to the planned audit procedures are documented so that there is an accurate record of the nature, timing and extent of the audit procedures performed; and
- (c) A record of changes to the overall audit plan may be necessary to explain the general strategy finally adopted for the audit.

### **Knowledge of the Business (KOB)**

APB statement of auditing standard 210 covers “Knowledge of the business” (KOB).

### **Obtaining the Knowledge**

#### **Prior to Acceptance of an Engagement**

Prior to acceptance of an engagement, auditors obtain a preliminary knowledge of the industry and of the ownership, directors, management and operations of the entity to be audited, sufficient to enable them to consider their ability to undertake the audit.

Knowledge obtained prior to acceptance of an engagement generally includes:

- (a) Knowledge from previous relevant experience;
- (b) Knowledge from enquiries of predecessor auditors;
- (c) Specific rules or regulations pertaining to the industry;
- (d) Accounting standards applicable to the industry;
- (e) An initial perception of the viability of the business; and
- (f) The perceived integrity of the directors and management.

Auditors also require sufficient knowledge to enable them to assess whether there is a requirement for staff with specialist audit expertise (for example computer audit specialists) or other experts. (Chitty, 2004)

### **Following Acceptance of an Engagement**

Following acceptance of an engagement, the auditor should:

- (a) Obtain further and more detailed knowledge and information sufficient to enable them to plan the audit and develop an effective audit approach;
- (b) Obtain the required knowledge at the start of the engagement. Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit; and
- (d) Information obtained as the audit progresses enable auditors to update and augment that knowledge, and may require them to reassess it.

### **Updating Knowledge for Succeeding Periods**

In succeeding periods, auditors should:

- (a) Consider the information gathered previously; and
- (b) Perform procedures designed to identify significant changes that have taken place since the last audit.

### **Sources of Knowledge**

Auditors can obtain knowledge of the industry and the entity from a number of sources including:

- (a) Previous experience with the entity and its industry;
- (b) Visits to the entity's premises and plant facilities;
- (c) Discussion with people within the entity (for example directors, internal auditors, computer personnel and senior operating personnel);
- (d) Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry;
- (e) Discussion with knowledgeable people outside the entity (for example economists, industry regulators);
- (f) Publications related to the industry (for example government statistics, surveys, texts, trade journals, reports prepared by banks and securities dealers, financial newspapers);
- (g) Legislation and regulations that significantly affect the entity;

- (h) Documents produced by the entity (for example minutes of meetings, material sent to shareholders or filed with regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manuals, manuals of accounting and internal control systems, charts of accounts, job descriptions, marketing and sales plans); and
- (i) Professional literature giving industry-specific guidance.

### **Using the Knowledge**

Understanding the business and using this information appropriately assists auditors in:

- (i) Assessing risks and identifying problems;
- (ii) Planning and performing the audit effectively and efficiently; and
- (iii) Evaluating audit evidence.

Auditors make judgements about many matters throughout the course of the audit where knowledge of the business is important, for example:

- (a) Considering risks pertaining to the entity's business activities and the directors' response thereto;
- (b) Identifying areas where special audit considerations and skills may be necessary;
- (c) Developing the overall audit plan and the audit programme;
- (d) Considering the complexity of the entity's information systems and any effect on the audit approach;
- (e) Determining a materiality level and assessing whether the materiality level chosen remains appropriate;
- (f) Assessing inherent risk and control risk;
- (g) Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions;
- (h) Evaluating accounting estimates and representations by the directors or management;
- (i) Recognising conflicting information (for example contradictory representations);
- (j) Recognising unusual circumstances (for example undisclosed related party transactions, possible fraud or non-compliance with law or regulations, or unexpected relationships of statistical operating data with reported financial results);
- (k) Making informed enquiries and assessing the reasonableness of answers; and
- (l) Considering the appropriateness of accounting policies and financial statement disclosures. (Chitty, 2004)

The audit engagement partner must ensure that the audit team obtains such knowledge of the business of the entity being audited as may reasonably be expected to be sufficient to enable it to carry out the audit work effectively. Such knowledge may be transmitted initially by:

- (a) Means of the overall audit plan;

- (b) An audit briefing meeting; and
- (c) Subsequently during the course of the audit.

The audit engagement partner also ensures that the audit team:

- (a) Understands the need to be alert; and
- (b) Shares additional information.

#### **4.3 REVIEWING THE CLIENT'S OPERATIONAL BACKGROUND WITH REGARD TO ITS FINANCIAL, LEGAL AND PERSONNEL SITUATIONS AND THE INDUSTRY ENVIRONMENT IN WHICH IT OPERATES**

Auditors should have or obtain knowledge of the business of the entity to be audited which is sufficient to enable them to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or the audit thereof.

Knowledge of the business is used by auditors in:

- (a) Assessing risks of error;
- (b) Determining the nature, timing and extent of audit procedures; and
- (c) Considering the consistency and reliability of the financial statements as a whole when completing the audit.

The auditors' level of knowledge for an engagement normally includes:

- (a) General knowledge of the economy and the industry within which an entity operates; and
- (b) A more particular knowledge of how the entity operates. The level of knowledge required by auditors is less than that possessed by the directors.

The extent to which auditors need to formally document their knowledge of the business depends:

- (a) Upon its complexity and the number of persons who will be engaged on the audit; and
- (b) The need to cover possible departure, illness or incapacity of key members of the audit team.

Auditors prepare such documentation to a level sufficient to facilitate proper planning of the audit.

#### **Matters to Consider in Relation to Knowledge of the Business**

The auditor should consider the following matters in relation to knowledge of the business:

##### **General Economic Factors**

- (a) General level of economic activity (for example recession, growth);
- (b) Interest rates and availability of financing;
- (c) Inflation;
- (d) Government policies:

- (i) monetary policies,
- (ii) fiscal policy,
- (iii) taxation – corporate and others,
- (iv) financial incentives (for example government aid programmes),
- (v) tariffs, trade restrictions; and
- (e) Foreign currency rates and controls.

### **The Industry – Conditions Affecting the Client’s Business**

- (a) The market and competition;
- (b) Cyclical or seasonal activity;
- (c) Changes in product technology;
- (d) Business risk (for example high technology, high fashion, ease of entry for competition);
- (e) Declining or expanding operations;
- (f) Adverse conditions (for example declining demand, excess capacity, and serious price competition);
- (g) Key ratios and operating statistics;
- (h) Specific accounting practices and problems;
- (i) Environmental requirements and problems;
- (j) Regulatory framework; and
- (k) Specific or unique practices (for example relating to labour contracts, financing methods, accounting methods).

### **The Entity**

#### Directors, management and ownership

- (a) Corporate structure – private, public, government (including any recent or planned changes);
- (b) Beneficial owners, important stakeholders and related parties, local, foreign, business reputation and experience) and any impact on the entity’s transactions;
- (c) The relationships between owners, directors and management;
- (d) Attitudes and policies of owners;
- (e) Capital structure (including any recent or planned changes); and
- (f) Organisational structure.

### **Group Structure**

- (a) Subsidiaries’ audit arrangements;
- (b) Directors’ objectives, philosophy, strategic plans;
- (c) Acquisitions, mergers or disposals of business activities (planned or recently executed);
- (d) Sources and methods of financing (current, historical);
- (e) Board of directors;
- (f) Composition of board;
- (g) Business reputation and experience of individuals independence from and control over operating management;
- (i) Frequency of meetings;
- (j) Existence and membership of audit committee and scope of its activities;

- (k) Existence of policy on corporate conduct; and
- (l) Changes in professional advisors (for example lawyers).

### **Operating Management**

- (a) Experience and reputation;
- (b) Turnover;
- (c) Key financial personnel and their status in the organisation;
- (d) Staffing of accounting department;
- (e) Incentive or bonus plans as part of remuneration (for example based on profit);
- (f) Use of forecasts and budgets;
- (g) Pressures on management (for example over-extended dominance by one individual, support for share price, unreasonable deadlines for announcing results);
- (h) Management information systems;
- (i) Internal audit function (existence, quality); and
- (j) Attitude to internal control environment.

### **The entity's business - products, markets, suppliers, expenses, operations**

- (a) Nature of business (for example, manufacturer, wholesaler, financial services, import/ export);
- (b) Location of production facilities, warehouses, offices;
- (c) Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation);
- (d) Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, export, pricing policies, reputation of products, warranties, order books, trends, marketing strategy and objectives manufacturing processes);
- (e) Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery);
- (f) Stocks (for example, locations, quantities);
- (g) Franchise, licences, patents;
- (h) Important expense categories;
- (i) Research and development;
- (j) Foreign current assets, liabilities and transactions by currency, hedging;
- (k) Legislation and regulations that significantly affect the entity;
- (l) Information systems – current, plan to change; and
- (m) Debt structure, including covenants and restrictions.

### **Financial performance - factors concerning the entity's financial condition and profitability are as follows:**

- (a) Accounting policies;
- (b) Earnings and cash flow trends and forecasts;
- (c) Leasing and other financial commitments;
- (d) Availability of lines of credit;

- (e) Off balance sheet finance issues;
- (f) Foreign exchange and interest rate exposures; and
- (g) Comparison with industry trends.

Reporting environment: external influences which affect the directors in the preparation of the financial statements are as follows:

- (a) Legislation;
- (b) Regulatory environment and requirements;
- (c) Taxation;
- (d) Accounting requirements;
- (e) Measurement and disclosure issues peculiar to the business;
- (f) Audit reporting requirements; and
- (g) Users of the financial statements.

**(Source: ACCA Auditing Handbook 2004/2005)**

#### **4.4 ALLOCATION AND SUPERVISION OF WORK AND RESPONSIBILITIES**

##### **Assignment of Personnel to Audit Engagements**

Each audit engagement should have an engagement partner who should take responsibility for the engagement on behalf of the firm. The audit engagement partner is responsible for the conduct of the audit to which he or she has been appointed in accordance with ethical and other regulatory requirements, and for the issue of the auditor's report on behalf of the firm.

Firms should assign audit staff with the competencies necessary to perform the audit work expected of them to individual audit engagements.

Firms should establish processes to assess individuals' knowledge, skills and abilities.

Firms should develop policies and processes to provide reasonable assurance that:

- (a) Audit engagement partners have the competencies necessary to perform their roles;
- (b) Audit engagement partners' responsibilities are clearly defined and communicated to them;
- (c) The identity and role of the audit engagement partner is known to the directors and senior management of the audited entity;
- (d) Audit engagement partners have appropriate support (e.g. another partner), where necessary, at meetings with the directors and senior management of the audited entity that will involve matters that are, or may be, material to the auditors' report; and
- (e) Audit engagement partners have sufficient time to discharge their responsibilities. (Chitty, 2004)

Competencies expected from audit staff will include:

- (a) Understanding and practical experience of auditing (through participation in audit engagements and appropriate training);

- (b) Understanding applicable accounting, auditing, ethical and other technical standards;
- (c) Knowledge of specific industries;
- (d) Professional judgement; and
- (e) Understanding the firm's quality control policy and processes. (Chitty, 2004).

### **Direction, Supervision and Review**

Audit engagement partners should ensure that audit work is directed, supervised and reviewed in a manner that provides reasonable assurance that the work has been performed competently.

Direction of audit staff involves:

- (a) Being informed of their responsibilities, the nature of the entity's business, accounting or auditing problems that may arise, and the overall audit plan;
- (b) Being encouraged to raise any questions they may have with more experienced team members;
- (c) Understanding the objectives of the work to avoid drawing inappropriate conclusions as a result of misunderstandings; and
- (d) Being educated on appropriate team-working and training.

Supervision is closely related to both direction and review. These include:

- (a) Considering the progress of the audit;
- (b) Considering whether audit staffs have the competencies necessary to perform the audit work expected of them and sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the overall audit plan and audit programme;
- (c) Addressing significant accounting and auditing questions raised during the audit, assessing their significance and modifying the overall audit plan and audit programme as appropriate;
- (d) Identifying matters for further consideration during the audit; and
- (e) Work performed by audit staff is reviewed by other more senior audit staff or the audit engagement partner. Reviewers consider whether:
  - (i) The work has been performed in accordance with the firm's procedures and in accordance with the audit programme;
  - (ii) The work performed is adequate in the light of results obtained and has been adequately documented;
  - (iii) Significant audit matters have been raised for further consideration;
  - (iv) Appropriate consultations have taken place and the results of such consultations have been documented;
  - (v) The objectives of the audit procedures have been achieved; and
  - (vi) The conclusions are consistent with the results of the work performed' (Chitty, 2004).

Audit engagement partners perform an overall review of working papers. The review is sufficient for them to be satisfied that the working papers contain sufficient appropriate evidence to support the conclusions reached and for the auditors' report to be issued. The review should cover substantially the working papers especially in the following areas:

- (a) All critical areas of judgement, especially any relating to difficult or contentious matters identified during the audit;
- (b) Audit evidence relating to high risk areas; and
- (c) Any other areas which the audit engagement partner considers important.

Audit engagement partners document the extent of their review and its timing so as to demonstrate what was completed before the auditors' report was signed.

Review notes recording questions or points raised in the course of the audit, need not be retained at the end of the audit provided that, the working papers have been updated thereto and, in particular, record the reasoning on all significant matters which require the exercise of judgement.

### **Individual Responsibilities and the Collective Responsibilities of the Firm**

This covers the following points:

- (a) Involvement of all members of an audit team who should feel responsible for the performance of their work in accordance with professional standards;
- (b) The audit engagement partner has an especially important role in promoting a quality culture within the audit team; and
- (c) The appointment of a suitably senior audit partner within the firm to take overall responsibility for quality control policy and processes will assist this process.

## **4.5 DESIGNING THE AUDIT PROGRAMME**

The APB Statement of Auditing Standard 200 on Planning requires auditors to develop and document the nature, timing and extent of planned audit procedures required to implement the overall audit plan.

In developing the detailed audit procedures to be performed, auditors consider the assessments of risks of error and the amount of audit evidence that the procedures are planned to provide. They also consider the co-ordination of audit work with any work on preparing the financial statements, the timing of tests of controls and substantive procedures, and the co-ordination of any assistance expected from the entity, the composition of the audit team and the involvement of other auditors or experts (Chitty, 2004).

The documentation may take the form of an audit programme which:

- (a) Sets out the audit procedures the auditors intend to adopt;

- (b) Includes reference to other matters such as the audit objectives, timing, sample;
- (c) Determine the size and basis of selection for each area;
- (d) Serves as a set of instructions to the audit team; and
- (e) Serves as a means to control and record the proper execution of the work.

The level of detail in the audit programme depends on the complexity of the audit, the extent of other documentation and experience of the members of the audit team.

#### **4.6 EXAMINING THE IMPACT OF RELEVANT LEGISLATIONS ON THE PERFORMANCE OF AUDIT.**

The APB Statement of Auditing Standard 120 covers “Consideration of law and regulations”. The IFAC International Standard on Auditing 250 also covers “Consideration of law and regulations in an audit of financial statements”.

In planning an audit, the auditor should recognise that “non-compliance by the entity with law or regulations may materially affect the financial statements” (ISA 250). Consequently, the auditor should plan the audit procedures to include:

- (a) An assessment of the compliance of the entity with laws or regulations affecting the business of the entity; and
- (b) An evaluation and report on the results thereof.

The APB SAS 120 provides the following definitions:

Non-compliance with law or regulations’ refers to acts, omission or commission by the entity being audited, either intentional or unintentional, which are contrary to law (comprising common law and statute) or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by its directors or employees. Non-compliance with law or regulations does not include personal misconduct (unrelated to the business activities of the entity) by the entity’s directors or employees. It does not also include civil wrongs, for example breach of duties in contract or tort.

Directors’ means the directors of a company, partners, proprietors, committee of management or trustees or other forms of entity, or equivalent persons responsible for directing the entity’s operations and preparing its financial statements.

Management means those persons who may include directors, who have executive responsibility for the conduct of the entity’s operations and the preparation of its financial statements.

Whether an act constitutes non-compliance with law or regulations is a legal determination that is ordinarily beyond the auditors’ professional competence. However, auditors’ training, experience and understanding of the entity and

its industry may enable them to recognise that some acts coming to their attention may constitute non-compliance with law or regulations' (Chitty, 2004).

The determination as to whether a particular act constitutes non-compliance with law or regulations is generally:

Based on the advice of an informed expert qualified to practice law, but ultimately can be determined only by a court of law. Laws and regulations vary considerably in their relation to the financial statements. Some laws and regulations relate directly to the preparation of, or the inclusion or disclosure of specific items, in the financial statements. Laws and regulations provide a legal framework within which an entity conducts its business. Thus, some entities operate in heavily regulated industries (such as banks) while others are subject only to the many laws and regulations that generally relate to the operating aspects of the business.

Therefore, determining the type of procedures necessary in a particular instance needs to take account of the particular entity concerned and the complexity of the regulations with which it is required to comply (Chitty, 2004).

Non-compliance with law or regulations may result in financial consequences for the entity, such as fines or litigation. The Central Bank of Nigeria Act and Banks and Other Financial Institutions Act require auditors to report non-compliance with the law and fines paid in the process.

### **Responsibilities of the Directors**

It is the responsibility of the directors:

- (a) To take appropriate steps to provide reasonable assurance that the entity complies with law and regulations applicable to its activities;
- (b) To establish arrangements for preventing any non-compliance with law or regulations and detecting any that occurs; and
- (c) To prepare financial statements that give a true and fair view of the state of affairs of a company and its profit or loss for the financial year.

The assignment of particular responsibilities to management or the audit process does not relieve the directors of these fundamental responsibilities.

In addition, directors and officers of companies have responsibility to provide information required by the auditors, to which they have a legal right of access under the Companies and Allied Matters Act, Cap. C 20 LFN 2004.

The following steps, among others, may assist the directors in discharging their responsibilities for the prevention and detection of non-compliance with law or regulations:

- (a) Maintaining an up-to-date register of significant laws and regulations with which the entity has to comply within its particular industry;
- (b) Monitoring legal requirements and any changes therein and ensuring that operating procedures are designed to meet these requirements;

- (c) Instituting and operating appropriate systems of internal control;
- (d) Developing a Code of Conduct, ensuring employees are properly trained in and understand its provisions, monitoring compliance and taking appropriate disciplinary action in cases of non-compliance; and
- (e) Engaging legal advisers to assist in monitoring legal requirements, and maintaining a record of complaints.

In large entities, these policies and procedures may be supplemented by assigning appropriate responsibility to:

- (a) An internal audit function;
- (b) A legal department;
- (c) A compliance function; and/or
- (d) An audit committee.

In certain sectors or activities (for example financial services), there are detailed laws and regulations that specially require directors to have systems to ensure compliance. These laws and regulations could, if breached, have a material effect on the financial statements. In addition, the directors are required to report certain instances of non-compliance to the proper authorities on a timely basis” (Chitty, 2004). For example, In Nigeria banks are required by law to report cases of fraud and attempted fraud to the Central Bank.

Considering the responsibility of the directors to prepare financial statements that give a true and fair view of the state of affairs of a company and of its profit or loss for the financial year, it is necessary, where possible non-compliance with law or regulations has occurred, which may result in a material misstatement in the financial statements, for the directors to ensure that the matter is appropriately reflected and/or disclosed in the financial statements.

## **RESPONSIBILITIES OF THE AUDITORS**

### **Prevention**

APB SAS 120 on Consideration of law and regulations states that: “it is not the auditors’ function to prevent non-compliance with law or regulations. The fact that an audit is carried out may, however, act as a deterrent”.

### **Detection**

The auditors plan, perform and evaluate their audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements of the entity audited. When doing so, they recognise that material misstatements may arise from non-compliance with law or regulations. However, an audit cannot reasonably be expected to detect all possible non-compliance with law and regulations. In an audit, there is the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with auditing standards. This risk is higher with regard to misstatements resulting from non-compliance with law or regulations due to such factors as the following:

- (a) There are many laws and regulations, relating principally to the operating aspects of the entity, that typically do not have a material effect on the financial statements and where the consequences of any non-compliance are not captured by the accounting and internal financial control systems;
- (b) The effectiveness of audit procedures is affected by the inherent limitations of the accounting and internal control systems and by the use of selective testing rather than the examination of all transactions;
- (c) Much of the evidence obtained by the auditors is persuasive rather than conclusive in nature; and
- (d) Non-compliance with law or regulations may involve conduct designed to conceal it, such as collusion, forgery, override or intentional misrepresentations being made to the auditors (Chitty, 2004).

### **The Auditors' Consideration of Compliance with Law and Regulations**

“The auditors plan, and perform the audit with an attitude of professional scepticism. They should recognise that the audit may reveal conditions or events that could lead to questioning whether, an entity is complying with law and regulations. For audit purposes, laws and regulations relevant to the audit, can be regarded as falling into two main categories:

- (a) Those which relate directly to the preparation of, or the inclusion or disclosure of specific items in, the financial statements of the entity, and;
- (b) Those which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and where non-compliance may reasonably be expected to result in the entity ceasing operations, or call into question its continuance as a going concern (Chitty, 2004).

APB SAS 120 requires the auditors to “obtain sufficient appropriate audit evidence about compliance with those laws and regulations which relate directly to the preparation of, or the inclusion or disclosure of specific items in the financial statements”.

Those laws and regulations which relate directly to the preparation of, or the inclusion or disclosure of specific items in, the financial statements include:

- (a) Those which specify the form and content of financial statements, such as, Schedule to the Companies and Allied Matters Act, 2004; and
- (b) Those laws which require auditors expressly to report non-compliance, such as, the requirements of the Companies and Allied Matters Act, 2004 relating to the maintenance of proper accounting records or the disclosure of particulars of directors remuneration in a company's financial statements.

Financial reporting requirements for particular industries e.g. banks. Where statutory requirements exist which require the auditors to report, as part of the audit of the financial statements, whether the entity complies with certain provisions of laws or regulations, for example the Companies and Allied Matters Act, 1990, the auditors need to have a sufficient understanding of such laws and regulations in order to consider them when auditing the assertions relating to the determination of the amounts to be recorded and the disclosures to be made; and to test for compliance with such provisions.

The auditors should perform procedures to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity's ability to conduct its business and hence to its financial statements, by:

- (a) Obtaining a general understanding of the legal and regulatory framework which is applicable to the entity and the industry, and of the procedures followed to ensure compliance with that framework;
- (b) Inspecting correspondence with relevant licensing or regulatory authorities;
- (c) enquiring of the directors instances of non-compliance with law or regulations; and
- (d) obtaining written confirmation from the directors that they have disclosed to the auditors all those events of which they are aware which involve possible non-compliance, together with the actual contingent consequences which may arise therefrom.

To obtain this general understanding, the auditors should:

- (a) Enquire of management as to the laws or regulations (and any changes therein) that may be central to the entity's ability to conduct its business;
- (b) Enquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations, in particular, those which may be central to its ability to conduct its business;
- (c) Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation, claims and assessments;
- (d) Use their existing knowledge of the entity's industry and business and of its regulatory environment; and
- (e) Discuss the legal and regulatory framework with auditors of subsidiaries in other countries (Chitty 2004).

APB SAS 120 stipulates that "when carrying out their procedures for the purpose of forming an opinion on the financial statements, the auditors should in addition be alert to instances of possible or actual non-compliance with law or regulations which might affect the financial statement".

The auditor may adopt the following procedures to bring to the fore instances of non-compliance with the law and regulations:

- (a) Reading minutes of board and management meetings;
- (b) Enquiring of the entity's directors and legal counsel concerning litigation, claims and assessments; and
- (c) Perform substantive tests of details of transactions or balances.

#### **4.7 EVALUATING THE QUALITY OF THE AUDIT AND MAINTAINING ADEQUATE WORKING PAPERS**

APB Statement of Accounting Standard 230 covers "Working papers". IFAC International Standard on Auditing 230 also covers "Documentation". APB SAS 230 states that "auditors should document in their working papers matters which are important in supporting their report". In this context, Working papers are the material that auditors prepare or obtain, and retain in connection with the performance of the audit. Working papers may be in the form of data stored on paper, film, electronic media or other media.

Working papers support, amongst other things, the statement in the auditors' report as to the auditors' compliance or otherwise with auditing standards, and thus record compliance with auditing standards to the extent that it is important in supporting their report.

Working papers are the record of:

- (a) The planning and performance of the audit;
- (b) The supervision and review of the audit work; and
- (c) The audit evidence resulting from the audit work performed which the auditors consider necessary and on which they have relied to support their report.

##### **Form and Content of Working Papers**

APB SAS 230 states that "working papers should record the auditors' planning, the nature, timing and extent of the audit procedures performed, and the conclusions drawn from the audit evidence obtained." Auditors should record in their working papers their reasoning on all significant matters which require the exercise of judgement, and their conclusions thereon.

The extent of working papers is a matter of professional judgement since it is neither necessary nor practical to document every matter auditors consider. Auditors base their judgement as to the extent of working papers upon what would be necessary to provide an experienced auditor, with no previous connection with the audit, with an understanding of the work performed and the basis of the decisions taken. Even then, that experienced auditor may only be able to obtain a comprehensive understanding of all aspects of the audit by discussing them with the auditors who prepared them.

It is in those areas of the audit that involve difficult questions of principle or judgement that auditors' judgement may be questioned subsequently, particularly by a third party who has the benefit of hindsight. In such circumstances it is important to be able to demonstrate the relevant facts that were known at the time the auditors reached their conclusion.

Auditors draw conclusions relating to specific financial statement assertions. However, all such conclusions are arrived at within the context of their report. That report relates to the financial statements taken as a whole, and not to the individual assertions embodied in the financial statements' (Chitty, 2004).

The following matters may affect the form and content of working papers:

- (a) The nature of the engagement;
- (b) The form of the auditors' report;
- (c) The nature and complexity of the entity's business;
- (d) The nature and condition of the entity's accounting and internal control systems;
- (e) The needs in the particular circumstances for direction, supervision and review of the work of members of the audit team; and
- (f) The specific methodology and technology the auditors use.

'Working papers are designed and organised to meet the circumstances and the auditors' needs for each individual audit. The use of standardised working papers (for example checklists, specimen letters, standard organisation of working papers) may improve the efficiency with which, such working papers are prepared and reviewed. While they facilitate the delegation of work and provide a means to control its quality, it is never appropriate to follow mechanically, a standard approach to the conduct and documentation of the audit without regard to the need to exercise professional judgement (Chitty, 2004).

The auditors may utilise schedules, analyses and other documentation prepared by the entity, to improve audit efficiency. In such cases, the auditors must see evidence that such information is properly prepared.

Detailed contents of Permanent and Current audit working papers were discussed earlier in Chapter I of this Study Pack.

Generally, working papers may include the following, where relevant:

- (a) Information concerning the legal and organisational structure of the entity;
- (b) Extracts or copies of important legal documents, agreements and minutes;
- (c) Information concerning the industry, economic environment and legislative environment within which the entity operates;
- (d) Evidence of the planning process and any changes thereto;
- (e) Evidence of the auditors' understanding of the accounting and internal control systems;
- (f) Evidence of inherent and control risk assessments and any revisions thereof;
- (g) Evidence of the auditors' consideration of the work of internal audit and their conclusions thereon;
- (h) Analyses of transactions and balances;

- (i) Analyses of significant ratios and trends;
- (j) A record of the nature, timing and extent of auditing procedures undertaken and the results of such procedures;
- (k) Details of procedures regarding components whose financial statements are audited by other auditors;
- (l) Copies of communications with other auditors, experts and other third parties;
- (m) Copies of correspondence with the entity, reports to directors or management and notes of discussions with the entity's directors or management concerning audit matters;
- (n) Letters of representation from the entity's directors or management;
- (o) A summary of the significant aspects of the audit including details of the information available, the amounts involved, management's views, the conclusions reached and how these matters are resolved or treated; and
- (p) Copies of the approved financial statements and auditors' reports. (Chitty, 2004; IFAC ISA 230).

Working papers typically records:

- (a) When and by whom audit procedures are undertaken; and
- (b) When and by whom working papers are reviewed.

Points raised during the review of working papers need not be retained providing the working papers demonstrate evidence of the extent of the review process and are updated to record the resolution of any significant matters noted.

In the case of recurring audits, some working paper files may be classified as 'permanent' audit files which are updated with new information of continuing importance, as distinct from 'current' audit files which contain information relating primarily to the audit of a single period.

### **Confidentiality, Safe Custody and Ownership of Working Papers**

APB SAS 230 states that "auditors should adopt appropriate procedures for maintaining the confidentiality and safe custody of their working papers".

Auditors comply with ethical guidance as to the confidentiality of working papers. Portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditors, provided such disclosure does not undermine the independence or the validity of the audit process. Information is generally not made available to other third parties (including parent companies or subsidiary undertakings or their auditors) without the permission of the entity (Chitty, 2004).

The auditors should exercise judgement to determine the appropriate period of retention bearing in mind the following:

- (a) Possible needs of their client, for example that audited information may need to be included in a prospectus at some future date;
- (b) Their own needs, including any regulatory requirements; and

- (c) Prior to their destruction, auditors consider whether there is likely to be a need to refer to them again.

Working papers are the property of the auditors. Although portions of or extracts from the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity's accounting records (IFAC ISA 230).

#### **4.8 PLANNING, DOCUMENTING AND MONITORING OF TIME AND COSTS**

##### **Planning**

At the planning stage of an audit, the auditors must prepare time and cost estimate as part of the audit plan. It is necessary for audits of entities of all sizes. The objectives of time planning which takes place before the detailed audit work begins include:

- (a) Ensuring that appropriate time is devoted to the different tasks and activities covering all areas of the audit;
- (b) Ensuring that potential problems are identified, and appropriate time estimate made to cover such matters;
- (c) Ensuring proper documentation of time and cost;
- (d) Ensuring proper monitoring of time and cost;
- (e) Ensuring timely completion and rendering of time sheets;
- (f) Ensuring that appropriate fee is charged for the audit; and
- (g) Facilitating review.

##### **Planning of time and costs also assist:**

- (a) In the proper assignment of work to members of the audit team and their briefing;
- (b) In the co-ordination of work done by other auditors and experts, so that the audit may be performed in an efficient and timely manner; and
- (c) In obtaining an understanding of the entity's affairs and, all members of the audit team in understanding the nature and scope of other work they are to carry out before the audit field work starts; within the time allocated to each aspect of the audit.

##### **Establishment of Policy and Processes**

The establishment of time and cost procedures as part of the quality control policy and processes within a firm involves:

- (a) Setting a framework within which all relevant requirements, including the requirements of time estimating, recording, monitoring and costing, can be met; and
- (b) Determine the size and nature of the practice and its organisation.

##### **Communication**

Communication of time and cost policy and processes usually involve:

- (a) Communication of time and cost policy and processes to all audit staff and audit engagement partners for effective implementation; and

- (b) Use of internal training, electronic and paper circulars, and staff manuals to communicate time and cost policy and processes.

### **Documentation**

Appropriate documentation of time and cost policy and processes normally includes:

- (a) A description of the policy and processes and the objectives they are designed to achieved;
- (b) Records of amendments to policies and processes; and
- (c) A record of how policy and processes and changes to them have been communicated.

### **Assignment of Personnel to Audit Engagements, Time Estimation and Recording**

Each audit engagement should have an engagement partner who should take responsibility for the engagement on behalf of the firm.

Audit engagement partners are responsible for the conduct of the audits to which they have been appointed, timely rendering of the bill and collection of amount billed.

Firms should assign audit staff with the competencies necessary to perform the audit work expected of them to individual audit engagements. Firms should establish processes to record, monitor and render time costs.

### **Timekeeping**

Audit engagement partners should ensure that audit work is directed, supervised and reviewed in a manner that provides reasonable assurance that the work has been performed efficiently and competently. They are also responsible for timely billing, rendering and collection of amount billed.

#### **Timekeeping involves:**

- (a) Knowing the firm's policy and procedures on time and cost processes;
- (b) Knowing the time budget for the tasks and activities assigned;
- (c) Timely arrival on assignments;
- (d) Keeping daily record of tasks and activities and time expended on them;
- (e) Timely completion, approval and submission of timesheets; and
- (f) Being educated on appropriate team-working and training.

### **Monitoring**

Firms should appoint a senior audit partner to take responsibility for monitoring the time aspects of audits carried out by the firm.

The responsibility for monitoring the time aspects of audit performance is different from the responsibility for the establishment of quality control policy and processes. Wherever possible, the two responsibilities are undertaken by different senior audit partners.

The objective of monitoring time and costs is to provide an independent assessment of:

- (a) The appropriateness of the time cost, billing and recovery of costs on audit; and
- (b) Whether the firm's own time and cost policy and processes have been applied.

The senior audit partner responsible for the monitoring process:

- (a) Develops procedures for the systematic review of time cost, billing and recovery on completed audit engagements;
- (b) Develops appropriate course of action where significant variances between estimated time cost and actual cost are identified. Courses of action may involve communication of the findings within the firm and additional training; and
- (c) Ensures changes to the firm's policies and procedures and disciplinary action against those who repeatedly fail to comply with the firm's standards.

#### **4.9 ESTABLISHING PROCEDURES FOR OBTAINING AUDIT EVIDENCE INCLUDING BALANCE AND TRANSACTION TESTING, ANALYTICAL PROCEDURES AND MANAGEMENT REPRESENTATION**

##### **Analytical Procedures**

###### **Introduction**

APB statement of auditing standard 410 covers 'Analytical Procedures'.

The standard requires auditors to apply analytical procedures at the planning and overall review stages of the audit.

The standard defines 'Analytical procedures' as the analysis of relationships between:

- (a) Items of financial data, or between items of financial and non-financial data, deriving from the same period; or
- (b) Comparable financial information deriving from different periods or different entries, to identify consistencies and predicted patterns or significant fluctuations and unexpected relationships, and the results of investigations thereof.

Analytical procedures are designed primarily to assist in planning the audit and as part of the evaluation of the financial statements.

Analytical procedures may also be performed as substantive procedures designed to obtain evidence directly.

###### **Nature and Purpose of Analytical Procedures**

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- (a) Comparable information for prior periods;
- (b) Anticipated results of the entity, from budgets or forecasts;
- (c) Predictive estimates prepared by the auditors, such as an estimation of the depreciation charge for the year; and
- (d) Similar industry information, such as a comparison of the entity's ratio of sales to trade debtors with industry averages, or with the ratio relating to other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships:

- (a) Between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales; and
- (b) Between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees (Chitty, 2004).

Various methods may be used in performing the analytical procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiary undertakings, divisions or branches) and individual elements of financial information. The auditors' choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures are used by auditors:

- (a) To assist in planning the nature, timing and extent of other audit procedures;
- (b) As substantive procedures when their use can be more effective or efficient than other procedures in reducing detection risk for specific financial statement assertions; and
- (c) As part of the overall review of the financial statements when finalising the audit.

### **Analytical Procedures in Planning the Audit**

Auditors should apply analytical procedures at the planning stage to assist in:

- (a) Understanding the entity's business;
- (b) Identifying areas of potential audit risk; and
- (c) Planning the nature, timing and extent of other audit procedures.

Analytical procedures at this stage are usually based on the entity's interim financial information, budgets and management accounts. Discussions with the entity's management, focused on identifying significant changes in the business since the prior financial period, may also be useful.

Application of analytical procedures may indicate:

- (a) Aspects of the entity's business of which the auditors were previously unaware; and

- (b) Assist in determining the nature, timing and extent of other audit procedures.

### **Analytical Procedures as Substantive Procedures**

The decision about whether to use analytical procedures as substantive procedures and the nature, timing and extent of their use is based on the auditors' judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statements assertions.

Auditors usually enquire of management as to the availability and reliability of information needed to apply analytical procedures and the results of any such procedures performed by the entity.

It may be efficient to use analytical data prepared by the entity, provided the auditors are satisfied that such data is properly prepared.

When intending to apply analytical procedures as substantive procedures, auditors consider a number of factors such as:

- (a) The plausibility and predictability of the relationships identified for comparison and evaluation. For example, there is a strong relationship between certain selling expenses and turnover in businesses where the sales force is paid by commission;
- (b) The objectives of the analytical procedures and the extent to which their results are reliable;
- (c) The degree to which information can be disaggregated, for example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to financial information relating to the entity as a whole;
- (d) The availability of information, both financial (such as budgets or forecasts) and non-financial (such as the number of units produced or sold);
- (e) The relevance of the information available, for example, whether budgets are established as results to be expected rather than as goals to be achieved;
- (f) The comparability of the information available, for example, broad industry data may need to be supplemented to make it comparable with that of an entity that produces and sells specialised products; and
- (g) The knowledge gained during the previous audits, together with the auditors' understanding of the effectiveness of the accounting and internal control systems and the types that in prior periods have given rise to accounting adjustments (Chitty, 2004).

The reliability of the information used in analytical procedures is likely to be enhanced:

- (a) If it comes from sources independent of, rather than internal to, the entity;

- (b) If the information is produced internally, its reliability is enhanced if it is produced independently of the accounting system or there are adequate controls over its preparation; and
- (c) If the necessity for the evidence on the reliability of such information depends on the results of other audit procedures and on the importance of the results of analytical procedures as a basis for the auditors' opinion.

The extent of reliance that auditors place in the results of analytical procedures when used as substantive procedures may also depend on the following factors:

- (a) Other procedures directed towards the financial statement assertions. For example, other procedures auditors undertake in reviewing the collectibility of debtors, such as the review of subsequent cash receipts, may confirm or dispel questions arising from the application of analytical procedures to an aged profile of customers' accounts;
- (b) The accuracy with which the expected results of analytical procedures can be predicted. For example, auditors normally expect greater consistency in comparing discretionary expenses, such as research or advertising; and
- (c) The frequency with which a relationship is observed, for example, a pattern repeated monthly as opposed to annually.

The application of analytical procedures is based on the expectation that relationships between data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the financial statement assertions relating to the data produced by the accounting system. However, reliance on the results of analytical procedures depends on the auditors' assessments of the risk that the analytical procedures may identify relationships as expected whereas, in fact, a material misstatement exists (Chitty, 2004).

### **Analytical Procedures as Part of the Overall Review when Completing the Audit**

APB SAS 410 titled "Analytical procedures" states that, "when completing the audit, auditors should apply analytical procedures in forming an overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity's business".

The conclusions drawn from the results of such procedures are intended to:

- (a) Corroborate conclusions formed during the audit regarding individual components or elements of the financial statements; and
- (b) Assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the auditors' knowledge of the entity's business. However, they may also identify areas requiring further audit procedures.

### **Investigating Significant Fluctuations or Unexpected Relationships**

APB SAS 410 states that when significant fluctuations or unexpected relationships are identified that are inconsistent with other relevant information or that deviate from predicted patterns, auditors should:

- (a) Investigate; and
- (b) Obtain adequate explanations and appropriate corroborative evidence.

The investigation of significant fluctuations and unexpected relationships ordinarily begins with enquiries of management, followed by corroboration of management's responses:

- (a) By comparing them with the auditors' knowledge of the entity's business and with other evidence obtained during the course of the audit; or
- (b) If the analytical procedures are being carried out as substantive procedures, by undertaking additional audit procedures where appropriate to confirm the explanations earlier received from entity's management.

Where the explanation obtained from the entity's management is considered inadequate, the auditors may determine the additional audit procedures to be undertaken to obtain an explanation for the fluctuation or relationship noted.

## **MANAGEMENT REPRESENTATIONS**

### **Introduction**

APB Statement of Auditing Standard 440 covers "Management Representations". SAS 440 establishes standards and provides:

- (a) Guidance on the use of management representations as audit evidence;
- (b) The procedures to be applied in evaluating and documenting management representations; and
- (c) The action to be taken if management refuses to provide confirmation of appropriate representations.

In the course of an audit, many representations are made to the auditors. The representations may be:

- (a) either unsolicited or in response to specific enquiries;
- (b) critical to obtaining sufficient appropriate audit evidence on which to base their audit opinion; and
- (c) on general matters, for example that the directors have made all accounting records available to the auditors.

The possibility of misunderstanding between auditors and management is reduced when oral representations are confirmed in writing. Written confirmation of representations may take the form of:

- (a) A representation letter from management; or
- (b) A letter from the auditors outlining their understanding of management's representations, duly acknowledged and confirmed in writing by management; or

- (c) Minutes of meetings of the board of directors, or similar body, at which such representations are approved.

An example of representations from management in the form of a letter is set out in the latter part of this section.

APB SAS 440 states that; “auditors should obtain written confirmation of appropriate representations from management before their report is issued”.

The standard describes, in the context of management representations, ‘management’ as including directors, officers and others who perform senior managerial function.

The standard defines ‘Directors’ as the ‘directors of a company or other body, the partners, proprietors, committee of management or trustees of other forms of entities, or equivalent persons responsible for directing the reporting entity’s affairs and preparing its financial statements.

### **Acknowledgement by the Directors of their Responsibility for the Financial Statements**

Auditors should obtain evidence that the directors acknowledge their collective responsibility for the preparation of the financial statements and have approved the financial statements.

The directors’ acknowledgement of such collective responsibility and approval may be obtained by the auditors receiving a signed copy of the financial statements which incorporate a statement of the directors’ responsibility for the financial statements.

Relevant minutes of meetings of the board of directors or similar body, or by attending such a meeting; or a written representation from the directors.

When auditors have responsibility for reporting on the financial statements of a group of companies, acknowledgement by the directors of their responsibility for the financial statements applies to both the group financial statements and the financial statements of the parent undertaking (Chitty, 2004).

### **Representations by Management as Audit Evidence**

Auditors often rely on representations by management as part of their audit evidence by:

- (a) Obtaining representations from the directors as to their responsibility for the financial statements; and
- (b) Relying on representations by management.

Auditors should obtain written confirmations of representations from management on matters which are material to the financial statements and when those representations are critical to obtaining sufficient appropriate audit evidence.

The auditors should discuss such matters with those responsible for giving the written confirmation before they sign it to ensure that they understand what they are confirming.

When representations to the auditors relate to matters which are material to the financial statements, they:

- (a) Seek corroborative audit evidence;
- (b) Evaluate whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations; and
- (c) Consider whether the individuals making the representations can be expected to be well-informed on the particular matters' (Chitty, 2004).

The auditors should not regard representations by management to be a substitute for other audit evidence that auditors expect to be available. If sufficient appropriate audit evidence regarding a matter that may have a material effect on the financial statements is not available, this constitutes a limitation on the scope of the audit, even if a representation from management has been received on the matter. In these circumstances it may be necessary for the auditors to consider the implications for the purpose of their report.

Management representations may be the only audit evidence available in certain instances, such as:

- (a) Where knowledge of the facts is confined to management (for example, when the facts are a matter of management intentions); or
- (b) When the matter is principally one of judgement or opinion (for example, on the trading position of a particular customer).

In some exceptional cases, the matter may be of such significance that the auditors refer to the representations in their report as being relevant to a proper understanding of the basis of their opinion.

If a representation appears to be contradicted by other audit evidence, the auditors should:

- (a) Investigate the circumstances to resolve the matter; and
- (b) Consider whether it casts doubt on the reliability of other representations.

The investigation of apparently contradictory audit evidence regarding a representation received involve further enquiries of management to ascertain whether the representation has been misunderstood or whether the other audit evidence has been misinterpreted, and obtaining corroboration of management's responses.

If management is unable to provide an explanation or if the explanation is not considered adequate, further audit procedures may be required to resolve the matter.

### **Basic Elements of a Management Representation Letter**

When requesting a management representation letter, the auditors ought to request that it should be:

- (a) Addressed to them;
- (b) Contain specified information;
- (c) Appropriately dated;
- (d) Approved by those with specific knowledge of the relevant matters; and
- (e) Discussed and agreed by the board of directors or similar body, and on their behalf by the chairman and secretary, before they approve the financial statements, to ensure that the board as a whole is aware of the representations on which the auditors intend to rely in expressing their opinion on those financial statements.

The auditors may also wish to consider whether to take the opportunity to remind the directors that, under section 369 of the Companies and Allied Matters Act, it is an offence to mislead the auditors.

A management representation letter is normally dated on the day the financial statements are approved by the directors.

If there is any significant delay between the date of the management representation letter and the date of the auditors' report, the auditors may consider it necessary to obtain further representations regarding the intervening period for the purpose of their report.

### **Action if Management Refuses to Provide Written Confirmation of Representations**

If management refuses to provide written confirmation of a representation that the auditors consider necessary, the auditors should:

- (a) Consider the implications of this scope limitation for their report.
- (b) Not place reliance on other representations made by management during the course of the audit.

### **Example of Management Representation Letter**

Company letterhead)  
(To the auditors)

We confirm to the best of our knowledge and belief, and having made appropriate enquiries of other directors and officials of the company, the following representations given to you in connection with your audit of the financial statements for the period ended 31 December .....

- (a) We acknowledge as directors our responsibilities under the Companies and Allied Matters Act for preparing financial statements which give a true and fair view and for making accurate representations to you. All the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the company have

been properly reflected and recorded in the accounting records. All other records and related information, including minutes of all management and shareholders’ meetings, have been made available to you.

- (b) The legal claim by ABC Nigeria Limited has been settled out of court by a payment of ₦5 million. No further amounts are expected to be paid, and no similar claims have been received or are expected to be received.
- (c) In connection with deferred tax not provided, the following assumptions reflect the intentions and expectations of the company:
  - (i) Capital investment of ₦10 million is planned over the next three years;
  - (ii) There are no plans to sell revalued properties; and
  - (iii) We are not aware of any indications that the situation is likely to change so as to necessitate the inclusion of a provision for tax payable in the financial statements.
- (d) The company has not had, or entered into, at any time during the period any arrangement, transaction or agreement to provide credit facilities including loans, quasi-loans or credit transactions) for directors or to guarantee or provide security for such matters.
- (e) There have been no events since the balance sheet date which necessitate revision of the figures included in the financial statements or inclusion of a note thereto.

We confirm that the above representations are made on the basis of enquiries of management and staff with relevant knowledge and experience (and, where relevant, of inspection of supporting documentation) sufficient to satisfy ourselves that we can properly make each of the above representations to you.

As minuted by the board of directors at its meeting on..... (date)

.....  
**Chairman**

.....  
**Secretary**

#### 4.10 QUALITY CONTROL AND PEER REVIEW

##### Introduction

APB statement of auditing standard 240 deals with “Quality Control for audit work”. It takes Quality Control to be of paramount importance to the independent audit function.

The standard describes quality control policy and processes as those “designed to provide reasonable assurance as to the appropriateness of the auditors’ report and of adherence to auditing standards, ethical and other regulatory requirements.

Many quality assurance frameworks take a holistic approach to quality, encompassing a wide range of business considerations including client and employee satisfaction, and commercial performance. Firms are encouraged to embed procedures to meet the requirements of the statement of auditing standards on quality control into a wider quality assurance framework". (Chitty, 2004).

Wider quality assurance objectives may be achieved by the auditors by discussing audit performance with boards of directors, audit committees (where they exist) and senior management.

#### 4.11 SUMMARY AND CONCLUSIONS

In this chapter we have laid down the necessary ground work for effective public audit assurance practice. Detailed discussions have been given on cardinal points relating to audit and assurance services. Such topics as audit planning, documentation, responsibilities of directors, and senior management, as distinct from that of the auditors were given adequate coverage. Methodology for carrying out an engagement and responsibilities of engaged Partners and field staff, were adequately covered.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

#### 4.12 REVISION QUESTIONS

##### 4.12.1 MULTIPLE CHOICE QUESTIONS

1. Auditors should plan the audit work so as to perform the audit in an effective manner
  - (A) True
  - (B) Untrue
  - (C) Writing audit planning summary is enough
  - (D) Writing management report will suffice
  - (E) Auditors' prior year knowledge will suffice.
  
2. The objectives of planning the audit work, which takes place before the detailed audit work begins, include:
  - (A) Ensuring that appropriate attention is devoted to the different areas of the audit
  - (B) Ensuring that potential problems are identified
  - (C) Facilitating review
  - (D) A-C
  - (E) Meeting with the entity's major suppliers.
  
3. Matters for auditors to consider in developing the overall audit plan, with particular regard to the knowledge of the entity's business, may include:
  - (A) General economic factors and industry conditions affecting the entity's business
  - (B) Important characteristics of the entity, its business, principal business strategies, its financial performance and its reporting requirements, including changes since the previous audit

- (C) The operating style and control consciousness of directors and management
  - (D) The auditors' cumulative knowledge of the accounting and internal control systems and any expected changes in the period
  - (E) All the above four cases.
4. The documentation of audit programme should
- (A) set out the audit procedures the auditors intend to adopt
  - (B) include reference to other matters such as the audit objectives, timing, sample size and basis of selection for each area
  - (C) serve as a set of instructions to the audit team
  - (D) serve as a means to control and record the proper execution of the work
  - (E) A-D above.
5. In planning an audit, the auditor should recognise that non-compliance by the entity with law or regulations may materially affect the financial statements. Consequently, the auditor should plan the audit procedures to include
- (A) an assessment of the compliance of the entity with laws or regulations affecting the business of the entity
  - (B) an evaluation and report on the results of the assessment of the compliance with laws and regulations
  - (C) Visit to the local FM station
  - (D) Raising progressive billings
  - (E) Visit to the Federal High Court.

#### 4.12.2 SHORT ANSWER QUESTIONS

1. Comment on the statement that 'Planning varies according to the size of the entity and the complexity of the audit'.
2. State two bodies within an entity that the auditors need to discuss elements of the overall audit plan and certain audit procedures with in order to improve the effectiveness of the audit and to co-ordinate audit procedures.
3. Work performed by audit staff is reviewed by other more senior audit staff or the audit engagement partner. State five matters which such reviewers consider in an audit engagement.
4. Why should an audit firm appoint a senior audit partner to take responsibility for monitoring the time aspects of audits carried out by the firm?
5. Why should auditors apply analytical procedures at the planning stage of an audit?

*Refer to Suggested Solutions in Appendix I on page 301.*

# ***VERIFICATION OF ASSETS AND LIABILITIES***

## **5.0 LEARNING OBJECTIVES**

After studying this chapter, the reader should be able to:

- ◆ Understand verification principles.
- ◆ Know how to verify current assets, fixed assets and liabilities.
- ◆ Know how to verify intangible assets, and others.
- ◆ Vouch Income and Expenditures.
- ◆ Understand the process of audit documentation.

## **5.1 INTRODUCTION**

In the conduct of the audit of an entity, the auditor is presented with audit evidence and other information supporting the assertions, classes of transactions and balances. The auditor checks the evidence and information presented in the primary documents. The auditor checks the initiation, authorisation, postings, amongst others. The auditor approaches his or her work with professional scepticism. The auditor does not readily believe what he or she has been presented with. This enables the auditor to identify errors which need to be corrected to ensure early detection of any material misstatements in the financial statements on which the auditor is providing an audit opinion.

The auditor uses verification principles to substantiate the evidence provided. Verification principles include:

- (a) Confirm authorisation;
- (b) Checking existence;
- (c) Confirmation of costs or value
- (d) Confirmation of title
- (e) Physical inspection
- (f) Completeness check
- (g) Presentation and disclosure.

Verification procedures in relation to assets and liabilities contained in a set of financial statements rely heavily on the original transactions being accurately recorded and appropriate distinction made between expenditure of capital nature and revenue. Verification procedures also rely on the transactions being properly authorised in line with the entity's authorisation procedures.

This chapter covers verification of current assets, fixed assets and liabilities. The readers will readily understand the various verification methods which the auditor uses in the conduct of his or her duties.

The chapter also covers verification of intangible assets such as goodwill, patents, trademarks, copyrights, reserve and equity, income and expenditure, revenue and expenses, sales and purchases, wages and salaries, and other income and expenditure.

The auditor must have good knowledge of verification principles and their documentation. The use of verification principles and their documentation enable the auditor to accomplish his or her statutory (or other) roles in a manner that leaves other professionals, who may need to review or evaluate his working papers, in no doubt as to the nature of work actually done in meeting professional standards and in supporting the audit opinion.

The learning objectives of this chapter have been carefully considered in structuring the topics in this chapter. A careful study of this chapter will enable the readers to understand the verification principles of auditing and the verification of various classes of assets and liabilities. At the end of this chapter, the student should be able to answer typical examination questions on the verification principles, verification of current assets, fixed assets and liabilities and verification of intangible assets.

## 5.2 VERIFICATION PRINCIPLES

Business entities keep records of their business activities on daily basis. The business of the clients may arise from buying, producing, and selling goods, services, and paying and collecting cash in connection with those activities. Recording of the transactions in the books of the clients are reflected in the revenue, expense, asset and liability accounts.

In the course of preparation of financial statements, the directors make certain financial statements assertions. The assertions constitute representations of the directors that are embodied in the financial statements. The directors, by approving the financial statements confirm the representations made by them. The following matters constitute representations or assertions usually made by the directors in approving financial statements:

- (a) **Existence:** an asset or a liability exists at a given date;
- (b) **Rights and Obligations:** an asset or a liability pertains to the entity at a given date;
- (c) **Occurrence:** a transaction or event took place which pertains to the entity during the relevant period;
- (d) **Completeness:** there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
- (e) **Valuation:** an asset or liability is recorded at an appropriate carrying value;

- (f) **Measurement:** a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
- (g) **Presentation and disclosure:** an item is disclosed, classified and described in accordance with the applicable reporting framework (for example relevant legislation and applicable accounting standards).

The above therefore are the fundamentals of all verification exercises.

The auditor must obtain audit evidence to support each financial statement assertion. The audit evidence presented in support of one assertion (for example, existence of stock) does not compensate for failure to obtain audit evidence regarding another (for example, its valuation). Tests may, however, provide audit evidence about more than one assertion (for example, testing subsequent receipts from debtors may provide some audit evidence regarding both their existence and valuation).

In conducting substantive tests, the auditor must consider the nature, timing and extent of substantive procedures. These may depend, amongst other factors, on the following matters:

- (a) The auditors' assessments of the control environment and accounting systems generally;
- (b) The inherent and control risks relating to each assertion;
- (c) Evidence obtained from audit work performed during the preparation of the financial statements; and
- (d) Where tests of control provide satisfactory evidence as to the effectiveness of accounting and internal control systems, the extent of relevant substantive procedures may be reduced, but not entirely eliminated.

Auditors normally obtain audit evidence by:

- (a) Inspection;
- (b) Observation;
- (c) Enquiry and confirmation;
- (d) Computation; and
- (e) Analytical procedures.

The choice of one or a combination of the procedures which the auditors may adopt is dependent, in part, on the type of audit, the time the audit is conducted and the form in which the accounting records are maintained.

### **Inspection**

Inspection provides reliable audit evidence about the existence of the tangible assets inspected but not necessarily as to the ownership or value of such assets.

It involves examining records, documents or tangible assets and provides audit evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing.

Inspection also provides three major categories of documentary audit evidence, listed in ascending degree of reliability, viz:

- (a) Evidence created and held by the entity;
- (b) Evidence created by third parties and held by the entity; and
- (c) Evidence created and provided to auditors by third parties.

### **Observation**

The auditor, by observation, looks at a procedure being performed by others, for example the auditors observe the counting of stock by the entity's staff or the performance of internal control procedures as part of the conduct of an audit.

### **Enquiry and Confirmation**

Enquiry involves seeking information within and outside the entity. Enquiry may be formal or informal. Responses to enquiries obtained from third parties may confirm or disprove information previously made available to the auditors.

Confirmation involves obtaining response to an enquiry to corroborate information previously made available to the auditors in the course of the audit.

Examples of direct confirmation are as follows:

- (a) Confirmation of debts by communication with debtors;
- (b) Confirmation of legal cases by communication with the entity's solicitors; and
- (c) Confirmation of bank balances by communication with the entity's bankers.

### **Computation**

The auditor uses computation to check the arithmetical accuracy of source documents and accounting records. Computation also involves re-performing independent calculations.

### **Analytical Procedures**

Analytical procedures consist of the analysis of relationships between:

- (a) Items of financial data;
- (b) Items of financial and non-financial data, deriving from the same period; or
- (c) Comparable financial information deriving from different periods or different entities.

Analytical procedures are used in identifying consistencies and predicted patterns or significant fluctuations and unexpected relationships, and the results of investigations thereof.

Verification of assets is essential in auditing. Verification is a form of substantive test. The auditor has a duty to verify the assets and liabilities which appear on the balance sheet. The auditor also has a duty to verify that no other assets and liabilities which ought to appear on the balance sheet have been omitted from the financial statements.

At this juncture, it is important to know that an auditor must have a good understanding of his or her client's business. He should document the client's business and conduct tests of control and substantives tests on class of transactions and balances usually generated by the entity. All items considered to be material must be covered in the substantive tests.

Auditors are not necessarily suggesting that the risk of material misstatement is particularly at the maximum, in the financial statements presented for audit. Before performing substantive tests on each asset, the auditor would have gathered sufficient information or updated the information previously at his disposal about the client to make preliminary materiality judgement and to assess inherent and control risk.

Verifications of the following accounts are considered below as part of substantive tests in the course of an audit:

- (a) Current assets;
- (b) Fixed assets;
- (c) Liabilities;
- (d) Goodwill, patents, trademarks, copyright and franchise accounts;
- (e) Reserve and equity;
- (f) Income and expenditure;
- (g) Revenue and expenses;
- (h) Sales and Purchases;
- (i) Wages and Salaries; and
- (j) Other income and expenditure account items.

Verification may be in the form of:

- (a) Confirmation of authorisation;
- (b) Checking existence;
- (c) Confirmation of costs or value;
- (d) Confirmation of title;
- (e) Physical inspection;
- (f) Ensuring completeness; and
- (g) Presentation and disclosure.

### 5.3 VERIFICATION OF CURRENT ASSETS AND LIABILITIES

#### Verification of Current Assets

##### Inventory

##### Audit objectives

The audit objectives applicable to inventories are:

- (a) **Completeness**  
This is to ensure that:
  - (i) Inventories represent all raw materials, work-in-progress, and finished goods that the entity owns, including those on hand, in transit or on the premises of others.

- (ii) All shipments of goods during the period covered by the financial statements.
- (b) **Accuracy**  
This is to ensure that:
  - (i) The detailed perpetual inventory records are correct and agree with the general ledger inventory control account.
  - (ii) Costs associated with inventories have been properly classified and accumulated.
  - (iii) Cost of sales is based on correct costs and quantities, is properly summarised and posted to the costs of sales and inventory control accounts, and, where appropriate, is credited in the perpetual inventory records.
- (c) **Existence/Occurrence**  
This is to ensure that:
  - (i) Recorded inventories physically exist in saleable condition and represent property held for sale in the ordinary course of business.
  - (ii) Recorded cost of sales relate specifically to goods actually shipped during the period covered by the financial statements.
- (d) **Cut-off**  
This is a procedure to ensure that production costs incurred are charged to work-in-progress and on completion are transferred to finished goods such that cost of goods sold are recorded in the period when the sales are made.
- (e) **Valuation**  
This is to ensure that:
  - (i) Costs associated with inventories and costs of sales are determined and accumulated using generally accepted accounting principles consistently applied.
  - (ii) Inventories are stated at cost or net realisable value, whichever is lower.
- (f) **Rights and obligation**  
This is to confirm that:  
The entity has legal title or ownership rights to the inventory; inventory excludes goods that are the property of others or have been billed to customers.
- (g) **Presentation and Disclosure**  
This is to ensure that:
  - (i) Inventories and cost of sales are properly described and classified in the financial statements.
  - (ii) All encumbrances against inventory are adequately disclosed.

The auditor achieves these objectives by performing substantive tests or a combination of substantive tests and tests of control, structure, policies and procedures.

### **Planning the Inventory Observation**

The client has the primary responsibility for planning and taking the physical inventory. The auditor should observe stocktaking and should include observation of stocktaking in his planning of the audit. The client and auditor should agree on the timing of the inventory after considering the following factors:

- (a) The inventory should be counted at year-end if it is subject to significant volatility of movement or quantities, or if the control procedures for accounting for movement are ineffective;
- (b) If those procedures are effective, the count can be taken before year-end or, if the client used cycle counts, on a staggered basis throughout the year; and
- (c) If the inventory is taken at once, both client and auditor usually prefer a month in the last quarter of the fiscal year.

Unless the client has effective control procedures that address proper cut-off, the auditor should discourage the client from taking inventories of different departments over a period of several days; this could result in double-counting of inventory.

The auditor should review and comment on the written instructions of inventory plans. Often the client personnel responsible for the inventory hold one or more instructional meetings with those who are to supervise the stock-taking. The auditor's presence at the meetings usually facilitates the plans for observing the inventory.

There may be a need for large number of audit staff to be present when a complete physical inventory is taken at a time than if cycle counts or staggered inventories are taken.

Audit staffing requirements must be determined based on the following variables:

- (a) Timing of inventories at various locations;
- (b) Difficulty of observing them; and
- (c) Number of counting teams the client provides.

### **Observing the Physical Inventory**

The auditor must keep in mind the objectives of observing a physical inventory, namely:

- (a) To ascertain that the inventory exists;
- (b) To observe that the count is accurate;
- (c) To ensure the description of the inventory is accurate; and
- (d) To ensure that its condition is properly recorded.

An auditor is neither a taker nor an expert appraiser of inventory quality, quantities, or condition; nonetheless, an auditor should intelligently apply common sense. Well-arranged inventory is more likely to be accurately counted than poorly arranged inventory. Signs of age and neglect are often obvious, for

example, dust on cartons or rust and corrosion of containers, and they naturally raise questions about the inventory's usefulness. The condition of the inventory is particularly important if the product must meet technical health specifications. Before observing the inventory auditor should know enough about the client's business to be able to recognise, at least in broad terms:

The product under observation and the measures appropriate to determining its quality and condition.

Thus, an auditor should spend some time examining the inventory being counted. However, the client, and everyone else concerned, should recognise that the auditor is not acting as an expert appraiser.

The auditor should spend most of the time observing the client's procedures in operation. The diligence of the counting teams should be noted as to:

- (a) How carefully they count, weigh, and measure;
- (b) How well they identify and describe the inventory; and
- (c) What methods they use to make sure no items are omitted or duplicated.

The auditor should also observe:

- (a) Whether supervisory personnel are present;
- (b) How planned recounting procedures are executed;
- (c) Whether cut-off procedures are performed;
- (d) How inventory count documents are controlled;
- (e) How individual areas or departments are controlled and "cleared"; and
- (f) Whether instructions are followed.

The auditor should do some test counts in order to:

- (a) Confirm the accuracy of the client's counting;
- (b) Record evidence to corroborate the existence of the inventory for later tracing to the inventory summary sheet; and
- (c) Perform random selection, independent counting and comparison with quantities recorded by the clients, provide evidence that all items on hand are accurately included in the client's recorded counts.

The auditor should use judgement in determining how many test counts to perform. In the absence of specific reasons to do otherwise:

- (a) The auditor usually performs a small number of test counts in relation to the total number of items in the inventory;
- (b) Where there are an unacceptable number of errors in a particular location, the client would ordinarily recount the inventory; and
- (c) The auditor should record the test counts for subsequent tracing to the inventory summarisation.

Client inventory counts are commonly recorded at least in duplicate, with one copy retained at the scene of the count and another collected for summarisation. The client normally controls the summarisation process, and the auditor makes

notations of tag or count sheet numbers or other control data on a test basis for later tracing to the summarised records to provide corroborative evidence that the process was adequately controlled.

As part of the review of plans and observation of the physical inventory procedures, the auditor should note and evaluate the procedures followed in separately identifying and counting items moved from one place to another (such as from department to department) and goods on hand belonging to others, such as consignments, bailment, goods on approval, and property of customers returned for repair or held awaiting delivery instructions. All items belonging to others should be counted and recorded separately, both because they should be subject to control and to preclude their mistaken or purposeful substitution for the client's inventory.

In order to adequately identify work-in-progress, especially its stage of completion, auditors should:

- (a) Check the bill of materials or similar document; and
- (b) Identify items in process and their condition or stage of completion.

### **Perpetual Inventories (Cycle Counts)**

All procedures applicable to wall-to-wall physical inventory observation can be readily adapted to cycle count observation. The auditor can:

- (a) Review the cycle counting schedules, plans, and instructions; and
- (b) Observe the physical arrangement and condition of the inventory.

The diligence and proficiency of the inventory count teams in counting, identifying inventory, and controlling records of test counts, would prevent omissions or duplications, and help in identifying and segregating slow-moving, obsolete, or damaged goods. In a situation where the entire inventory is not being counted at the same time, the auditor must take steps to ensure that the items counted are properly identified. The auditor can make few test counts either independently or with the count teams and can observe and, if desired, participate in reconciling the counts to perpetual records and investigating differences.

Effective cycle counting depends on:

- (a) Effective control procedures for inventory quantities; and
- (b) Timely recording throughout the production process.

Once the client's procedures for controlling inventory quantities and related cycle counting are found to be effective, the auditor can choose to observe and test physical inventory procedures at any other time.

The auditor also needs evidence that the perpetual inventories procedures observed:

- (a) Were functioning before;
- (b) Can be expected to function after they were observed; and
- (c) That they are applied to substantially all inventory items.

A formal schedule of counts and specific assignments (covering both personnel to perform the counts and supervisory responsibility) is preferable. Many companies, however, operate under a loose policy of counting all items at least once a year and assign the counting to the stock keepers to do as time allows. In those instances, the auditor can review work sheets, entries in the perpetual inventory records and other evidence of the regularity of test counting, and can evaluate the results. Evidence of proper count procedures include:

- (a) Frequent counting; Absence of substantial differences between counts and records over a period of time;
- (b) Quality of investigation of differences that occur and those investigating differences;
- (c) And quality of storeroom, housekeeping and inventory identification.

### **Difficult Inventories**

Certain types of materials - for example, logs in a river, piles of coal and scrap metal, chemicals - by their nature may be difficult to count, and an auditor may have to use ingenuity to substantiate quantities on hand. Measurement of a pile of metals, for example, may be difficult for a number of reasons:

- (a) The pile may have sunk into the ground to an unknown depth;
- (b) The metals may be of varying weights, precluding the use of an average; and
- (c) The pile may be of uneven density.

The quality of chemicals and similar materials may be impossible to determine without specialised knowledge, and the auditor may find it necessary to draw samples from various levels of holding tanks and send them for independent analysis. Irregularities have been perpetrated by substituting water for materials stored in tanks.

### **Alternative Procedures when Observation is Impracticable**

The auditor should not readily take observation of inventories as impracticable or impossible. In a situation where the client does not or cannot take a physical inventory, or if the auditor cannot be present at the stocks taking, the auditor may be able to form an opinion regarding the reasonableness of inventory quantities by applying any of the following alternative procedures:

### **Examining Other Physical Evidence that may be Tantamount to Observing Physical Inventories**

If the auditor is engaged after the physical inventory has been taken, subsequent physical tests may be a satisfactory substitute for observing the inventory-taking. The auditor may also examine written instructions for the inventory-taking, review the original tags or sheets, and make other suitable tests. In any event, the auditor must:

- (a) Examine or observe some physical evidence of the existence of the inventory; and
- (b) Make appropriate tests of intervening transactions or control procedures applied to them.

If the auditor is satisfied that inventories are fairly stated; he or she is in a position to express an unqualified opinion. Otherwise, there may be no practicable substitute for observation of inventory-taking, and an auditor may have to express a qualified opinion or disclaimer, depending on the materiality of the inventories and on whether failure to observe was unavoidable or resulted from management's decision to limit the scope of the audit.

### **Substantiating Through Further Examination of Accounting Documents**

Sometimes procedures for substantiating inventories must be based on examining other accounting documents and records. For example, in an initial audit, the auditor generally would not have observed the physical inventory at the previous year-end, which is a principal factor in determining cost of sales for the current year. If reputable independent accountants expressed an unqualified opinion on the prior-year statements, a successor auditor may accept that opinion and perhaps merely review the predecessor auditor's working papers supporting the prior-year balances. If no audit was made for the preceding year, the auditor may have no alternative but to substantially expand the tests of accounting records to attempt to obtain reasonable assurance about the beginning inventories in order to be able to express an opinion on the current year's results of operations.

Those expanded tests may include a detailed examination of physical inventory sheets and summaries, including review and testing of cut-off data, examination of perpetual inventory records and production records, and review of individual product and overall gross profit percentages. In connection with the latter procedures, cost accumulations for selected inventory items should be tested and significant changes in unit costs directly traced to factors such as technological changes, mass buying economies and changes in freight rates, changes in labour costs, and changes in overhead rates.

Changes in gross profit percentages should be further related to changes in unit sales prices and changes in the profitability of the sales mix, if applicable. An auditor who is unable to form an opinion on the opening inventory may decide to qualify the audit opinion or disclaim an opinion with respect to results of operations for the year under audit.

### **Testing Ownership and Cut-off**

The auditor must determine that the client holds title to the inventories. Where materials are imported by the entity, the shipping documents determine the ownership of the consignment. The test of ownership of such materials includes:

- (a) Shipping documents showing consignee, Free on Board (FOB) terms and bill of lading; and
- (b) Actual receipts of the materials into the client's warehouse.

In the case of the cut-off test, the auditor needs to ensure:

- (a) The completeness of primary documents such as purchase and sales invoices;

- (b) The invoices so issued followed pre-numbered serials;
- (c) Purchases are generally recorded when received; and
- (d) Sales are made when the transactions took place.

Determination of ownership would depend on proper control of receiving and shipping activities and cut-offs at year-end and, if different, at the physical inventory date.

At the time of the inventory observation, the auditor should:

- (a) Visit the receiving and shipping departments;
- (b) Record the last receiving and shipping document numbers; and
- (c) Ascertain that each department has been informed that no receipts after or shipments before the cut-off date should be included in inventory.

After the inventory, the auditor should:

- (a) Review the records of those departments; and
- (b) Compare the last receiving and shipping numbers with accounting department records to ensure that a proper cut-off was achieved.

Special care should be taken to control the movement of inventory when manufacturing operations are not suspended during the physical inventory. If there are consignment inventories, inventories in public warehouses, or customer inventories, those procedures must be expanded. Inventory held by others should be substantiated by direct confirmation in writing with the custodians.

If such inventory is material, the auditor should apply one or more of the following procedures to obtain reasonable assurance with respect to the existence of the inventory:

- (a) Test the owner's procedures for investigating the stock-keeper and evaluating the store keeper's performance;
- (b) Obtain an independent accountant's report on the store-keeper's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable;
- (c) Observe physical counts of the goods, if practicable and reasonable; and
- (d) If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts.

If goods are billed to customers and held for them, care must be exercised to exclude the goods from inventory and to determine that the customers have authorised billing before delivery. Goods belonging to customers or others should be counted and, if significant in amount, should be confirmed with their owners. The auditor should be alert to the possibility of such goods and should ensure that the client properly segregates and identifies them.

The auditor should also be alert for liens and encumbrances against the inventories. These are normally evident from reading minutes and agreements, or as a result of confirmations with lenders relating to loans or loan agreements.

It may be necessary to investigate whether additional liens and encumbrances have been filed with relevant authorities.

### **Valuation of Inventory**

Generally accepted accounting principles require that inventories be reported at the lower of historical cost or market (current replacement cost), provided that the carrying value should not exceed net realisable value (estimated selling price minus costs of completion and disposal) or be lower than net realisable value reduced by the normal profit margin. To achieve the valuation objective for inventories, the auditor should test the inventory costing. In addition, he should:

- (a) Review and test procedures for identifying obsolete or slow-moving items;
- (b) Review the costing of damaged or obsolete items to determine that the assigned value does not exceed net realisable value; and
- (c) Review and test the determination of market prices to determine whether market value is lower than cost.

The auditor should:

- (a) Consider not only finished goods but also work in process and raw materials that will eventually become finished goods in the review for obsolete items;
- (b) Compare quantities with those in previous inventories on test basis to identify slow-moving items or abnormally large or small balances; and
- (c) Reviews of usage records can provide further indications of slow-moving items.

If the client does not maintain perpetual records, the auditor may examine purchase orders or production orders to determine how recently certain items of inventory were acquired. Many companies have formulae or rules of thumb that translated overall judgements on obsolete stocks into practical detailed applications, for example:

- (a) All items over a year's supply;
- (b) All items that have not moved within six months; and
- (c) All items bearing certain identifying numbers with regard to date or class of product.

The auditor should review whether the rules are realistic and comprehensive enough as well as whether they are fully and accurately applied. In addition to reviewing and testing the client's rules, the auditor must evaluate, based on an understanding of the client's business climate, whether inventory can be realised in the normal course of operations. Past experience can be a good guide to the net realisable value of items that must be disposed of at salvage prices.

When certain finished goods are declared obsolete or severe markdowns are required, consideration should be given to related raw materials and work-in-process inventories write down.

### **Verification of Cash Sales**

Cash sales are included under this topic because of the level of cash transactions in Nigerian economy. In the supermarkets, restaurants, filling stations, etc, transactions are made predominantly by cash. Physical and accounting controls on cash pose problems. Segregation of duties between access to merchandise and access to cash receipts is difficult, hence control procedures are put in place to improve accountability. For effective control, customers are encouraged to demand for receipts to cover cash payments.

Steps in verification of cash sales are:

- (a) Obtain records of the entity's daily cash sales;
- (b) Check the records of cash receipts with the totals of the cash register;
- (c) Investigate and obtain necessary explanations for any discrepancy;
- (d) Check the procedures for cash transactions; and
- (e) Conduct cash count.

### **Cash Balances**

It is assumed that the auditor, using appropriate combination of risk assessment activities and substantive tests, would have reduced audit risk to an appropriately low level with regard to cash receipts from customers, cash disbursements to vendors, and other cash transactions. Because cash is so liquid and transferable, the risk of theft is greater than that of any other asset. Accordingly, the auditor focuses on how responsive the client's control structure policies and procedures are to the inherent characteristic risk.

Failure to detect cash defalcations is frequently a source of embarrassment to the auditor. It may be the basis for litigation; particularly if it involves material fraud that a client contends should have been detected by an auditor following a testing plan that gave appropriate consideration to the inherent risk associated with cash and the client's response to that risk. Cash defalcations are concealed by unauthorised charges to income statement accounts, resulting in income statement containing misclassified or fictitious expenses.

The nature, timing and extent of substantive tests of cash are strongly influenced by the auditor's assessment of inherent and control risk. The effectiveness of control procedures also affects the timing of substantive tests.

### **Audit Objectives**

The objectives of auditing cash are to obtain reasonable assurance that:

- (a) Recorded cash on hand and in financial institutions, exists, and is accurate and complete, and the client has legal title to it at the balance sheet date;

- (b) All items properly included as part of cash are realisable in the amounts stated; for example, foreign currency on hand or on deposit in foreign countries is properly valued;
- (c) Cash restricted as to availability or use is properly identified and disclosed; and
- (d) Cash receipts, disbursements, and transfers between bank accounts are recorded in the proper period.

Cut-off objective with respect to cash receipts from customers and disbursements to vendors should be met to prevent end-of-period “window dressing” of working capital accounts. Recording bank transfers in the wrong period could be a tell-tale of a defalcation.

### **Substantive Tests of Cash Balances**

Substantive tests are as follows:

- (a) Testing completeness, accuracy, and existence of year-end balances so as to:
  - (i) Confirm balances and other information with banks and other financial institutions;
  - (ii) Prepare, review bank reconciliations; and
  - (iii) Cash count.
- (b) Testing bank transfer cut-off.
- (c) Review restrictions on cash balances and related disclosures.

### **Confirmation of Bank Balances**

The auditor should ordinarily confirm balances at year-end by direct correspondence with all banks the client has conducted business with during the year, regardless of whether all year-end reconciliation's are reviewed or tested. Usual practice is to confirm all bank accounts open at any time during the year under audit. The auditor should ask the client to request the financial institution to communicate directly with the auditor.

### **Indebtedness and Other Arrangements**

A bank may have arrangements with or provide services to the client other than maintaining deposits or granting loans.

Auditor should confirm:

- (a) Amount(s) on deposit kept as a condition for a loan;
- (b) Items held as agent or trustee, securities or other items in safekeeping or for collection for the account of the client; and
- (c) Other arrangements - such as oral and written guarantees, commitments to buy foreign currencies, repurchase or reverse repurchased agreements, and letters of credit and lines of credit.

### **Bank Reconciliation Procedures**

Periodic reconciliation of cash receipts and disbursements to the amounts shown on bank statements is key control procedure to meet the asset protection

objective for cash. The reconciliation procedure will be more effective if in addition to reconciling the balances, the detailed items listed on the bank statements are reconciled to the detailed items recorded in the accounts during the period covered by the bank statement. Reconciling detailed items listed on the bank statements ensures that all items recorded in the accounts, including offsetting items within receipts or disbursements, are also recorded on the bank statement and vice versa.

Effective segregation of duties requires that the person reconciling bank balance to account balances does not have functions relating to:

- (a) Cash receipts;
- (b) Cash disbursements; and
- (c) Preparing or approving vouchers for payment.

It also requires that the person performing the reconciliation obtains the bank statements directly from the bank and makes specific comparisons, like comparing paid cheques and other debits and credits listed on the bank statement with entries in the accounts, examining cheques for signatures and endorsements, and reconciling bank transfers.

The client's reconciliation of bank accounts and the appropriate division of duties with respect to cash balances and transactions are important control procedures. The auditor's assessment of how effective the client's reconciliations are determined by the nature, timing, and extent of many of the substantive tests of cash. Other factors are:

- (a) Adequacy of the accounting system;
- (b) Competence of employees doing the reconciliations; and
- (c) Segregation of duties.

The more effective the auditor finds the client's reconciliations to be, that is, the lower the assessed level of control risk, the less detailed the auditor's reconciliation procedures have to be.

Those procedures may range from simply reviewing the client's reconciliations at year-end, if control risk has been assessed as low, to performing independent reconciliations covering the entire year using the proof of cash form. Generally, performing proof of cash reconciliations for the entire year is considered necessary only in special situations, such as when a defalcation is believed to have occurred. Between those two extremes falls the auditor's judgemental discretion.

### **Review and Test of Client's Reconciliations**

If the auditor has assessed control risk as low, then merely reviewing the client's reconciliations at year-end may be appropriate. The steps in reviewing a client's bank reconciliation are:

- (a) Obtain copies of the client's bank reconciliations and establish their mathematical accuracy;

- (b) Reconcile the total of the bank balances on the reconciliations to the general ledger balance. This will generally require using a summary of the individual cash account balances in the general ledger account;
- (c) Scan the bank reconciliation for significant unusual reconciling items and adjustments, and obtain evidence to support them by inquiry or examination of appropriate documents.

In addition to the review procedures the auditor may decide to test the client's reconciliations. The tests may be performed at an interim date, if the auditor has assessed that the client's reconciliations are subject to effective supervisory control procedures. If supervision during the intervening period is not considered effective, the auditor would probably perform the tests at year-end. The following procedures in addition to steps (a) and (b) above are typically performed in testing the client's reconciliations:

- (a) Determine that paid cheques, deposits, and debit and credit advices appearing on the cut-off bank statements and issued on or before the balance sheet date appear on the year-end reconciliations;
- (b) Trace to the cash disbursements records outstanding cheques listed on bank reconciliations but not returned with the cut-off statements;
- (c) Trace deposits in transit on the bank reconciliations to the cut-off bank statements and the cash receipts records, and determine whether there are any unusual delays between the date received per the books and the date deposited per the bank statements;
- (d) Trace other reconciling items to supporting documentation and entries in the cash records;
- (e) Investigate old or unusual reconciling items. If cheques remain uncashed after a specified period of time, the reason should be determined and the amounts restored to the cash account; and
- (f) Determine the exact nature of items on the year-end bank statements not accounted for by the reconciliation procedures, such as debits or credits followed by offsetting entries of identical amounts that appear to be, or are represented by the client to be, bank errors and corrections not so coded. If information in the client's records is inadequate, clarification should be requested from the bank. In these circumstances, the auditor should consider performing a "proof of cash" reconciliation (described below) if the client's reconciliation process does not include one. These procedures assume that the testing is performed as of the balance sheet date and that cut-off statements for a reasonable period after the balance sheet date are obtained from the bank.

### **Bank Transfer Schedule**

To ensure there has been a proper cut-off at year-end, the auditor should determine whether significant transfers of funds occurred among the client's

various bank accounts near the balance sheet date. All transfers of funds within the organisation should be considered - whether among branches, divisions, or affiliates - to make sure that cash is not “double counted” in two or more bank accounts and that “kiting” has not occurred.

The auditor should determine:

- (a) That each transaction represented as a transfer is in fact an authorised transfer;
- (b) That debits and credits representing transfers of cash are recorded in the same period; and
- (c) That the funds are actually deposited in the receiving bank in the appropriate period.

**Kiting** is a way of concealing cash shortage caused by a defalcation, such as misappropriating cash receipts that were perpetrated previously. It involves the careful and deliberate use of the “float” (the time necessary for a cheque to clear the bank it was drawn on). Drawing a cheque on one bank, depositing it in another bank just before year-end, so that deposit appears on the bank statement and the recording of the transfer in the receipts is not done until after year-end amounts to kiting. The float period will cause the cheque not to clear the bank it was drawn on until after year-end, and the amount transferred is included in the balances of both bank accounts. Since the transfer is not recorded as a receipt or a disbursement until the following year, it will not appear as an outstanding cheque or a deposit in transit on the reconciliation of either bank account. The effect is to increase receipts per the bank statement; if the misappropriation of cash receipts and the kiting take place in the same period, receipts per the bank statement will agree with receipt per the cash receipts journal at the date of the bank reconciliation. (If the misappropriation of cash receipts takes place in the period before the kiting, a proof of cash may also reveal the kiting). Kiting requires that the transfer process be repeated continually until the misappropriated funds have been restored. Kiting could have a wider meaning to encompass writing cheques against inadequate funds with the intent of depositing sufficient funds later, but before the cheques clear the bank.

Bank transfer schedule is an effective tool that assists the auditor in ensuring that:

- (a) all transfers of funds among bank accounts near the balance sheet date are recorded in the books in the proper accounting period;
- (b) cash has not been double-counted; and
- (c) there is no apparent kiting.

The schedule should indicate, for each transfer:

- (a) The date the cheque affecting the transfer was recorded as a cash disbursement;
- (b) The date it was recorded as a cash receipt, the date it cleared the bank it was drawn on; and

- (c) The date it was deposited and cleared in the bank.

When kiting is suspected, the auditor should:

- (a) Compile bank transfers and the client's cash receipts and disbursement records;
- (b) Obtain dates on the bank transfer schedule from the cash records and the dates on the cheque showing when it was received by the bank it was deposited in and when it was paid by the bank it was drawn on;
- (c) Compare date the cheque was recorded as a disbursement with the date it was recorded as a receipt; the dates should be the same;
- (d) If they are not and the entries are in different fiscal years, an adjusting entry may be necessary to prevent double-counting of cash, depending on the offsetting debit or credit to the entry that was made in the year being audited;
- (e) Compare the bank dates (paid and cleared) with the corresponding dates the transaction was recorded in the books (received and disbursed) for each transfer;
- (f) If those dates are in different accounting periods, the transfer should appear on the bank reconciliation as a reconciling item; and
- (g) Lastly, investigate unusually long time lags between dates recorded and dates for possible holding of cheques at year end - a cut-off problem.

### **Reviewing Cash Restrictions and Related Disclosures**

The auditor should review the evidence previously obtained and, if necessary, perform further procedures to ensure that all appropriate disclosures related to cash have been made. The following may indicate restrictions on the availability or use of cash that should be disclosed:

- (a) Bank confirmations;
- (b) Responses to inquiry letter;
- (c) Loan agreements;
- (d) Minutes of board of directors' meetings; and
- (e) Bond indentures.

Inquiry of client management may also indicate the need for disclosures of cash balances that are restricted or the property of others. If the entity has substantial funds in other countries or in foreign currencies, the auditor should determine whether there are any restrictions on their availability and that appropriate disclosures have been made.

### **Verification of Fixed Assets**

Most businesses use fixed assets, e.g., property, plant, and equipment in the process of generation of income. Expenditure to maintain or improve assets acquired are normal. A major audit consideration is whether such expenditure should be classified as expenses of current period or an addition to the cost of assets.

The general rule is to capitalise expenditure if it will prolong the useful or productive life of the asset into future periods. There should be proper distinction between revenue and capital expenditure. Companies often have policies defining which expenditure are to be capitalised. The auditor must exercise judgement in determining whether the policies are appropriate and being complied with.

### **Audit Objectives**

The audit objectives for fixed assets are that:

- (a) The fixed assets in the accounts exist;
- (b) The fixed assets are owned or leased under capital leases by the entity;
- (c) No material items were charged to expense that should have been capitalised;
- (d) Additions and disposals have been duly authorised and accurately recorded;
- (e) Cost or other basis of initially recording value is appropriate;
- (f) Appropriate methods of depreciation have been applied, on a consistent basis;
- (g) The carrying value of fixed assets is appropriate in periods subsequent to acquisition, considering such factors as utilisation, location and technological changes; and
- (h) Assets pledged as collateral are identified and properly disclosed.

### **Verification Methods**

Obtain a schedule of each asset showing:

- (a) **Opening Balance**  
Review previous year's working papers and the client's records to provide necessary understanding of the accounting principles, policies and methods employed.
- (b) **Additions**
  - (i) Examine purchase order and other supporting documents;
  - (ii) Vouch the cost vide invoices, cost includes all expenditures necessary to make an asset ready for its intended use; and
  - (iii) Vouch the authority for acquisition by review of minutes of board of directors or other committees to confirm whether major additions were appropriately authorised.
- (c) **Disposals**
  - (i) Vouch the authority;
  - (ii) Examine relevant documentation;
  - (iii) Compare acquisition cost with underlying records, re-compute accumulated depreciation and the resulting gain/loss and balancing charge/allowance;
  - (iv) Verify proceeds as reasonable;
  - (v) Pay attention to scrap value; and
  - (vi) Confirm proper accounting treatment.

- (d) **Depreciation and Other Write Downs**
- (i) Review client's methods and policies;
  - (ii) Examine adequacy and appropriateness of policy;
  - (iii) Vouch authorisation policy;
  - (iv) Vouch revaluations ;
  - (v) Check calculations; and
  - (vi) Consider changes in business condition that may warrant reviews of estimated useful life of the assets.
- (e) The stated procedure must agree the physical assets to the closing Naira value of the assets.
- (f) Internal control procedures as regards additions, disposals, accounting and maintenance of fixed assets are relevant. The auditor should also make use of fixed assets registers.

### **Presentation, Disclosures and Value**

- (a) Accounting policies appropriate to the entity must be adopted. This must be consistently applied and adequately disclosed;
- (b) The entity must adhere to relevant Accounting Standards;
- (c) Materiality in the context of the individual company must be considered;
- (d) Proper classification of assets should be done;
- (e) There should be proper disclosure and accurate description; and
- (f) Clear distinction between capital and revenue is important. It could be a matter of accounting policy - research and development - or matter of opinion - repair expenditure is a charge against revenue, but may include elements of improvement which is capital.

### **Other Matters Considered**

- (a) Letter of representation. Obtain management representation on carrying values and classifications of fixed assets.
- (b) Reasonableness and professional scepticism. Auditors should diligently investigate and seek adequate assurance on the truth and fairness of the financial statements. This he does with professional scepticism. If therefore, he comes across anything that seems wrong, unlikely, unreasonable, or suspicious, he is said to be "put upon enquiry". In that case he should diligently investigate the matter and be assured of the truth of the matter.
- (c) Assets pledged as collateral are identified and disclosed, along other necessary disclosures.
- (d) Appropriate depreciation methods are properly applied, on a basis consistent with the previous year, to all items of assets that should be depreciated.
- (e) Taxation. Tax and capital allowances should be in accordance with the asset accounts and the applicable laws.
- (f) Insurance certificates of assets, e.g., motor vehicles, should be examined to provide further corroborative proof of realising audit objectives.

- (g) Assets leased under capital leases by the client are verified and properly described.
- (h) Assets held by third parties are equally included in the balance sheet and properly described.

## **VERIFICATION OF LIABILITIES**

### **Audit Objectives**

The auditor should approach accrued liabilities with the view, that liabilities are more likely to be understated or omitted from the accounts than overstated. Therefore, audit objectives should focus on ascertaining that accrued liabilities are not understated, but without ignoring the possibility that the opposite may occur.

The auditor's objectives in examining liability transactions and accounts are to obtain reasonable assurance that:

- (a) All obligations for amounts payable, long-term debt, and capitalised leases and all equity accounts have been properly valued, classified, described, and disclosed;
- (b) All off-balance-sheet obligations have been identified and considered (e.g., operating leases, product financing arrangements, build and operate contracts, etc);
- (c) All liability and equity transactions, accounts, and changes therein have been properly authorised and are obligations of the entity or ownership rights in the entity;
- (d) Interest, discounts, premiums, dividends, and other debt-related and equity-related transactions and accounts have been properly valued, classified, described, and disclosed; and
- (e) All terms, requirements, instructions, commitments, and other debt-related and equity-related matters have been identified, complied with and disclosed, as appropriate.

### **Substantive Tests of Balances**

A convenient way to document substantive tests of liabilities at balance sheet date is obtaining or making detailed schedules of liabilities by categories, owing the movement in each account during the period. The auditor should compare the list with the accounts and reconcile the total to the general ledger.

Tests of details of debt and equity transactions and balances consist of obtaining confirmations from third parties, re-performing computations, and examining documents and records. The following are some examples:

### **Authorisation**

- (a) The auditor should trace authorisation to board minutes, or where such authority was delegated, should be traced to the delegated officer's signature.

**(b) Confirmations**

Confirm debt payable and terms with holder; outstanding stock with holder and registrar; and dividend and interest payable. Ensure the recorded liabilities relate to values of goods and services received by the entity.

**Examination of Lease Documents**

Terms in finance lease must be evaluated to determine whether it should be accounted for as an operating or capital lease. If leases are capitalised, the auditor must test computations of the carrying amounts of assets and debt, and compare them with the underlying lease contract.

**Rights and Obligations**

- (a) Ascertain that all accounts payables, accrued expenses and other liabilities are legal obligations of the entity at the balance sheet date;
- (b) Check presentation and disclosure as to amount falling due within or after one year; and
- (c) Consider the description and classification of liabilities in the financial statements. If material loss could arise from unfulfilled purchase commitments, the auditor should identify the commitments and assess the potential need for a provision. In all, the auditor should ensure compliance with all statutory provisions and other accounting requirements.

**Letter of Representation**

Management must explicitly assert the existence, rights and obligations, completeness and appropriate presentation, and disclosure in the financial statements. These assertions are made in a letter of representation.

**Inclusion of all Liabilities**

It is not enough for the auditor to be satisfied that all the liabilities recorded in the books are correct and are incorporated in the financial' statements. Auditors must be satisfied that there are no unrecorded liabilities, transactions or undisclosed items. The auditor should appreciate the possibilities of the existence of undisclosed liabilities. He also has an obligation to take reasonable steps to unearth them.

The auditors discharge these obligations by:

- (a) Diligently enquiring of the directors and other officers and by obtaining letter of representation;
- (b) Examining post balance sheet events, where applicable; and
- (c) Examining minutes of meeting of the board and management where the existence of unrecorded liabilities may be mentioned.

**Provisions**

A clear understanding of the words - provision and reserves - is imperative. The correct usages of these two words are:

Provision - any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

Thus a provision:

- (a) Is a debit to profit and loss account reducing profit and therefore dividends;
- (b) Is in respect of a likely or certain future payment; and
- (c) Arises where the amount or the rate of payment is uncertain.

Reserve - that part of shareholders' funds not accounted for by the nominal value of issued share capital or by the share premium account.

The need for the creation of provisions is an important consideration for directors who are responsible for the financial statements. Post balance sheet events can often give an indication of the amount of provision required. The auditor has a duty to see that any provisions set up are used for the purpose for which they were set up and that any provisions, which are no longer needed, are written back to profit and loss account.

Items should be provided for, only when the company has a firm commitment (not merely an intention) to the expenditure. It should be noted that the only costs to be provided for should be those incremental costs necessary to sort out a past problem. Any costs that will bring benefits in the future should be charged in the future period.

## **Share Capital**

*When there are new issues*

Share capital is a special sort of liability of a company. When share capital has been issued during the year, auditors should:

- (a) Ensure that the issue is within the limits authorised by Memorandum and Articles of Association of the entity;
- (b) Ensure that the issue was subject to directors' minutes and shareholders' approval, where applicable;
- (c) Ascertain and evaluate the system for the control of issue; and
- (d) Verify that the system has been properly operated. This will involve examining the prospectus (where applicable), application and allotment sheets, the share register, cash received records, share certificate counterfoils, and refunds to unsuccessful applicants.

Where Stock Exchange approval was required, the auditors should:

- (a) Ensure that permission has been obtained. If it has not been given all the money subscribed is returnable;
- (b) Ensure that all the money is maintained in a separate bank account until all conditions were satisfied;
- (c) Ensure that the minimum subscription has been received. If there are not enough subscribers then the whole amount is returnable; and

- (d) Vouch the payment of underwriting and other fees.

*Where there are no new issues*

When no new issue of shares has been made, the auditor should:

- (a) Determine the total of shares of each class as stated in the balance sheet and obtain a list of shareholdings, which in total should agree with the balance sheet total;
- (b) Test the balances in the share register with the list;
- (c) If this is not possible at the balance sheet date, it may be permissible to do it earlier provided that the auditor is satisfied with the system of control over transfers; and
- (d) Where the share register is maintained by an independent firm of registrars, the auditor should obtain a certificate as to the accuracy and completeness of the shares and their holdings. The certificate should state that the balances on the share registers agree with the issued capital at the balance sheet date.

### **Accounting Estimates**

An important aspect of evaluating the application of accounting principles, particularly as they relate to the valuation objective for many accounts, involves evaluating accounting estimates. Accounting estimates are:

- (a) Financial statement approximations that are necessary because the measurement of an account is uncertain until the outcome of future events is known, e.g., uncollectible receivables, obsolete inventory, useful lives of assets, actuarial assumptions in pension plans, and warranty claims; and
- (b) Financial statement approximations that come about in respect of relevant data concerning events which could not be accumulated on a timely, cost-effective basis.

Examples of accounting estimates are:

- (a) Allowances to reduce inventory and accounts receivable to their estimated realisable value;
- (b) Provisions to allocate the cost of fixed assets over their estimated useful lives;
- (c) Accrued revenue;
- (d) Deferred tax;
- (e) Provision for a loss from a lawsuit;
- (f) Losses on construction contracts in progress; and
- (g) Provision to meet warranty claims.

Management is responsible for making the accounting estimates whilst the auditor is to evaluate their reasonableness. Even when management's estimating process involves competent personnel using relevant and reliable data and the most likely assumptions about the factors that affect an accounting estimate, subjectivity can still creep into those estimates which in turn may lead to bias. As a result, the auditor should evaluate accounting estimates

with an attitude of professional scepticism. The auditor's objective in evaluating accounting estimates is to obtain sufficient evidence to provide reasonable assurance that all material accounting estimates have been developed, are reasonable, and are presented and disclosed in conformity with the Nigerian Standards on Auditing.

### **Basic Approaches to Establish Reasonableness of an Estimate**

The auditor should use any or a combination of these basic approaches in assessing the reasonableness of an estimate, viz:

- (a) Review and test the process management used to develop the estimate;
- (b) Independently develop an expectation of the estimate to corroborate the reasonableness of management's estimate; and
- (c) Review events or transactions occurring after the date of the financial statements (but before the audit is completed) that provide an actual amount to compare the estimate with.

In the application of the approach in (a) above, the auditor should:

- (a) Obtain an understanding of the process management established to develop the estimate;
- (b) Assess the inherent and control risks related to management's process for developing the estimate; and
- (c) Identify and evaluate the key factors and assumptions used by management to formulate the estimate.

The following are helpful procedures to identify and evaluate the key factors and assumptions that are unique to auditing accounting estimates:

- (a) Analysing historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and determining whether it is sufficiently reliable;
- (b) Considering whether changes in the business or industry or in other facts or circumstances may cause factors different from those considered in the past to become significant to the accounting estimate;
- (c) Reviewing available documentation of the assumptions used in developing the accounting estimate, and inquiring about any other relevant plans, goal, and objectives of the entity; and considering their relationship to the assumptions;
- (d) Evaluating whether the assumptions are consistent with one another, with the supporting data, and with relevant historical data;
- (e) Concentrate on those key factors and assumptions that are:
  - (i) Material to the estimate;
  - (ii) Sensitive to variations; and
  - (iii) Subject to deviations from historical patterns.
- (f) Considering using the work of a specialist.

When errors or irregularities are found as a result of substantive tests, the auditor should ascertain the reason for them and consider the implications.

## 5.4 VERIFICATION OF INTANGIBLE ASSETS

### Goodwill

#### Introduction

Goodwill is the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets.

Separable net assets are those assets (and liabilities) which can be identified and sold (or discharged) separately without necessarily disposing of the business as a whole. They include identifiable intangibles.

Other definitions of goodwill include:

- (a) The value attributable to a company's average strength in areas such as technical skill and knowledge;
- (b) The value of the business community's attitudes to the entity; and
- (c) That part of the value of a business which arises from all its advantageous circumstances, which generate earnings above an assumed norm (super profits).

#### Types of Goodwill

Goodwill can be classified into two, viz:

(a) **Non-purchased or Inherent Goodwill**

All businesses have an element of non-purchased goodwill, in that as going concerns they are worth more (positive goodwill) or less (negative goodwill) than the aggregate of the fair values of their separable net assets.

(b) **Purchased Goodwill**

Purchased goodwill is goodwill, which is established as a result of the purchase of a business. Purchased goodwill will not always be a positive amount; at some time in the life of a business, its market value may stand at a discount in relation to the fair value of the separable net assets employed. This gives rise to 'negative goodwill'.

Negative goodwill arises from circumstances that are not advantageous to the entity, such as weak markets or marketing.

#### Factors Contributing to Goodwill

Positive goodwill arises from advantageous circumstances such as an effective management team, weakness of competitors, a prime location or established customers. Other factors which are believed to contribute towards goodwill are good labour relations, a secret or patented manufacturing process, effective advertising, high standing in the society through contributions to and participation in community activities and an excellent reputation for quality and reliability of products.

Purchased goodwill will also depend on the acquirer's reasons for the purchase, such as economy of scale, fiscal advantages from tax losses, diversification of risk or combined market dominance and other factors which affect the price such as general economic conditions and cost of financing.

### **Characteristics of Goodwill**

Goodwill is intangible, intrinsic to the business and incapable of realisation separate from the business; these characteristics of goodwill distinguish it from most other items in the accounts. Its other characteristics are that:

- (a) The value of goodwill has no reliable, predictable relationship to any costs which may have been incurred;
- (b) Individual intangible factors which may contribute to goodwill cannot be valued;
- (c) The value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time; and
- (d) The assessment of the value of goodwill is subjective, in the sense that not only its value but also the assessment of its actual existence is subjective.

Thus, any amount attributed to goodwill is arrived at by estimation to the specific point in time at which it is measured, and is only valid for that point in time, and in the circumstances then prevailing.

### **Audit Objective**

The audit emphasis for intangible assets should be on determining that:

- (a) The carrying value of the assets can be fully recovered;
- (b) That there has not been permanent impairment of their value; and
- (c) That the remaining period of amortisation is appropriate.

The audit objectives of goodwill and related intangible assets accounts are to confirm the assertions by management, explicit or otherwise, embodied in the financial statements as to:

#### *Existence*

That the goodwill reported in the financial statements through measurement or disclosure exists at the date of the balance sheet. It may be desirable to confirm the existence of certain material intangible assets by direct correspondence with third parties.

#### *Rights and obligations*

An asset pertains to the entity at a given date. It must be established that the entity has the rights and obligations associated with the goodwill reported in the financial statements.

#### *Occurrence*

A transaction or event took place that pertains to the entity during the period. For example, the transaction that gave rise to the goodwill occurred within the financial reporting period.

#### *Completeness*

There are no unrecorded assets, liabilities, transactions or events, or undisclosed items relating to the matter. For example, all of the entity's goodwill is reported in the financial statements through measurement or disclosure.

*Valuation*

Goodwill is recorded at an appropriate carrying value. Documentation for an account balance seldom provides conclusive evidence of value. Auditors require extensive judgement to substantiate the values of the intangible asset. For example, that the values of the goodwill reported in the financial statements through measurement or disclosures were determined in accordance with the Nigerian Standard on Auditing.

*Measurement*

A transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period. For example, the amounts associated with the goodwill reported in the financial statements through measurement or disclosure were determined in accordance with the Nigerian Standards on Auditing, and the revenues or expenses associated with the goodwill reported in the financial statements were allocated to the correct financial reporting period.

*Presentation and Disclosure*

An item is disclosed, classified and described in accordance with the Nigerian Standards on Auditing. For example, the classification, description and disclosure of goodwill in the financial statements are in accordance with the Nigerian Standards on Auditing.

**Substantive Tests**

In performing a substantive test, the auditor should:

- (a) Evaluate the desirability of goodwill and determine the need for amortisation thereof;
- (b) Quantify the amount of the amortisation where a provision is required. Provide details of the calculation of the provision;
- (c) Compare the amount of the provision to the amount established by the entity and quantify the difference. Summarise the amounts identified;
- (d) Obtain a listing of amortisation established at the previous year-end and ensure all significant movements have been reviewed; and
- (e) Discuss findings on the above procedures with management.

Based upon the preceding procedures, the auditor should:

- (a) Determine the appropriateness of the client's amortisation of goodwill;
- (b) Review the client's methods and policies of amortisation;
- (c) Confirm that the accounting policies applied for determining goodwill amortisation are:
  - (i) Consistent with those applied in the previous year;
  - (ii) In accordance with relevant accounting principles; and
  - (iii) Are appropriately disclosed in the entity's financial statements.
- (d) State whether any exceptions were noted in the steps enumerated above, and if so;
  - (i) Confirm that they have been recorded on the working papers and that the nature and level of substantive procedures have been amended as necessary; and

- (ii) Confirm that all exceptions have been carried forward to the summary of unadjusted differences.
- (e) Consider whether the above substantive procedures have provided any evidence that the entity's goodwill amortisation are not fairly stated in its accounts; and
- (f) If there is such evidence, document it and discuss with management.

### **Disclosure Requirements**

- (a) The accounting policy followed in respect of goodwill should be properly explained in the notes to the accounts;
- (b) The amount of goodwill recognised as a result of any acquisitions during the year should be shown separately for each acquisition where material;
- (c) Where the amortisation treatment is selected, purchased goodwill should be shown as a separate item under intangible fixed assets in the balance sheet, until fully written off;
- (d) The movement on the goodwill account during the year, showing-
  - (i) The cost, accumulated amortisation and net book value of goodwill at the beginning and end of the year, and the amount of goodwill amortised through the profit and loss account during the year;
  - (ii) The period selected for amortising the goodwill to each major acquisition; and
  - (iii) The above-stated procedures are of equal application to the audit of other intangible assets like patents, trademarks, copyrights and franchise.

## **5.5 DEBENTURE LOANS AND BORROWINGS**

A debenture is a certificate of agreement of loans which is given under the company's stamp and carries an undertaking that the debenture holder will get a fixed return in terms of interest rates and the principal amount whenever the debenture matures. It is a long-term debt instrument used by governments and large companies to obtain funds. It can also be defined as "a debt secured only by the debtor's earning power, not by a lien on any specific asset." A debenture is usually unsecured in the sense that there are no liens or pledges on specific assets. It is, however, secured by all properties not otherwise pledged. In the case of bankruptcy, debenture holders are considered general creditors. The advantage of debentures to the issuer is that they leave specific assets burden free, and thereby leave them open for subsequent financing. Debentures are generally freely transferable by the debenture holder. Debenture holders have no voting rights and the interest given to them is a charge against profit. In auditing, debentures verification is given the same treatment as long term loans. The following are the verification procedures for debentures:

- (a) Request for a schedule of the amounts due at the beginning of the year, additions during the year, redemptions during the year, and the total sub due at the end of the year;

- (b) Make a record for the audit file the terms and conditions of the debenture loans as evidenced in the debenture deed;
- (c) Agree opening balances with previous years working papers;
- (d) Vouch new debenture loans with prospectus, board minutes, memorandum and articles of association, and register of debenture holders;
- (e) Vouch payments with debenture deeds, ensure that terms are correctly interpreted, check entries into cash book, and trace repayments to register of debenture holders;
- (f) Interest payments should be checked to debenture deeds, cash book and ensure that the amount paid is agreed to the percentage of the amount outstanding;
- (g) Agree total amount outstanding with register of debenture holders; and
- (h) Ensure that disclosure is in accordance with the Companies and Allied Matters Act.

## 5.6 INCOME AND EXPENDITURE

### ***Income***

There is a close relationship between income and revenue. In some cases, income is associated with net income which connotes total revenue less expenses. Revenue is sometimes associated with non-profit organisations while income is associated with cash flow derived from business transactions. The amount of money or its equivalent received during a period of time in exchange for labour or services, from the sale of goods or property, or as profit from financial investments may be regarded as income.

The International Accounting Standards Board (IASB) “Framework for the Preparation and Presentation of Financial Statements” defines income as “increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.” The IASB definition of income encompasses both revenue and gains.

The objective of substantive procedure for income is to confirm the assertions made in the financial is correct, complete, and reported in accordance with the International Accounting Standards and the Statement of Accounting Standards.

The following substantive procedures may be adopted in verifying income:

- (a) Obtain schedules of the various classes of income reported in the financial statement; and
- (b) For each of the schedules obtained, carry out the following audit actions:

### ***Sales of Goods***

- (a) Verify that, the entity has transferred to the purchaser the significant risks and rewards of ownership of the goods;

- (b) Verify that, the entity retains neither continuing managerial involvement to the degree usually associated, with ownership nor effective control over the goods sold;
- (c) Verify that the amount has been measured reliably;
- (d) Verify that it is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and
- (e) Verify that the costs incurred or to be incurred in respect of the transaction can be measured reliably.

### ***Interest, Royalties and Dividends***

The following substantive procedures may be used:

- (a) Verify that it is probable that the economic benefits or service potential associated with the transaction does flow to the entity;
- (b) Verify that the amount of the income has been measured reliably;
- (c) Verify that interest has been recognised on a time proportion basis that takes into account the effective yield on the asset;
- (d) Verify that royalties are recognised as they are earned in accordance with the substance of the relevant agreement; and
- (e) Verify that dividends or their equivalents are recognised when the entity's right to receive payment is established.

### ***Disclosure***

The requirement should include the following:

- (a) Confirm consistency and proper disclosure of the accounting policies adopted for the recognition of income including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- (b) Verify that there is disclosure of the amount of each significant category of income recognised during the period including income arising from:
  - (i) The rendering of services;
  - (ii) The sale of goods;
  - (iii) Interest; and
  - (iv) Royalties.
- (c) Verify that there is disclosure of the amount of income arising from exchanges of goods or services included in each significant category of income.

### ***Expenditure***

Substantive procedures for expenditure aims at ensuring that assertions about expenditure in financial statements are correct, properly recorded and properly disclosed.

The following substantive procedures may be applied in the verification of expenditure:

- (a) Obtain schedules of all expenditure in their various classes;
- (b) Obtain specimen signatures of officials mandated to authorise and approve various classes of expenditure;

- (c) Select a representative sample from each class of expenditure for detail substantive testing;
- (d) Verify that each expense is properly authorised and approved including approval limits for each authorising official;
- (e) Verify that expenditure are properly classified;
- (f) Check calculations and additions for all invoices selected;
- (g) Check that value for the expense is received by inspecting delivery documents or performance reports;
- (h) Check entries in expenditure register and verify that they are correctly analysed;
- (i) Check posting to the general ledger; and
- (j) Trace expenditure total to the final accounts.

## 5.7 REVENUE AND EXPENSES

### ***Revenue***

Revenue is the gross inflow of economic benefits or service potentials during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners. Revenue includes only the gross inflows of economic benefits or service potential received and receivable by the entity on its own account. Amounts collected as agent of the government or another government organisation or on behalf of other third parties are not economic benefits or service potential which flow to the entity, and do not result in increases in assets or decreases in liabilities. Therefore, they are excluded from revenue. Similarly, in a custodial or agency relationship, the gross inflows of economic benefits or service potential include amounts collected on behalf of the principal and which do not result in increases in net assets/equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of any commission received or receivable for the collection or handling of the gross flows.

The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits or service potential will flow to the entity and these benefits can be measured reliably.

Substantive procedures for the verification of revenue lay more emphasis on recognition, measurement, classification, timing, and disclosures. Specific classes of revenue may be verified using substantive procedures more suitable for it.

### ***Rendering of Services***

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the reporting date. Substantive procedures may include the following:

- (a) Verify that the amount of revenue is measured reliably;
- (b) Verify that it is probable that the economic benefits or service potential associated with the transaction will flow to the entity;
- (c) Verify that the stage of completion of the transaction at the reporting date is measured reliably; and
- (d) Verify that the costs incurred for the transaction and the costs to complete the transaction is measured reliably.

### ***Sale of Goods***

Substantive procedures may include the following:

- (a) Verify that the entity has transferred to the purchaser the significant risks and rewards of ownership of the goods;
- (b) Verify that the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- (c) Verify that the amount of revenue has been measured reliably;
- (d) Verify that it is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and
- (e) Verify that the costs incurred or to be incurred in respect of the transaction can be measured reliably.

### **Interest, Royalties and Dividends**

The following substantive procedures may be used:

- (a) Verify that it is probable that the economic benefits or service potential associated with the transaction does flow to the entity;
- (b) Verify that the amount of the revenue has been measured reliably;
- (c) Verify that interest has been recognised on a time proportion basis that takes into account the effective yield on the asset;
- (d) Verify that royalties are recognised as they are earned in accordance with the substance of the relevant agreement; and
- (e) Verify that dividends or their equivalents are recognised when the entity's right to receive payment is established.

### ***Disclosure***

Substantive procedures should include the following:

- (a) Confirm consistency and disclosure of the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- (b) Verify that there is disclosure of the amount of each significant category of revenue recognised during the period including revenue arising from:
  - (i) The rendering of services;
  - (ii) The sale of goods;
  - (iii) Interest; and
  - (iv) Royalties.

- (c) Verify that there is disclosure of the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

### **Expenses**

Expenses are the economic costs that a business incurs through its operations to earn revenue. Examples of expense include payments to suppliers, employee wages, factory leases and depreciation. In accounting, 'expense' has a very specific meaning. It is an outflow of cash or other valuable assets from a person or company to another person or company. This outflow of cash is generally one side of a trade for products or services that have equal or better current or future value to the buyer than to the seller. Technically, an expense is an event in which an asset is used up or a liability is incurred. In terms of the accounting equation, expenses reduce owners' equity. Expenses are the decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distribution to equity participants.

Substantive procedures for expenses aim at ensuring that assertions about expenses in financial statements are correct, properly recorded and properly disclosed. The following substantive procedures may be applied in the verification of expenses:

- (a) Obtain schedules of all expenses in their various classes;
- (b) Obtain specimen signatures of officials mandated to authorise and approve various classes of expenses;
- (c) Select a representative sample from each class of expenses for detail substantive test;
- (d) Verify that each expense is properly authorised and approved including approval limits for each authorising official;
- (e) Verify that expenses are properly classified;
- (f) Check calculations and additions for all invoices selected;
- (g) Check that value for the expense is received by inspecting delivery documents or performance reports;
- (h) Check entries in expenses register and verify that they are correctly analysed;
- (i) Check posting to the general ledger; and
- (j) Trace expense total to the final accounts.

## **5.8 SALES AND PURCHASES**

### **Sales**

The audit objective is to ensure that sales invoices are properly authorised, recorded in the books of accounts to avoid understatement or overstatement of sales, and delivery made to customers.

The following substantive procedures may be applied:

- (a) Verify sales with customer orders;
- (b) Check that invoices are properly authorised;
- (c) Check price charged with official price list;
- (d) Check entries in sales day book with invoices and credit notes;
- (e) Verify that the functions of recording sales, maintaining customer accounts, and preparing statements are well segregated;
- (f) Match sales invoices with dispatch notes;
- (g) Check that all sales invoices are recorded;
- (h) Match cash receipts with invoices;
- (i) Verify that sales returns and adjustments are properly recorded and authorised;
- (j) Verify that there are proper cut-off procedures and duly complied with;
- (k) Verify that there are proper safeguards to ensure that debtors statements cannot be altered before despatch;
- (l) Verify that writing-off of bad debts are properly authorised;
- (m) Trace sales invoices to summaries;
- (n) Check summary totals to sales ledger control accounts; and
- (o) Check additions in the sales ledger control accounts.

### **Purchases**

The audit objective is to ensure that all purchases are accounted for, authorised and properly presented. The auditor should adopt the following procedures:

- (a) Randomly select a number of invoices and credit notes for detailed checking;
- (b) Obtain specimen signatures of all officials authorised to approve purchases;
- (c) Compile a schedule of the items selected and also the test to be applied;
- (d) Verify that each invoice is supported by a properly signed requisition;
- (e) Verify that each invoice is supported by an authorised copy order;
- (f) Verify that each invoice is backed by a goods received notes as evidence of delivery;
- (g) Verify that prices are authorised by the appropriate signatories;
- (h) Recompute the entries in the invoice;
- (i) Check calculations, extensions, and additions;
- (j) Check that invoices are correctly coded for ledger accounts classification;
- (k) Verify that appropriate acknowledgments such as initials or signatures appear on each purchase document;
- (l) Verify that each correct invoice has been passed for payment;
- (m) Check that each invoice is entered in the invoice register;
- (n) Check that each invoice has been posted to the purchase ledger account;
- (o) Check for completeness of purchase orders by enquiring into missing numbers;
- (p) Investigate outstanding orders;
- (q) Enquire into unmarked Goods Received notes;
- (r) Enquire into unprocessed invoices;

- (s) Check additions of invoice register; and
- (t) Agree invoice register total with purchases total account.

## 5.9 WAGES AND SALARIES

Substantive tests may be conducted, as follows:

### 5.9.1 Wages

- (a) Check gross pay with approved pay rate;
- (b) Check calculation of gross pay with number of hours worked;
- (c) Check that extra hours such as overtime is properly authorised;
- (d) Check calculation of approved deductions;
- (e) Trace deductions to check-off ledgers;
- (f) Check totals of wage sheets to wages summary;
- (g) Check additions in the summary sheet;
- (h) Check posting of summary sheet total to wages nominal ledger;
- (i) Check net cash payments to cash book;
- (j) Check that there is proper approval for wage payment; and
- (k) Verify that there is adequate procedure for the treatment of unclaimed wages and ensure that this is properly complied with.

### 5.9.2 Salaries

- (a) Verify that the engagement of new employees and discharges have been carried out in line with the organisation's policies;
- (b) Check gross salaries to employee records;
- (c) Verify proper authorisation of overtime;
- (d) Check calculation of employee salaries including re-computation of deductions;
- (e) Confirm receipt of cash paid to employees;
- (f) Confirm payment of salaries through bank transfers to employees;
- (g) Re-compute payroll sheet;
- (h) Trace totals of salary sheets to summaries;
- (i) Check additions of summary sheet;
- (j) Trace summary sheet total to nominal ledger;
- (k) Trace total of net pay to cash book;
- (l) Trace total of deductions to check-off accounts; and
- (m) Verify that there is proper approval for the payment of salaries.

## 5.10 OTHER INCOME AND EXPENDITURE ACCOUNT ITEMS

Other income refers to income derived from activities not in the normal course of business of an entity; sometimes called other revenue. Examples are interest on customers' notes, dividends and interest from investments, profit from the disposal of assets other than inventory, gain on foreign exchange, and miscellaneous rent income.

Substantive procedures to verify other income may include the following:

- (a) Obtain schedule of classes of other income;
- (b) Verify the sources of the income;
- (c) Verify that the income is properly lodged in the bank and classified;
- (d) Verify that the entity has right to the receipt of the income;
- (e) Check posting to the General Ledger; and
- (f) Verify that the income is properly disclosed in the financial statement.

## 5.11 AUDIT DOCUMENTATION

### ***Definition***

Audit documentation means the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

The International Standards on Auditing (ISA 230), Audit Documentation, emphasises the following areas as key points for audit documentation:

### ***Objectives of Audit Documentation***

- (a) The auditor should prepare, on a timely basis, audit documentation that provides:
  - (i) A sufficient and appropriate record of the basis for the auditor's report; and
  - (ii) Evidence that the audit was performed in accordance with ISAs (International Standards on Auditing) and applicable legal and regulatory requirements.
- (b) Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared subsequently;
- (c) Compliance with the requirements of this ISA together with the specific documentation requirements of other relevant ISAs is ordinarily sufficient to achieve the objectives in (b) above.
- (d) In addition to these objectives, audit documentation serves a number of purposes, including:
  - (i) Assisting the audit team to plan and perform the audit;
  - (ii) Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220, "Quality Control for Audits of Historical Financial Information;"
  - (iii) Enabling the audit team to be accountable for its work;
  - (iv) Retaining a record of matters of continuing significance to future audits;
  - (v) Enabling an experienced auditor to conduct quality control reviews and inspections in accordance with ISQC 1 (International Standards on Quality Control), "Quality Control for Firms that

- Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”; and
- (vi) Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements.

### ***Nature of Audit Documentation***

Audit documentation may be recorded on paper or on electronic or other media. It includes, for example, audit programs, analyses, issues memoranda, summaries of significant matters, letters of confirmation and representation, checklists, and correspondence (including e-mail) concerning significant matters. Abstracts or copies of the entity’s records, for example, significant and specific contracts and agreements, may be included as part of audit documentation if considered appropriate. Audit documentation, however, is not a substitute for the entity’s accounting records. The audit documentation for a specific audit engagement is assembled in an audit file.

The auditor ordinarily excludes from audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

### ***Form, Content and Extent of Audit Documentation***

The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

- (a) The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements; Audit procedures performed include audit planning, as addressed in ISA 300, “Planning an Audit of Financial Statements”;
- (b) The results of the audit procedures and the audit evidence obtained; and
- (c) Significant matters arising during the audit and the conclusions reached thereon.

The form, content and extent of audit documentation depend on factors such as:

- (a) The nature of the audit procedures to be performed;
- (b) The identified risks of material misstatement;
- (c) The extent of judgment required in performing the work and evaluating the results;
- (d) The significance of the audit evidence obtained;
- (e) The nature and extent of exceptions identified;
- (f) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained;
- (g) The audit methodology and tools used; and

- (h) It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

### ***Documentation of the Identifying Characteristics of Specific Items or Matters Being Tested***

In documenting the nature, timing and extent of audit procedures performed, the auditor should record the identifying characteristics of the specific items or matters being tested. Recording the identifying characteristics serves a number of purposes. For example, it enables the audit team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies.

Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested. For example:

- (a) For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers;
- (b) For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register);
- (c) For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report);
- (d) For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel; and
- (e) For an observation procedure, the auditor may record the process or subject matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

### ***Significant Matters***

Judging the significance of a matter requires an objective analysis of the facts and circumstances. Significant matters include, amongst others:

- (a) Matters that give rise to significant risks (as defined in ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement”);
- (b) Results of audit procedures indicating;
  - (i) that the financial information could be materially misstated, or a need to revise the auditor’s previous assessment of the risks of material mis-statement and the auditor’s responses to those risks;

- (ii) Circumstances that cause the auditor significant difficulty in applying necessary audit procedures; and
- (iii) Findings that could result in a modification to the auditor's report.

The auditor may consider it helpful, to prepare and retain as part of the audit documentation, a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters.

The auditor should document, discussions of significant matters with management and others on a timely basis.

The audit documentation includes records of the significant matters discussed, and when and with whom the discussions took place. It is not limited to records prepared by the auditor but may include other appropriate records such as agreed minutes of meetings, prepared by the entity's personnel. Others with whom the auditor may discuss significant matters include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion. The documentation of how the auditor addressed the contradiction or inconsistency, however, does not imply that the auditor needs to retain documentation that is incorrect or superseded.

### **Documentation of Departures from Basic Principles or Essential Procedures**

The basic principles and essential procedures in ISAs are designed to assist the auditor in meeting the overall objective of the audit. Accordingly, other than, in exceptional circumstances, the auditor complies with each basic principle and essential procedure that is relevant in the circumstances of the audit.

Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure, that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure. This involves the auditor documenting how the alternative audit procedures performed were sufficient and appropriate to replace that basic principle or essential procedure.

The documentation requirement does not apply to basic principles and essential procedures that are not relevant in the circumstances, i.e., where the circumstances envisaged in the specified basic principle or essential procedure do not apply.

### ***Identification of Preparer and Reviewer***

In documenting the nature, timing and extent of audit procedures performed, the auditor should record:

- (a) Who performed the audit work and the date such work was completed; and
- (b) Who reviewed the audit work performed and the date and extent of such review.

The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The audit documentation, however, evidences who reviewed specified elements of the audit work performed and when.

### ***Assembly of the Final Audit File***

The auditor should complete the assembly of the final audit file on a timely basis, after the date of the auditor's report. ISQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. As ISQC 1 indicates, 60 days after the date of the auditor's report is ordinarily an appropriate time limit within which to complete the assembly of the final audit file.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they, are administrative in nature. Examples of such changes include:

- (a) Deleting or discarding superseded documentation;
- (b) Sorting, collating and cross-referencing working papers;
- (c) Signing off on completion checklists relating to the file assembly process; and
- (d) Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the audit team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period.

ISQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. As ISQC 1 indicates, the retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.

When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:

- (a) When and by whom they were made, and (where applicable) reviewed;
- (b) The specific reasons for making them; and
- (c) Their effect, if any, on the auditor's conclusions.

When exceptional circumstances arise after the date of the auditor's report that require the auditor to perform new or additional audit procedures or that lead the auditor to reach new conclusions, the auditor should document:

- (a) The circumstances encountered;
- (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and
- (c) When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed.

Such exceptional circumstances include the discovery of facts regarding the audited financial information that existed at the date of the auditor's report that might have affected the auditor's report had the auditor then been aware of them.

## 5.12 SUMMARY AND CONCLUSIONS

Assets, are important components of an organisation's resources; this chapter was therefore devoted to the audit of assets and liabilities. Detailed coverage of various forms of assets (including tangible and intangible assets) and the relevant audit procedures associated with all the classes of assets and liabilities were given adequate coverage. The chapter concludes with audit documentation with respect to assets and liabilities as well as income and expenditure.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

## 5.13 REVISION QUESTIONS

### 5.13.1 MULTIPLE CHOICE QUESTIONS

1. The auditor's purpose for considering a class of transactions relating to inventory as a cycle is
  - A. To ensure all goods purchased before year-end are received before physical inventory count
  - B. To ensure obsolete inventory items are segregated and excluded
  - C. Restricting substantive tests from those that would otherwise be required
  - D. To discover whether a client has counted a particular inventory item or group of items
  - E. To detect write offs.

2. The auditor's count of the client's cash should be co-ordinated to coincide with the
  - A. Assessment of the internal control structure with respect to cash
  - B. Close of business on the balance sheet date
  - C. Count of inventories
  - D. Count of marketable securities
  - E. Budget date.
  
3. Which of the following is the best evidence of property ownership at the balance sheet date
  - A. Insurance policy on the property.
  - B. Tenement rate paid.
  - C. Original Certificate of Occupancy held in the client's safe.
  - D. Closing statement.
  - E. Development levy paid.
  
4. The auditor should make some test counts to
  - A. Confirm the accuracy of the client's counts
  - B. Record evidence to corroborate the existence of the inventory for later tracing to the inventory summary sheet
  - C. Random selection of inventory items and which are independently counted and compared with quantities recorded by the clients
  - D. A-C above
  - E. Solely rely on clients counts.
  
5. Which of the following is not one of the auditing techniques that might be used by an auditor to detect kiting between inter-related company banks?
  - A. Review composition of authenticated deposit slips.
  - B. Review subsequent bank statements received directly from the banks
  - C. Prepare a schedule of bank transfers.
  - D. Prepare year-end bank reconciliations.
  - E. Reliance on client's reconciliations.

### 5.13.2 SHORT ANSWER QUESTIONS

1. Often an important aspect of the audit of financial statement is the observation of the taking of the physical inventory. Required:
  - (a) What are the general objectives or purposes of the observation of the taking of the physical inventory? (Do not discuss the procedures or techniques involved in the making of the observation).
  - (b) Why would an auditor make and record test counts of inventory quantities during observation of the taking of the physical inventory?
  
2. State two factors that would influence the timing of the inventory.
  
3. Explain the term, "goodwill". State two matters which the auditor must consider before observing the inventory at year end.
  
4. What is kiting?

*Refer to Suggested Solutions in Appendix I on page 301.*

# ***APPLICATION OF INFORMATION TECHNOLOGY IN AUDITING***

## **6.0 LEARNING OBJECTIVES**

After studying this chapter, readers should be able to:

- ◆ Identify the impact of IT on Audit Functions.
- ◆ Appreciate the role of Auditors in IT security control implementation.
- ◆ Appreciate the opportunities created and challenges posed by IT application.
- ◆ Understand IT General Controls such as the COBIT, COSO and SOX Frameworks.
- ◆ Identify and apply a select number of Computer-Assisted Audit Techniques (CAATs) in the audit function.

## **6.1 INTRODUCTION**

Whilst computers have virtually replaced a lot of the manual tasks hitherto performed by human beings, such as transaction processing, payroll processing, and online teller operations as in the case of ATMs in the financial institutions, traditional auditing still retains its core objectives, of ensuring reliability of internal controls over processes and that of raising assurance of the accuracy and consistency of processing, through the normal testing and vouching processes. The `explosion' in the use of Information Technology devices and models such as, complex networks, the internet, and indeed the convergence of both telecommunication devices and networking infrastructure on a single terminal, has created virtual offices where employees and customers alike, do perform the most sophisticated transaction processing. Examples are banking transactions which use mobile phones, accounts update, ATM and vending machine operations, from the confines of people's homes and/or offices. These models while creating vast business opportunities for companies and institutions have also created a great deal of audit risks and challenges which, if unchecked, can cause devastating impacts on companies and organisations. It is noteworthy, that in the mesh of these internetworking infrastructure powered by cyberspace – the internet - and even the employees, can become potential risk agents.

## 6.2 IMPACT OF INFORMATION TECHNOLOGY ON THE AUDIT FUNCTION

The transition from 'pen/paper technology' to electronic environment has created obvious challenges for the auditor. First, there is the invisibility of data and processing, In other words, traditional paper work in which the auditor can see and feel the printed marks evidencing transaction is now disappearing, as transactions are carried out online and in most cases 'real-time form.'

Secondly, there is also the radical change in the control structure *electronic controls replacing manual controls*; for example, an auditor who opts to vouch the authenticity of a transaction carried out manually will generally look for the authorising signatures on the papers evidencing the transactions. In an electronic processing environment such authority is evidenced by the use of user identification codes and passwords which are all invisible to the naked eye. To this extent, the auditor is faced with the challenge of acquiring the necessary IT skills to see through the 'wires' or be "boxed up" in a corner, and may at best fall back to his "Black Box" to the extent he can see through the 'dark box.'

The third challenge is that of speed of processing which puts auditors on their 'toes'. Whilst an irregularity occurring in a manual environment has fifty per cent chance of being tracked before it is consummated by the perpetrators, it is not often the case within electronic environment, as the perpetrators may be done with their acts before the auditors discover. This is evident in most online frauds such as super-zapping of customers accounts, Salami Techniques, Piggybacking. A case has recently been reported of an employee of the Institute who upon receiving housing loan in excess of half a million naira which was credited to his bank account, wanted to make withdrawals the next day, only to discover that he had suffered an ATM/Cash Card fraud in excess of 500,000. The bank denied liability, claiming that the victim could have compromised his ATM credentials. This type of fraud could not have been as swift as that in a manual environment.

Fourthly, IT dynamics always challenges the auditors' competence in the business place. Changes in the IT environment occur very frequently, such that auditors are left continually catching up with the trends. Where their 'catch-up speed' is slower than developments their organisations may be at the receiving end.

## 6.3 REASONS FOR CARRYING OUT INFORMATION SYSTEMS AUDITING

The observable trend is that there are innumerable risks associated with mechanising the business environment. These may include but not limited to:

- (a) Data loss or other kinds of disasters;
- (b) Malicious destruction of electronic information;
- (c) Information theft;
- (d) Hacking by malicious agents;
- (e) Espionage activities;

- (f) Computer viruses & worms;
- (g) Unauthorised access to information and data;
- (h) Computer fraud and abuse; and
- (i) Privacy violations.

The above situations, if unchecked, could upset the balance of business controls. Since the risks should be checked, as in all cases (manually or electronically), IS auditing function should be fully in place and piloted by trained IS auditors.

#### 6.4 AUDITORS' ROLE IN INFORMATION TECHNOLOGY CONTROLS IMPLEMENTATION

'IT governance nomenclature,' is the term used to describe how those persons entrusted with governance of an entity will consider IT in their supervision, monitoring, control and direction of the entity. "How IT is applied within the entity will have an immense impact on whether the entity will attain its vision, mission or strategic goals" (Robert S. Roussey, CPA Professor at University of South California). Auditors have a role to play in ensuring that IT controls are well implemented for the overall control objective of the organisation.

Such roles as may be ascribed to auditors include:

- (a) Serving as specialists in the IT Strategy Committee, to offer advice on matters pertaining to IT controls;
- (b) Auditors should be members of the IT steering committee as key advisors;
- (c) Auditors should ascertain the management framework for IT governance, e.g. COBIT, COSO;
- (d) Auditors should get involved in the business plan development. The strategic alignment need makes this imperative;
- (e) Auditors should evaluate IT business processes, ensuring that the processes fit with the organisation's culture and structure, and the management of risks effectively;
- (f) Auditors should contribute to the implementation of IT governance by facilitating the training and awareness of risk management controls best practices;
- (g) Auditors should develop an inventory of corporate assets and apply risk assessment and ranking models to identify the technical support policies, procedures as well as policies to help users perform more efficiently and report problems;
- (h) Being conversant with the hardware/software configuration, installation, testing, packaging of management standards, policies and procedures;
- (i) Disaster recovery/backup and recovery procedures, to enable continued processing despite adverse conditions

#### 6.5 INTERNAL CONTROL ENVIRONMENT

In accounting and auditing, **internal control** is defined as a process effected by an organisation's structure, work and authority flows, people and management information systems, designed to assist the organisation to accomplish specific

goals or objectives. The COSO report further states that internal control is a means whereby an entity's board or senior management obtains reasonable assurance of the achievements of the set objectives. COSO maintains that the strength or weakness of an entity's internal control environment rests on what is called "the foundations of the internal control", namely; integrity, ethical values and the competence on the part of the personnel. The availability of the logistics stated above are described as the invisible control environment. Essentially, internal controls are process and people-driven and the people's 'mind-set' could make or mar its effectiveness.

The IT environment is similar to this notion of effective internal control. While this environment recognises people-oriented controls as postulated by COSO, it also ensures that computer applications used in running the business of the entity has adequate controls so as to create the necessary assurance of integrity, reliability and accuracy of processing.

COSO states that 'internal control' has five components, just as in IT environment, listed as follows:

- (a) Control Environment - sets the tone for the organisation, influencing the control consciousness of its people. It is the foundation for all other components of internal control.
- (b) Risk Assessment - the identification and analysis of relevant risks to the achievement of objectives, forming a basis for how the risks should be managed.
- (c) Information and Communication - systems or processes that support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- (d) Control Activities - the policies and procedures that help ensure management directives are carried out.
- (e) Monitoring - processes used to assess the quality of internal control performance over time.

## **6.6 INFORMATION TECHNOLOGY GENERAL CONTROLS (ITGC) – COBIT FRAMEWORK**

ITGC represents the foundation of the IT control structure. They assist in ensuring the reliability of data generated by IT systems. They support the assertion that systems operate as intended and that output is reliable. ITGC usually include the following types of controls:

- (a) Control Environment, or those controls designed to shape the corporate culture or "tone at the top" as enunciated by COSO;
- (b) Change management procedures - controls designed to ensure changes to meet business requirements and are authorised;
- (c) Source code/document version control procedures - controls designed to protect the integrity of program code;
- (d) Software development life cycle standards - controls designed to ensure IT projects are effectively managed;

- (e) Security policies, standards and processes - controls designed to secure access based on business need, for now;
- (f) Incident management policies and procedures - controls designed to address operational processing errors;
- (g) Technical support policies and procedures - policies to help users perform more efficiently and report problems;
- (h) Hardware/software configuration, installation, testing, management standards, policies and procedures; and
- (i) Disaster recovery/backup and recovery procedures, to enable continued processing despite adverse conditions.

## **6.7 INFORMATION TECHNOLOGY APPLICATION CONTROLS**

IT application or program controls are fully-automated (i.e., performed automatically by the systems) designed to ensure the complete and accurate processing of data, from input to output. These controls vary based on the business purpose of the specific application. The controls may also help to ensure the privacy and security of data transmitted between applications. Categories of IT application controls include:

- (a) Completeness checks - controls that ensure all records were processed from initiation to completion;
- (b) Validity checks - controls that ensure only valid data are input or processed;
- (c) Identification - controls that ensure all users are uniquely and irrefutably identified;
- (d) Authentication - controls that provide an authentication mechanism in the application system;
- (e) Authorisation - controls that ensure only approved business users have access to the application system;
- (f) Problem management - controls that ensure all application problems are recorded and managed in a timely manner;
- (g) Change management - controls that ensure all changes on production environment are implemented with preserved data integrity; and
- (h) Input controls - controls that ensure data integrity fed from upstream sources into the application system.

## **6.8 INTERNAL CONTROL FRAMEWORKS - COBIT and COSO**

### **Control Objective for Information Technology (COBIT)**

COBIT is a widely-utilised framework containing best practices for both ITGC and application controls. It consists of domains and processes. The basic structure indicates that IT processes satisfy business requirements which is enabled by specific IT control activities. It also recommends best practices and methods of evaluation of an enterprise's IT controls.

### **Committee of Sponsoring Organisations (COSO)**

COSO identifies five components of internal control: **control environment, risk assessment, control activities, information and communication** and **monitoring**. The components should be in place to achieve financial reporting and disclosure objectives. COBIT provides a similar and detailed guidance for IT, while the interrelated Val IT concentrates on higher-level IT governance and value-for-money issues. The five components of COSO can be visualised as the horizontal layers of a three-dimensional cube, with the COBIT objective domains-applying to each individually and in aggregate. The four COBIT major domains are: plan and organise, acquire and implement, deliver and support, and monitor and evaluate.

## **6.9 INFORMATION TECHNOLOGY CONTROLS AND THE SARBANES-OXLEY ACT (SOx)**

The discussion of ITGC would have been incomplete without a mention of Sarbanes-Oxley Act. SOx requires the chief executive and chief financial officers of public companies to attest to the accuracy of financial reports (Section 302) and require public companies to establish adequate internal controls over financial reporting (Section 404). Passage of SOx resulted in an increased focus on IT controls, as these support financial processing and therefore fall into the scope of management's assessment of internal control under Section 404 of SOx.

The COBIT framework may be used to assist with SOx compliance, although COBIT is considerably wider in scope. The 2007 SOx guidance from the PCAOB and SEC state that IT controls should only be part of the SOx 404 assessment to the extent that specific financial risks are addressed, which significantly reduces the scope of IT controls required in the assessment.

This scoping decision is part of the entity's SOx 404 top-down risk assessment. In addition, Statements on Auditing Standards No. 109 (SAS109) discusses the IT risks and control objectives pertinent to a financial audit and is referenced by the SOx guidance.

IT controls that typically fall under the scope of a SOx 404 assessment may include:

- (a) Specific application (transaction processing) control procedures that directly mitigate identified financial reporting risks. There are typically a few such controls within major applications in each financial process, such as accounts payable, payroll, general ledger, etc. The focus is on "key" controls (those that specifically address risks), not on the entire application;
- (b) IT general controls that support the assertions that programs function as intended and that key financial reports are reliable, primarily change control and security controls;

- (c) IT operation controls which ensure that problems with processing are identified and corrected.

Specific activities that may occur to support the assessment of the key controls above include:

- (a) Understanding the organisation's internal control program and its financial reporting processes;
- (b) Identifying the IT systems involved in the initiation, authorisation, processing, summarisation and reporting of financial data;
- (c) Identifying the key controls that address specific financial risks;
- (d) Designing and implementing controls designed to mitigate the identified risks and monitoring them for continued effectiveness;
- (e) Documenting and testing IT controls;
- (f) Ensuring that IT controls are updated and changed, as necessary, to correspond with changes in internal control or financial reporting processes; and
- (g) Monitoring IT controls for effective operation over time.

In order to comply with Sarbanes-Oxley, companies and institutions should appreciate how the financial reporting process works and ascertain the areas where technology plays a critical role. In considering which controls to include in the program, organisations should recognise that IT controls can have a direct or indirect impact on the financial reporting process. For instance, IT application controls that ensure completeness of transactions can be directly related to financial assertions.

In another development, Access Controls which may exist within these applications or within equally important supporting systems such as databases, networks and operating systems, may not directly align to a financial assertion. Similarly, Application Controls are generally aligned with a business process that gives rise to financial reports.

While there are many IT systems operating within an organisation, Sarbanes-Oxley compliance only focuses on those that are associated with a significant account or related business process and mitigate specific material financial risks. This focus on risk enabled management to significantly reduce the scope of IT general control testing in 2007 relative to prior years. Readers wishing to get more details on SOx and its related sections may visit the net or get hold of Public Company Accounting Oversight Board (PCAOB) auditing standards No.5, SEC interpretative guidance and/or American Institute of Certified Public Accountants (AICPA) auditing standard No. 109.

## **6.10 INTRODUCTION TO INFORMATION SYSTEMS AUDIT PROCESS**

IS audit process encompasses the entire practice of Information Systems auditing, including procedures and a thorough methodology which allows an Information Systems auditor to perform an audit on any IT area in a professional manner – ISACA Technical Review Manual.

In practice, the IS audit environment presents three scenarios:

- (a) Data input scenario;
- (b) Data processing stage; and
- (c) Output/Result stage, all of which constitutes the IS audit universe.

Generally, the audit activity that should be covered in the above stages is spelt out in three areas namely:

- (a) Application systems reviews;
- (b) System development reviews; and
- (c) Installation and facilities reviews

#### **6.10.1 Application Review**

This process covers audit of controls over business systems that are supported by computers. For example, applications could include:

- (a) General ledger;
- (b) Payroll;
- (c) Accounts receivable; and
- (d) Banking applications in the case of financial institutions.

Application controls are classified into:

- (a) Input controls;
- (b) Processing controls;
- (c) Output controls;
- (d) Documentation; and
- (e) Programming/Change controls.

#### **6.10.2 System Development Reviews**

This has to do with the audit of application development process. The stages in this process include review of:

- (i) Feasibility study;
- (ii) Application Development process;
- (iii) Application Testing;
- (iv) Implementation;
- (v) Documentation; and
- (vi) Maintenance.

#### **6.10.3 Installations and Facilities Review**

These are audits of operations and support functions of the computer environment. These are also called Computer Information Systems (CIS) operations review. These will cover such things as: Proper controls over installation and facilities to ensure that computer systems are operating efficiently and adequately secured from loss or damage. The following areas should be covered under the review:

- (a) Security of installations/facilities and should include:
  - (i) Physical access to the computer area;
  - (ii) Environmental controls;

- (iii) Data security; and
  - (iv) Disaster recovery issues (the ability to recover and process in the event of an interruption or disaster).
- (b) Organisation of the computer functions to ensure adequate segregation of duties. Segregation of duties ensures that no one can manipulate the processing or data for unauthorised purposes. For example, the programming function should be separate from the operating of the computer.
- (c) Data Control covering:  
Examination of controls governing the receipt of data for processing; these controls should include methods that ensure that all data was received for processing and that only authorised transactions were received.
- (d) Computer equipment; accounting for individual computer equipment, maintenance procedures should maximise the life and usefulness of the equipment.
- (e) Computer equipment controls should include:
- (i) Periodic preventive maintenance;
  - (ii) Documented maintenance agreements;
  - (iii) Service request procedures;
  - (iv) Documented procedures for use of equipment; and
  - (v) Review of equipment should include perishables and non-perishables.
- (f) Library
- (i) Library contain files used by applications and systems/ sub-system for data processing activities;
  - (ii) Magnetic tape files may also be controlled by the library; and
  - (iii) Controls should include: library management systems (manual or automated) which provides records of file location, contents, and retention periods, inventory procedures for accounting for files; and cleaning, maintenance and replacement procedures.
- (e) Programs and Systems
- (i) Establish procedures to ensure that systems and programs in live working environment are authorised and fully documented,
  - (ii) The IS auditor should evaluate the controls over support systems such as *operating systems, database management systems, telecommunications software and utility programs*.

### **6.11 INFORMATION SYSTEMS AUDIT APPROACH**

An audit approach is a series of documented audit procedures designed to achieve planned audit objectives. It comprises of:

- (a) Statement of scope of the audit;
- (b) Defined measurable audit objectives; and
- (c) An audit program

The audit methodology should be setup and should have the approval of the audit management such that consistency is maintained in the audit approach. The audit methodology as documented is a formal document and should made available to audit staff for careful perusal.

The table overleaf shows a standard IS audit methodology as adopted from the Information System Audit and Control Association Examination Technical Manual 2009.

**Table 1: Typical Phases of an Information Systems Audit Activity**

S/No.	Audit Phase	Description of audit activity
1	Audit Subject	Identify the area to be audited.
2	Audit Objective	<ul style="list-style-type: none"> <li>◆ Identify the purpose of the audit. For example, an objective might be to determine that program source code changes occur in a well-defined and controlled environment.</li> </ul>
3	Audit Scope	<ul style="list-style-type: none"> <li>◆ Identify the specific systems, function or unit of the organization to be included in the review. For example, in the previous program changes example, the scope statement might limit the review to a single application system or to a limited period of time.</li> </ul>
4.	Pre-audit Planning	<ul style="list-style-type: none"> <li>◆ Identify technical skills and resources needed.</li> <li>◆ Identify the sources of information for test or review such as functional flowcharts, policies, standards, procedures and prior audit work papers.</li> <li>◆ Identify locations or facilities to be audited.</li> </ul>
5.	Audit procedures and steps for data gathering	<ul style="list-style-type: none"> <li>◆ Identify and select the audit approach to verify and test the controls.</li> <li>◆ Identify a list of individuals to interview.</li> <li>◆ Identify and obtain departmental policies, standards and guidelines for review.</li> <li>◆ Develop audit tools and methodology to test and verify control.</li> </ul>
6.	Procedures for evaluating the test or review results	Organization specific
7.	Procedures for communicating with management	Organization specific
8.	Audit report preparation	<ul style="list-style-type: none"> <li>◆ Identify follow-up review procedures.</li> <li>◆ Identify procedures to evaluate/test operational efficiency and effectiveness.</li> <li>◆ Identify procedures to test controls.</li> <li>◆ Review and evaluate the soundness of documents, policies and procedures.</li> </ul>

(Source: ISACA Technical Manual 2009)

## 6.12 APPLICATION OF COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)

### Introduction

Business activities are now largely driven by computer. Performing an audit of any Computerised enterprise without a computer is hardly an option. Therefore CAATs refer to the use of certain computer software that can be used by an auditor to perform audits and to achieve audit excellence.

#### 6.12.1 CAAT Vs Traditional Audit approach

Traditionally auditors have come under criticisms because they reach audit conclusions based upon limited samples. It is not uncommon for an auditor to sample 20-40 transactions and declare a problem or conclude that “controls appear to be effective.” Management upon receiving the verdict of the auditors may question the validity of the audit conclusions. Management realises that they conduct thousands or perhaps millions of transactions a year and the auditor only sampled a handful. The auditors will then state that they conducted the sample based upon Generally Accepted Audit Standards (GAAS) and that their sample was statistically valid. The auditors are then forced to defend their audit approach.

Another common criticism of the audit profession occurs after a problem emerges. Whenever a problem occurs within a department, management might ask, “What was the auditor doing?” If the audit department had reviewed the area recently it becomes a sticky situation as the Audit Manager attempts to explain that the reason the problem was not identified was because the problem was outside of the scope of the audit. The audit manager might also try to explain that the sample was “a statistically valid sample with a 95% confidence level.” The Audit Committee cares only that a problem went undetected by the audit function.

#### 6.12.2 CAATs to the Rescue

CAATs addresses the problems highlighted above. CAATs, as it is commonly used, is the practice of analysing large volumes of data which look for anomalies. A well designed CAATs audit will not be a sample, but rather a one hundred per cent review of all transactions. Using CAATs the auditor will extract every transaction which the business unit performed during the period reviewed.

The auditor will then test the data to determine if there are any problems. For example, using CAATs, the auditor can find payroll data such as duplicated employee names or numbers or other data anomalies.

The CAATs auditor could also easily look for duplicate vendors or transactions. When such a duplicate is identified, they can approach management with the knowledge that they tested 100% of the transactions and that they identified 100% of the exceptions.

### 6.12.3 Classification of CAATs

There are probably four classes of CAATs, namely:

- (a) Data analysis;
- (b) Network Security Monitoring Software/Utilities;
- (c) OS and DBMS security Monitoring software/utilities; and
- (d) Software and code testing tools.

### 6.12.4 Specialised Software

In general terms, CAATs can refer to any computer program utilised to improve the audit process. Generally, however, it is used to refer to any data extraction and analysis software. This would include programs such as SAS, Excel, Access, Crystal Reports, Business Objects, etc. There are, however, two main companies that have developed specialised data analytic software specifically for auditors. They are Audit Command Language (ACL) and Interactive Data Extraction and Analysis (IDEA). A third one is InformationActive's ActiveData For Excel. This particular software is normally attached to excel spreadsheet as an add-in program.

### 6.12.5 Features of CAATs

The general feature of CAAT tools includes the ability to perform varied analytical procedures and queries as listed below:

- (a) Data Queries;
- (b) Statistics;
- (c) Stratification;
- (d) Summarisation;
- (e) Missing Numbers detection;
- (f) Duplicate Items detection;
- (g) Aging of Transactions such as inventory and receivables aging;
- (h) Sampling Functions;
- (i) Field Manipulations;
- (j) Payroll Audit as in Ghost Worker Detection; and
- (k) Exporting and Importing data files across and between different software platform such as; Access, Excel, Word, and even publish audit reports as PDF documents directly from the CAAT software.

## 6.13 GUIDELINES FOR ESTABLISHING AN INFORMATION SYSTEMS AUDIT FUNCTION

Organisations wishing to set up an IS audit function may consider the following guide:

### (a) The Information Systems Audit Charter

This is a key element in the development of the IS audit function. The charter should specify among other issues:

- (i) Objectives;
- (ii) Scope; and
- (iii) Reporting level of the IS audit function.

In developing the IS audit charter, consideration should be given to the internal audit charter, where it exists.

(b) **Organisation and Management Issues**

This has to be addressed to offer structure to the IS audit function and the following issues are considered:

- (i) Identifying the staff skill level required and ways to obtain such expertise;
- (ii) Establishing salary guidelines which conform to organisation's policies and provide competitive and fair compensation;
- (iii) Identify the activities required to support the organisation's external auditors;
- (iv) Formulating the audit schedule to plan for IS audit activities; and
- (v) Developing standards and procedures to support the IS audit function.

(c) **Staff Skills Level**

This will generally depend on the complexity of the computer systems and environment. The lowest level of skilled staff should be able to use IS audit tools, techniques and control concepts in computerised systems. They should also possess good interpersonal skills and solid understanding of management concepts. A Certified Information Systems Auditors' (CISA) qualification will surely be imperative and non-negotiable for a very complex IS environment.

- (d) Finally, the organisation must procure the necessary IS audit resources such as computer laptops; a close ration of one-to-one to each IS audit personnel is recommended, and the CAAT software of choice.
- (e) Necessary training and retraining of the IS audit personnel is also a non-negotiable consideration.

## 6.14 SUMMARY AND CONCLUSIONS

In this era of information technology where all kinds of IT models and designs are deployed in the business process, traditional auditing has to change towards the direction of IT auditing. This chapter discussed the importance of IT driven audit function; various Computer Assisted Audit Techniques (CAATs) available and concludes with general guidelines for establishing an Information Systems Audit Department.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

**6.15 REVISION QUESTIONS****6.15.1 MULTIPLE CHOICE QUESTIONS**

1. One of the following is not a risk associated with mechanising the business environment.
  - (A) Data loss
  - (B) Malicious destruction
  - (C) Authorised access to information and data
  - (D) Computer virus
  - (E) Privacy violation
  
2. One of the following is not a component of internal control as defined by the Committee of Sponsoring Organisations of the Treadway Commission (COSO)
  - (A) Control environment
  - (B) Risk assessment
  - (C) Information and communication
  - (D) Monitoring
  - (E) Outsourcing
  
3. ITGC represents the foundation of IT ————.
  - (A) Control structure
  - (B) General control
  - (C) System
  - (D) Governing control
  - (E) Communication
  
4. The controls that ensure that all application problems are recorded and managed in a timely manner is called ————.
  - (A) Authentication
  - (B) Authorisation
  - (C) Change management
  - (D) Problem management
  - (E) Input controls
  
5. How many components of internal control have been identified by the Committee of Sponsoring Organisations of the Treadway Commission (COSO)?
  - A. 4
  - B. 5
  - C. 2
  - D. 4
  - E. 1

**6.15.2 SHORT ANSWER QUESTIONS**

1. What is the name given to the process effected by an organisation's structure, work and management information systems, designed to help it accomplish specific goals and objectives?
  
2. One of the challenges auditors have to face with the impact of IT is the invisibility of data and processing as transactions are now carried out —.

3. Serving as a specialist in the IT strategy committee to offer advice on matters pertaining to IT controls is one of such \_\_\_\_\_ that may be ascribed to an auditor.
4. The IT control structure that helps ensure the reliability of data generated by IT systems and also support the assertion that systems operate as intended and the output is reliable is called \_\_\_\_\_.
5. The types of control that ensures that all records are processed from initiation to completion is called \_\_\_\_\_.

*Refer to Suggested Solutions in Appendix I on page 347*

# ***INTRODUCTION TO PUBLIC SECTOR AUDIT***

## **7.0 LEARNING OBJECTIVES**

After studying this chapter, readers should be able to understand:

- ◆ Appointment, powers and functions of the Auditor-General for the Federation, States and Local Governments.
- ◆ Auditing for compliance with legislative and related authorities.
- ◆ The role of Public Accounts Committee in the audit process.
- ◆ Internal audit in the public sector.
- ◆ Value-for-Money Audit.
- ◆ Due Process and Public Procurement Act.

## **7.1 INTRODUCTION**

A student making his first attempt at the professional examinations of the Institute of Chartered Accountants of Nigeria needs to be well grounded in the basics of public sector audit. The student needs to master the definitions of basic terms and terminologies used in public sector audit, which is a segment of the public sector financial management.

## **7.2 APPOINTMENT, POWERS AND FUNCTIONS OF THE AUDITORS-GENERAL FOR THE FEDERATION, STATES AND LOCAL GOVERNMENTS**

### **Appointment of Auditor-General**

The Auditor-General for the Federation is appointed by the President on the recommendation of the Federal Civil Service Commission, subject to confirmation by the Senate. He is appointed in accordance with the provision of Sec. 86 of the 1999 Constitution of the Federal Republic of Nigeria. The power to appoint a person to act in the office of the Auditor-General is vested in the President.

At the level of a State, a similar dispensation is put in place under the 1999 Constitution, for the Governor to appoint the Auditor-General on the recommendation of the State Civil Commission, subject, however, to the confirmation of the relevant House of Assembly. The appointment of the Auditor-General for Local Government of a State undergoes the same process outlined above.

### **Acting Capacity**

No person acts in the office of the Auditor-General for a period exceeding six months, except with the sanction of a resolution duly passed by the Senate.

### **Tenure of Office of Auditor-General**

- (a) A person holding the office of the Auditor-General for the Federation can be removed from office by the President acting on an advice supported by two-thirds majority of the Senate, praying that he be so removed for inability to discharge the functions of his office. Auditor-General shall be so removed only on account of:
  - (i) Infirmary of mind, body or any other cause; or
  - (ii) Misconduct.
- (b) The Auditor-General cannot be removed from office before such retiring age as may be prescribed by law, save in accordance with the provisions of aforementioned paragraph.

### **Powers and Functions of Auditor-General**

According to the Financial Regulations No 103 (December 2006), the Officer responsible under the Constitution of the Federation for the audit and report on the public accounts of the Federation, including all persons and bodies established by law entrusted with the collection, receipt, custody, issue, or payment of Federal Public monies or with the receipt, custody, issue, sale, transfer or delivery of any stamps, securities, stores or other property of the Government of the Federation and for the certification of the Annual Accounts of that Government is the Auditor-General for the Federation. The Auditor-General shall examine and ascertain in such manner as he may think fit the accounts relating to public funds and property and shall ascertain whether in his opinion:

- (a) The accounts have been properly kept;
- (b) All public monies have been full accounted for, and the rules and procedures applied are sufficient to secure effective checks on the assessment, collection and proper allocation of revenue;
- (c) Monies have been expended for the purposes for which they were appropriated and the expenditure have been made as authorised; and
- (d) Essential records are maintained and the rules and procedures applied are sufficient to safeguard and control public property and funds.

### **Free Access to Books and Accounts**

By virtue of the responsibilities and functions of the Auditor-General for the Federation, the officer and/or his/her representatives are permitted free access, at all reasonable times, to all files, safes, documents, books and other records relating to the accounts of all Federal Ministries/Extra-Ministerial Departments or units. They are also entitled to require and receive from members of the public services such information, reports and explanations as they may deem necessary for the proper performance of their functions.

The Auditor-General is empowered to conduct periodic checks of all government statutory corporation, commissions, authorities, agencies, including all persons and bodies established by an Act of the National Assembly.

The Auditor-General shall, within ninety days of receipt of the Accountant-General's financial statements, submit his reports to each House of the National Assembly, and each House shall cause the reports to be considered by a committee of the House of the National Assembly responsible for public accounts.

In the exercise of his functions under the Constitution, the Auditor-General is not subjected to the direction or control of any other authority or person.

### **Audit of Public Accounts**

- (a) The Auditor-General for the Federation shall be appointed in accordance with the provisions of section 86 of the Constitution of Federal Republic of Nigeria;
- (b) The public accounts of the Federation and of all offices and courts of the Federation shall be audited and reported on, by the Auditor-General who shall submit his reports to the National Assembly.  
For that purpose, the Auditor-General or any person authorised by him in that behalf shall have access to all the books, records, returns and other documents relating to those accounts; and
- (c) Nothing in sub-section 2 of this section shall be construed as authorising the Auditor-General to audit the accounts of or appoint auditors for government statutory corporations, commissions, authorities, agencies, including all persons and bodies established by an Act of the National Assembly.

Nonetheless the Auditor-General shall:

- (i) Provide such bodies with:
  - ◆ A list of auditors qualified to be appointed by them as external auditors and from which the bodies shall appoint their external auditors;
  - ◆ Guidelines on the level of fees to be paid to external auditors; and
- (ii) Comment on their annual accounts and auditors' reports thereon.
- (d) The Auditor-General shall have power to conduct periodic checks of all government statutory corporations, commission, authorities, agencies, including all persons and bodies established by an Act of the National Assembly.
- (e) The Auditor-General shall, within ninety days of receipt of the Accountant-General's financial statement, submit his reports under this section to each House of the National Assembly and each House shall cause the report to be considered by a committee of the House of the National Assembly responsible for public accounts.

- (f) In the exercise of his functions under this Constitution, the Auditor-General shall not be subject to the direction or control of any other authority or person.

### **7.3 AUDITING FOR COMPLIANCE WITH LEGISLATIVE AND RELATED AUTHORITIES**

The Auditor-General performs the external audit function of the examination of financial statements of the government and its allied activities in a financial year. The Auditor-General performs post-audit functions. The post-audit refers to the audit performed after the close of transactions in a particular period; it is a post-mortem audit. The audit takes place after the end of the financial year.

The appointment, termination and mode of operation of the Auditor-General are governed by the provisions of the Audit Act of 1956, the Nigerian Constitution and Financial Regulations of 1976 as amended.

#### **Functions**

The 'green paper' on the Role of the Comptroller and Auditor-General lists the following as the functions of the Auditor-General:

#### **Financial and Regularity Audit**

A financial audit is to ensure that:

- (a) Systems of accounting and financial control are efficient and operating properly; and
- (b) Financial transactions have been correctly authorised and accounted for.

A Regularity Audit - is that which verifies that expenditure has been incurred on approved services and in accordance with statutory and other regulations and authorities governing them (sometimes called Compliance Audit).

#### **Economy and Efficiency Audit**

This is a measurement of how economic resources are efficiently employed and deployed. It is also to highlight areas of wastes; extravagant or unrewarding expenditure. It looks into failure to maximise receipts, financial arrangements that are detrimental to the treasury and weaknesses leading to them.

#### **Effectiveness Audit**

This is an examination to assess whether programmes or projects undertaken to meet established policy goals or objectives have met their respective aims. It is also called Programme Results Audit. It aims at focused or comprehensive audit in government.

#### **Value-for-money Audit**

This is variously called Performance Audit; or Economy and Efficiency Audit. The essence is to determine whether an entity is acquiring, managing or utilising its resources in the most economical and efficient manner. It traces the causes

of any inefficiencies or uneconomical practices. Value-for-money Audit is defined as an objective professional and systematic assessment of:

- (a) The nature and function of an authority's managerial systems and procedures;
- (b) The economy and efficiency with which its services are processed; and
- (c) The effectiveness of its performance in achieving objectives.

Phases of value-for-money audit are:

- (a) **Proposal Phase:** aims at justifying the study of a particular area, authorise initial resources and determine further considered initial analysis of financial statistics, audit costs and other performance indicators.
- (b) **The Scooping Phase:** aims at gathering sufficient details. It embraces gathering working information, studying related legislations and testing controls act. At this stage there will be comprehensive management systems and objective review.
- (c) **Planning Phase:** aims at planning to fully develop identified potentials. The planning and control processes are properly analysed and methods of reviewing operating results are examined through analysis of control and reporting systems.
- (d) **Implementation Phase:** aims at reporting the audit results to those responsible for receiving or acting on them.
- (e) **Evaluation Phase:** is to evaluate the audit result, methodology and performance of the audit staff. The focus here will be assessment of efficiency and effectiveness review. Value-for-money audit aims to identify ineffectiveness in the system and under-utilisation of resources.

### **Composition of office of Auditor-General**

The Office of the Auditor-General comprises the following directorates:

- (a) Personnel Management Directorate
- (b) Finance & Supply
- (c) Planning Research and Statistics Directorate
- (d) Project Monitoring and Evaluation Directorate

The various divisions under the set-up are:

- (a) Treasury Accounts, which handles the audit of accounts and financial statements;
- (b) State Accounts, which audits the transactions of Pay Officers operating in various states;
- (c) Public Enterprises, which oversees the audit of parastatals;
- (d) Project Audit which investigates justifications of spending on government projects;
- (e) Pension which conducts pre-audit of gratuities and pensions;
- (f) Losses and Investigations that handles all cases of loss of funds; and
- (j) Annual report and P. A.C., which handle all reports and links with Public Accounts Committee deliberations.

### **Audit Queries and Alarms**

Audit queries are observations or points raised by the audit in a particular transaction seeking further clarifications. Such queries raised by Internal Auditor are pre-audit queries while those raised by the Auditor-General are termed post-audit queries.

Queries serve as an important part of the mechanism of financial control as well as valuable means of detecting and preventing errors, fraud etc.

The guidelines on Civil Service Reforms gave prominence to queries by specifying time limit for replying audit queries and possible sanctions for failure to respond. Matters on which queries may be raised can be classified as:

- (a) Irregularities resulting in losses to the government due to either fraudulent activity of the functionaries or their negligence or incompetence;
- (b) Irregularities not directly or immediately resulting in losses to government but which infringe upon budgetary and proper financial management; and
- (c) Irregularities arising through poor or inefficient management and accounting, which may lead to losses to the government.

## **7.4 ROLE OF PUBLIC ACCOUNTS COMMITTEE (PAC) IN THE AUDIT PROCESS**

### **Power to Conduct Investigation**

In line with the provisions of the Constitution, each House of the National Assembly shall have power by resolution published in its journal or in the Official Gazette of the Government of the Federation to direct or cause to be directed an investigation into:

- (a) Any matter or thing with respect to which it has power to make laws; and
- (b) The conduct of affairs of any person, authority, ministry or government department charged, or intended to be charged, with the duty of or responsibility for:
  - (i) Executing or administering laws enacted by the National Assembly, and
  - (ii) Disbursing or administering moneys appropriated or to be appropriated by the National Assembly.

The powers conferred on the National Assembly under the provisions of this section are exercisable only for the purpose of enabling it to:

- (a) Make laws with respect to any matter within its legislative competence and correct any defects in existing laws; and
- (b) Expose corruption, inefficiency or wastes in the execution and administration of laws within its legislative competence and in the disbursement or administration of funds appropriated by it.

### **Power as to Matters of Evidence**

For the purposes of any investigation under section 88 of this Constitution and subject to the provisions thereof, the Senate or House of Representatives or a committee appointed in accordance with section 62 of this Constitution shall have power to:

- (a) Produce all such evidence, written or oral, direct or circumstantial, as it may think necessary or desirable, and examine all persons as witnesses whose evidence may be material or relevant to the subject matter; and
- (b) Require such evidence to be given on oath.

This committee is invariably known as Public Accounts Committee. The purpose of the provision of the constitution and the establishment of the PAC is to expose corruption, inefficiency or waste in the execution of disbursement or administration of funds appropriated by it.

Public Accounts Committee is empowered to:

- (a) Examine such audited accounts of the Federation and of all offices and courts of the Federation and the Auditor-General report thereon as may be referred to it.
- (b) Examine:
  - (i) The Accounts and reports of ministries and Departments of the Government of the Federation;
  - (ii) The Audited Accounts of statutory corporations, boards and such other government bodies; and
  - (iii) The causes which led to, or might have led to, any excess over approved appropriations.

In the performance of its functions, the PAC is further empowered to:

- (i) Procure all such evidence, oral or written and examine such persons as it may deem necessary or desirable; and
- (ii) Require any person to produce any books, documents or records, as it may deem necessary and desirable.

The composition of PAC is geared towards functioning like a court of enquiry empowered to look into civil and criminal cases as regards allocation and disbursement and use of public funds by public officers who have been entrusted with the responsibility of judiciously using the funds, carrying out government programmes, and recommending appropriate actions against officers found wanting in carrying out their duties.

### **Basis of PAC activities**

The major bases of the PAC activities are the report of the Auditor-General. In these reports, statement of how the accounts of the government departments, agencies and ministries are examined is stated and queries raised and the response to these queries is also stated.

Consequently, all cases that are of prime importance or which the committee feels should be properly examined are then picked out of the report. Other bases of PAC activities are the cases referred to the committee by the House in respect of issues examined by it during deliberation.

### **Problems of PAC**

These include:

- (a) Political instability (either through violent change as in the military regimes or change of political party) leading to continuous changes in the composition of the committee;
- (b) Financial Statements to be examined are often in arrears;
- (c) Members are not knowledgeable in accounting and financial reporting;
- (d) Lack of co-operation and information from the expected facilitators; and
- (e) Resolutions are not always implemented amongst others.

## **7.5 INTERNAL AUDIT IN THE PUBLIC SECTOR**

The Institute of Internal Auditors defined internal auditing as “the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as a basis for protective and constructive service to management.”

### **Objectives and Scope**

The basic objective of internal auditing is to assist the management in the effective discharge of its responsibilities. The internal audit department provides this assistance by furnishing management with analysis, appraisals, recommendations and comments regarding the activities reviewed. Internal auditors can be concerned with any phase of the operations of the department/ministry. This may involve going beyond accounting and financial records to obtain a full understanding of the operation under review. Internal auditing is a managerial control in itself and a duty performed by personnel employed for such specific purpose. Internal audit exists in every Ministry/Department to carry out pre-auditing of all activities of the establishment. Pre-audit is the audit performed with the main objective of checking before payment for a transaction takes place in order to ensure compliance with the rules governing each transaction.

In order to attain the overall objective, internal audit activities should include:

- (a) Reviewing and appraising the soundness, adequacy and application of accounting, financial and other administration controls, and promoting effective controls at reasonable cost;
- (b) Ascertaining the extent of compliance with established policies, plans and procedures;
- (c) Ascertaining the extent to which the assets of the department/ministry are accounted for and safeguarded from losses of all kinds;
- (d) Ascertain the reliability of data developed or produced;

- (e) Preserving the integrity of files on which those transactions and related data are stored; and
- (f) Appraising the quality of performance in carrying out assigned responsibilities.

### **Operation of Internal Audit**

Internal auditor derives his powers from the power as delegated by the Auditor-General. Internal auditor has full access to all the department/ministry's records, properties and personnel that could be relevant to the subject under review. The internal auditor should be free to review and appraise policies, plans, procedures and records. Most of the actions carried out by the internal auditor fall within the following responsibilities executed by him in the establishment:

- (a) **Operation Audit:** which focuses on a particular activity within the establishment e.g. audit of Agricultural and Rural Development in a local government.
- (b) **Functional Audit:** which focuses on a particular function e.g. audit of salary preparation etc.
- (c) **Organisational Audit:** which focuses on all activities with the establishment globally viewed. It includes (i) & (ii) above.
- (d) **Investigation:** Focuses on ad-hoc assignments.
- (e) **Management Audit:** Focuses on advising on policies introduced from time to time by the establishment.

### **Responsibilities of Internal Auditor**

The Internal Auditor is responsible for:

- (a) Reviewing, evaluating and reporting on the adequacy or otherwise of the controls installed and operated and the extent to which they assure propriety, security, completeness and accuracy of operations of the establishment;
- (b) Performing the responsibility imposed by the Civil Service Reforms. The Reforms state that he shall carry out complete and continuous audit of accounts and records of revenue and expenditure, plant stores and assume the duty of Stock Verifier where none exists in an establishment; and
- (c) Confirmation of reliability and accuracy of extracted financial information to management.

### **Matters Influencing Setting up of Internal Audit Unit**

These include:

- (a) The necessity of the internal audit unit in the circumstances of the government, bearing in mind the provisions of Civil Service Reforms/guidelines and relevant extant laws;
- (b) Determining the size and structure of the unit;
- (c) Preparation of Audit Manual;
- (d) Recruitment of appropriate staff for respective office; and
- (e) Training and inducting the staff.

The above-stated procedures are of equal application to the audit of other tiers of government - the State and Local Governments.

## 7.6 SUMMARY AND CONCLUSIONS

This chapter has provided full coverage of the statutory as well as the constitutional provisions regarding the appointment and functions of the Auditor-General for the Federation. Similarly, functions of the Public Accounts Committee which is a unit of the National Assembly, were also detailed. The information provided in this chapter will enable readers have full understanding of the workings of the office of the Auditor-General for the Federation, as well as of the States and equivalent officers in the Local Governments, together with requirement for the audit of Public Accounts/Value-for-money audit.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

## 7.7 REVISION QUESTIONS

### 7.7.1 MULTIPLE CHOICE QUESTIONS

1. Which of the following is not part of the functions of the Auditor-General for the Federation
  - (A) The accounts have been properly kept.
  - (B) All public monies have been fully accounted for, and the rules and procedures applied are sufficient to secure an effective check on the assessment, collection and proper allocation of revenue.
  - (C) Ensuring the voted representatives occupy their seat in the assembly.
  - (D) Monies have been expended for the purposes for which they were appropriated and the expenditures have been made as authorised.
  - (E) Essential records are maintained and the rules and procedures applied are sufficient to safeguard and control public property and funds.
  
2. Offences on which the Auditor-General may raise queries in accordance with the guidelines on Civil Service Reforms can be classified as
  - (A) Irregularities resulting in losses to the government due to either fraudulent activity of the functionaries or their negligence or incompetence
  - (B) Irregularities not directly or immediately resulting in losses to government but which infringe upon budgetary and proper financial management
  - (C) Irregularities arising through poor or inefficient management and accounting, which may lead to losses to the government
  - (D) All the above
  - (E) None of the above.
  
3. In the exercise of his functions under the Constitution, the Auditor-General is:
  - (A) Subjected to the direction or control of National Assembly
  - (B) Subjected to the direction or control of the President
  - (C) Subjected to the direction or control of both the President and National Assembly

- (D) Not subjected to the direction or control of any other authority or person
  - (E) Independent to the judiciary only.
4. Auditor-General is not permitted
- (A) Access to State House
  - (B) Access to Minutes of Council of State
  - (C) Free access to books and accounts of the institution being audited
  - (D) To conduct an inquest
  - (E) All of the above.

#### **7.7.2 SHORT ANSWER QUESTIONS**

1. Who appoints the Auditor-General for the Federation?
2. For how long can a person act in the office of the Auditor-General of a state?
3. What are the powers of Public Accounts Committee?
4. Describe what the phases of Value-for-money audit are.
5. What are the functions of an internal auditor in relation to public sector account?

*Refer to Suggested Solution in Appendix I on page 301*



# AUDIT REPORTING

## 8.0 LEARNING OBJECTIVES

After studying this chapter, readers should be able to understand:

- ◆ The structure and framework of statutory audit report, appreciate instances of statement statutory and non-statutory, qualified and unqualified.
- ◆ Reviewing subsequent events, going concern status, management representation and the truth and fairness of financial statements.
- ◆ The relationship of Auditors with Audit Committees and Third Parties.

## 8.1 INTRODUCTION

Students writing the professional examinations of The Institute of Chartered Accountants of Nigeria need to understand the basics of assurance reporting. The final outcome of any audit is the issuance of the report of the auditors. The report may be **qualified** or **unqualified**. The auditors' responsibility is to give an opinion on the financial statements, based on the result of the audit. The phrase "we have audited" implies that the auditor is providing the highest level of assurance that can be given. It is important that the reader of the document in which the financial statements appear know precisely what is covered by the auditors' report and, by inference, what is not.

It is the auditors' responsibility to obtain knowledge about subsequent events up to the effective date of signing the auditors' report on the financial statements. After the financial statements and audit report have been issued, however, an auditor may become aware of new information regarding the client. If the new information refers to a condition that did not exist at the date of the audit report, or if it refers to the final resolutions of contingencies or other matters disclosed in the financial statements or the auditors' report, the auditors may not have further obligation thereon. The new information may, however, relate to facts existing at the date of the audit report that might have affected the financial statements or auditors' report had the auditors been aware of them. For example, the auditors may learn on April 14, 2008, after the financial statements for 2007 were issued, that a large receivable on December 5, 2007 believed at the balance sheet date to be collectible was in fact uncollectible because, the customer had been declared bankrupt on December 5, 2007.

In those circumstances, the auditors are obligated to pursue the matter further. They may issue a disclaimer in the circumstance if the directors do not agree to

an update of the auditors' report. The continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary.

The audit committee should normally receive information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process, for which management is responsible. The auditors normally communicate with the management of the entity which they are auditing.

The auditors obtain representation from management in the course of conducting the audit of an entity. Obtaining management representation does not absolve the auditor from any blame, in case of proven negligence.

The concepts of true and fair view, materiality and judgement guide the auditors in the conduct of the audit in that they assist the auditors to know the level and quantum of the transactions and balances to which attention has to be given and matters which should be considered in the rendering of the audit opinion.

## 8.2 AUDIT REPORT: STATUTORY AUDIT

The auditor's report that appears in illustration 8-1 overleaf indicates the wording of the standard report as prescribed by SAS No. 58, "*Report on Audited Financial Statements.*"

### Organisation and Wording

The following paragraphs explain the language used in the standard report on audited financial statements of an entity:

- (a) **Title**  
The title should include the phrase "Auditor's Report." This is intended to remind the reader of the credibility an audit adds to the financial statements because of the auditor's independence.
- (b) **Introductory paragraph**  
The opening paragraph of the report identifies the financial statements that are audited and states that management is responsible for them. The auditor's responsibility is to give an opinion on those statements based on the result of the audit. The phrase "we have audited" implies that the auditor is providing the highest level of assurance that can be given. The introductory paragraph also specifies the dates and periods covered by the financial statements that are audited.

It is important that the reader of the document in which the financial statements appear knows precisely what is covered by the auditor's report and, by inference, what is not. Since an annual report or prospectus contains much more than financial statements, the reader should be told specifically what has been audited (the financial statements and the related notes that are, as stated on each page of the financial statements and what, by implication, has not been audited, such as the Chairman's Statements and Report of Directors,

financial ratios, and information about stock prices. An example of a report of the auditors is set out below:

### **ILLUSTRATION 8-1: STANDARD AUDIT REPORT**

#### **REPORT OF THE AUDITORS**

##### **To Members of XYZ Limited**

We have audited the financial statements of XYZ LIMITED as at December 31, 2008, which have been prepared on the basis of the accounting policies on page x.

##### **Respective Responsibilities Of Directors And Auditors**

The company's directors are responsible for the preparation of the financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and report our opinion to you.

##### **Basis of Opinion**

We conducted our audit in accordance with the Nigerian Standards on Auditing. 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 the significant estimates and judgement 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 obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements.

The financial statements are in agreement with the books of accounts which have been properly kept, and we obtained the information and explanation we required.

##### **Opinion**

In our opinion, the financial statements give a true and fair view of the state of affairs of the company as at December 31, 2008 and of the profit and cash flow for the year then ended and have been properly prepared in accordance with the Companies and Allied Matters Act, CAP C20, LFN 2004, and relevant statements of accounting standards issued by the Nigerian Accounting Standards Board.

.....  
**ABR & CO.**  
**CHARTERED ACCOUNTANTS**  
**LAGOS, NIGERIA.**

DATE .....

**(c) Scope Paragraph**

The scope paragraphs describe the auditor's basis for forming the opinion on the financial statements. Informing the reader that the audit was conducted in accordance with the Nigerian Standards on Auditing, which are adaptations of International Standards on Auditing, is tantamount to affirming that the auditor has complied with the standards established by the auditing profession for performing an audit. The auditor's objective in performing an audit is to gather enough evidence to enable him to provide reasonable assurance, not a guarantee, that the financial statements do not contain material mis-statements. A mis-statement is considered material if it is probable that the judgement of a reasonable person relying on the financial statements would have been changed or influenced by the mis-statement.

The scope sketches what an audit entails. It highlights that evidence about the accounting measurements and disclosures in the financial statements were obtained only on a test basis. The report specifically states that assessing the client's accounting principles, the estimates that are part of the financial statements and the overall financial statement presentation are the key elements of an audit. Lastly, the auditor explicitly states that the evidence obtained and evaluated in the course of the audit was sufficient to support the opinion given.

**(d) Opinion Paragraph**

The opinion paragraph of the auditor's report – usually the third, and final, paragraph – states the auditor's conclusions reached from the work performed. The auditor's opinion represents a judgement made after evaluating evidence about the assertions implicit in the financial statements; the phrase "in our opinion" is intended to convey this element of judgement, as opposed to a statement of fact or guarantee.

The conclusion the auditor reaches in most audits, is that the financial statements "give a true and fair view ... in accordance with". The opinion illustrated here is technically called an **unqualified opinion**, i.e., it is not qualified by any exceptions. A less technical term for an unqualified opinion is a "clean" opinion. Although authoritative audit literature describes other types of opinions (qualified opinions, adverse opinions, and disclaimers of opinion), the usual expectation is that the auditor will be able to render a positive, unqualified opinion. Anything less is usually undesirable, and often unacceptable either to the client or to regulatory bodies. Users of financial statements are best served if the client's financial statements do "give a true and fair view" in conformity with accepted accounting principles. Thus, auditors have a responsibility to both the public and their clients to assist clients in receiving unqualified opinions by seeking to improve their financial reporting practices, whenever practicable.

- (e) **Routine Variations In the Standard Report**  
Routine variations in the wording of the standard report include the party or parties to whom it is addressed, the identification of the statements reported on, the period(s) covered, and the date of the report. An auditor should not alter the standard report unless there are problems or unusual conditions to be highlighted. Alterations should follow the carefully drawn rules referred to in the other sections of this chapter. This is so because, any departure from the standard words is usually regarded as some sort of warning to the reader.
- (f) **Addressing The Report**  
The report may be addressed to the client company itself or to its board of directors or shareholders. The auditors have a responsibility to the owners of a business enterprise and therefore the report should be addressed to the members of the company (normally the shareholders), partners or proprietors. An auditor's ultimate responsibility is to the shareholders rather than the company or its management.
- Sometimes an auditor is retained to audit the financial statements of a non-client company on behalf of a client. In that case, the report should be addressed to the client and not the company being audited or its directors or shareholders.
- (g) **Identification of Financial Statements**  
The financial statements should be clearly identified, usually in the introductory paragraph. The exact name of the company should be used and the statements audited should be enumerated. Generally, these are accounting policies, the balance sheet, the statement of income and retained earnings, and the statement of cash flows - generally referred to as the financial statements. If any other statements are covered by the report, they should also be enumerated.
- (h) **Periods Covered**  
The periods reported on should also be specified. It is a standard norm to report on the financial statements of one year with the comparative figures for the previous year. Companies whose securities are registered with the Securities and Exchange Commission are required to present a five-year financial summary in their annual report and accounts. A continuing auditor should update his or her report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.
- (i) **Dating the Report**  
Inevitably, an auditor's report is issued on a date later than the end of the period being reported on because it takes time to close the books, prepare financial statements and complete final auditing procedures.

International Auditing and Assurance Board (IAAB) states that: “the auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that the entity’s complete set of financial statements has been prepared and that those with the recognised authority have asserted that they have taken responsibility for them.”

The date of the auditor’s report informs the reader that the auditor has considered the effect of events and transactions of which he became aware and that occurred up to that date. The auditor’s responsibility for events and transactions after the date of the auditor’s report is addressed in International Standard on Auditing (ISA) 560, “*Subsequent Events*.”

The auditor’s report should be dated after the audit field work is completed. It is dated after all statements and all other information contained in financial statements have been approved by the directors, and the auditors have considered all necessary available evidence. Matters that may require follow-up with the client, particularly if performed off the client’s premises, generally do not affect the date of the auditor’s report.

“The date of an auditors’ report on a reporting entity’s financial statements is the date on which the auditors signed their report expressing an opinion on those statements.” Please see, *Auditors’ Report on Financial Statements*.

### **Dual Dating**

The following may require adjustment or disclosure in the financial statements:

- (a) Subsequent events that occur after the date of the auditor’s report but before the report is issued; and
- (b) Such events that come to the auditor’s attention after the report is dated and issued.

If such an event is disclosed, the auditor can either re-date the report as of the date of that event or use “dual dating.” In practice, unless the time period is very short, dual dating is more common because of the additional work necessary for the extended period if the report is re-dated.

An auditor may be required or requested to re-issue a report after it was first issued. If the auditor is aware of subsequent events that occurred after the date of the original report, these alternatives are possible:

- (a) For events that require adjustment of the previously issued financial statements, the report should be dual dated.
- (b) For events that require disclosure only, the auditor may dual date the report, or the disclosure may be included in an additional (usually the last) note to the financial statements.

## Uncertainties

Management is expected to evaluate and reach a reasoned conclusion on all matters materially affecting financial position and results of operations, and an auditor is expected to review and form an opinion on those conclusions. Sometimes, however, the financial statements are affected by uncertainties concerning future events, such as a lawsuit, the outcome of which cannot be reasonably estimated by neither management nor the auditor. Such uncertainties may give rise to explanatory paragraphs in the auditor's report, or possibly even to disclaimers when the uncertainties are pervasive.

SFAS 5, Accounting for Contingencies classified potential losses due to uncertainties as "probable," "reasonably possible," or "remote."

- (a) If loss is probable, management must provide for it in the financial statements, either by accruing it, if the amount is susceptible to reasonable determination or by disclosing it, if the amount is susceptible to reasonable determination or by disclosing it, if the amount cannot be reasonably estimated. No explanatory language is needed in the auditor's standard report if the auditor agrees that the provision or disclosure is appropriate; if the amount cannot be reasonably estimated, however, the auditor should add an explanatory paragraph to the report because of the uncertainty.
- (b) Likewise, a "remote" uncertainty would not require an explanatory paragraph in the standard report.
- (c) If a material loss is "reasonably possible," however, management is required to disclose the uncertainty in the notes to the financial statements, including an estimate of the amount, and the auditor would normally add an explanatory paragraph to the report.

For instance, if the outcome of a matter having an impact on the financial statements depends on the decisions of others, it may be impossible for management and the auditor to reach a valid conclusion about it because competent evidential matter simply does not exist. The most common events of that kind are lawsuits and tax disputes. The mere existence of an unresolved question does not relieve management or the auditor of the responsibility for forming a judgement about the outcome. The outcome of many tax disputes, for instance, can be reasonably determined by an informed analysis. In some cases, however, the best possible efforts result in a judgement that no valid conclusion can be formed. In that event, the auditor should describe the uncertainty in a separate explanatory paragraph following the opinion paragraph of the report, along with an indication that its outcome cannot presently be determined. The separate paragraph may be shortened to refer to disclosures made in a note to the financial statements.

An example of the wording of a report containing an explanatory paragraph describing an uncertainty affecting the financial statements is given hereunder:

*(Separate paragraph following the opinion paragraph)*

As discussed in Note x to the financial statements, the company has filed an appeal with the Supreme Court as defendant against a judgement awarded against the company. The ultimate outcome of the litigation cannot at present be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the company's financial statements.

## **THE LIKELIHOOD AND MATERIALITY OF UNCERTAINTIES**

### **Tests of Likelihood of Uncertainties**

The auditor should use professional judgement in considering whether a loss resulting from the resolution of an uncertainty is sufficiently likely and material to require adding an explanatory paragraph in the report.

- (a) If the likelihood of a material loss were only remote, no explanatory paragraph would be necessary.
- (b) If it is probable (likely) that a material loss will occur, but management cannot make a reasonable estimate of the amount or range of the potential loss and thus cannot accrue the loss in the financial statements, the auditor should add an explanatory paragraph.
- (c) If the chance of a material loss is "reasonably possible" (that is, more than remote but less than probable), whether or not an explanatory paragraph should be added depends on the likelihood of the loss occurring (for example, where a client defendant appeals against a judgement awarded to a Superior Court), and on by how much the possible loss exceeds the auditor's materiality threshold.

### **Tests of Materiality of Uncertainties**

SAS 58, *Report on Audited Financial Statements*, offers the following guidance regarding materiality considerations in situations where uncertainties exist: "Materiality judgements involving uncertainties are made in the light of the surrounding circumstances. Some uncertainties relate primarily to financial position, while others more closely relate to results of operations or cash flows. Thus, for purposes of evaluating the materiality of a possible loss, the auditor should consider which, if any, of the financial statements is the more appropriate base in the circumstances.

Some uncertainties are unusual in nature, or infrequent in occurrence and thus more closely related to financial position than to normal, recurring operations (for example, litigation relating to alleged breach of contractual obligations). In such instances, the auditor should consider the possible loss in relation to shareholder's equity and other relevant balance sheet components such as total assets, total liabilities, current assets and current liabilities.

In other instances, the nature of an uncertainty may be more closely related to normal, recurring operations (for example, litigation with a party to a royalty agreement concerning whether a royalty fee should be paid on certain revenue). In such circumstances, the auditor should consider the possible loss in relation to relevant income statement components such as income from continuing operations."

### **Lack of Consistency**

Auditor's report shall identify those circumstances in which generally accepted accounting principles (GAAP) have not been consistently observed in the current period in relation to the preceding period.

The consistency standard requires an auditor to inform readers in the report if GAAP have not been applied consistently from period to period. Consistency within a period and between periods is presumed unless otherwise disclosed.

The objective is to ensure that changes in accounting principles that materially affect the comparability of financial statements between periods are highlighted in the auditor's report as well as in the financial statements.

Changes in accounting principles occur fairly often. Companies from time to time change managements, operating philosophies, or judgements about which accounting principles are most appropriate for the company. Any significant change in accounting principle or method of applying a principle should be referred to in the auditor's report in an explanatory paragraph (following the opinion paragraph). The paragraph should identify the development and refer to the note in the financial statements that discusses the change.

### **Departures From Unqualified Opinions**

SAS 58, *Reports on Audited Financial Statements*, classifies departures from the standard unqualified reports as **qualified opinions**, **adverse opinions**, and **disclaimers of opinion**. These departures are discussed as follows.

#### **Qualified opinions**

There are two basic reasons for qualifying an opinion, viz:

- (a) Limitations on the scope of the audit; and
- (b) Departures from General Accepted Accounting Principles (GAAP), International Standard on Auditing (ISA), Nigeria Standard on Auditing (NSA).

#### **Scope of Limitations**

An audit can be limited in scope:

- (a) By circumstances beyond the client's control that preclude the auditor from employing the auditing procedures that would otherwise be considered necessary; and
- (b) By client-imposed restrictions.

#### **Circumstances Precluding Necessary Auditing Procedures**

Sometimes an auditor is not able to carry out procedures that customarily are considered necessary in the circumstances as a basis for rendering unqualified opinion. In most instances, the auditor is able to design and perform alternative procedures that provide sufficient assurance that the relevant audit objectives and procedures have been achieved. Those common instances in which the auditor might not be able to perform alternative procedures are when conditions make it very difficult to confirm accounts receivable or observe inventories.

If an auditor cannot obtain satisfaction by means of alternative auditing procedures, he should:

- (a) Describe the problem;
- (b) Modify the standard report; and
- (c) Describe the problem in a separate paragraph and refer to it in both the scope paragraph and the opinion paragraph if the auditor decides to express a qualified opinion (rather than disclaim an opinion).

### **Client-imposed Restrictions**

The most common client-imposed restrictions are limitations preventing observation of physical inventories, confirmation of accounts receivable, or examination of a significant subsidiary. Usually, if scope is limited by client-imposed restrictions, auditors should disclaim an opinion because the client's election to limit the auditor's scope implies also an election to limit the auditor's responsibility. Very rarely, if a client-imposed scope limitation applies to an isolated transaction or a single account, a qualified opinion may be acceptable.

### **Departures from GAAP**

Financial statements should be presented in conformity with Generally Accepted Accounting Principles; any departures from GAAP are infringements. Such departures are rare in practice because most companies believe that an auditor's opinion qualified because of a departure from GAAP carried intolerable implications, and so they use accounting principles that are generally accepted. Such qualified opinions are rarely acceptable in SEC filings. Nevertheless, instance of departures sometimes occur; the most common ones are described and examples presented in the following paragraphs:

#### **Departure Related to Accounting Changes**

SAS 58, *Reports on Audited Financial Statements*, requires the auditor to evaluate a change in accounting principle in order to be satisfied that:

- (a) The newly adopted accounting principle is GAAP;
- (b) The method of accounting for the effect of the change is in conformity with GAAP; and
- (c) Management's justification for the change is reasonable.

In other words, the presumption that an entity should not change an accounting principle may be overcome only if the entity justifies the use of an alternative acceptable principle on the basis that it is preferable.

Auditors shall express a qualified opinion or, if the effect is material, express an adverse opinion on the financial statements if:

- (a) There are no reasonable justification for the change;
- (b) The change does not meet other conditions previously mentioned, the auditor should express a qualified opinion; and
- (c) The effect of the change is sufficiently material.

Accounting changes that result in qualified or adverse opinions should also trigger similar opinions in future years as long as the change continues to have a material effect on either, the subsequent year's financial statements, or those of the year of the change when presented for comparative purposes.

### **Adverse Opinions**

An adverse opinion expresses a belief that financial statements are not presented fairly in conformity with generally accepted accounting principles or otherwise do not present fairly, what they purport to present. It is required when an auditor believes that one or more departures from GAAP are sufficiently material to make the statements as a whole misleading. It should be noted that an auditor can not sidestep an adverse opinion by disclaiming an opinion.

When an adverse opinion is issued, the opinion paragraph should include a reference to a separate paragraph in the auditor's report that discloses all the reasons for the adverse opinion, including any reservations, the auditor may have regarding fair presentation in conformity with GAAP, other than those that gave rise to the adverse opinion.

Adverse opinions are rare. It is much better for all concerned to correct the conditions before such an opinion is issued, and when it is within the client's power to correct them. Adverse opinions are sometimes issued on financial statements of a regulated company that are prepared in accordance with a basis of accounting prescribed by a governmental agency, and are presented other than in filings with the agency. In that situation, the auditor generally should issue either a qualified or an adverse opinion. Depending on the materiality of the departures from GAAP, an additional paragraph of the report, shall express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting.

### **Disclaimers of Opinion**

Auditors give disclaimers of opinion when they do not have enough evidence upon which to form an opinion. A disclaimer can result from an inability to obtain sufficient competent evidential matter, because the scope of the audit was seriously limited. In addition, while SAS 58, *Reports on Audited Financial Statements*, indicates that the addition of an explanatory paragraph to the auditor's report serves adequately to inform financial statement users when there are uncertainties, an auditor may decline to express an opinion in some cases involving uncertainties.

SAS 58, *Reports on Audited Financial Statements*, requires that the reasons for a disclaimer must be given in a separate paragraph of the report. The auditor is also required to disclose in a separate paragraph any reservations about fair presentation in conformity with GAAP. It would be misleading for an auditor to issue a disclaimer if a basis for an adverse or a qualified opinion existed. Adverse opinions and disclaimers of opinion are never interchangeable, nor can an auditor's report contain both an adverse opinion and a disclaimer of

opinion. A report may, however, contain an opinion that is qualified for more than one reason. For example, an opinion may be qualified because of a scope of limitation and because of a departure from GAAP.

**Comparison Between Adverse Opinion and Disclaimer of Opinion**

There is a fundamental difference between departures from GAAP which affect the quality of the financial statements, and scope of limitations, which affect the sufficiency and competence of audit evidence.

- (a) Departures from GAAP call for a qualified opinion because of the auditor’s reservations about the quality of the financial statements;
- (b) Where departures from GAAP become glaring as to make the financial statements useless, it is an adverse opinion;
- (c) A scope limitation, that affects the degree of assurance contained in the opinion and arising from:
  - (i) client-imposed limitations; and
  - (ii) the result of circumstances; will result in an expression of disclaimer of opinion.

The following tabulation helps to keep in perspective the distinctions among qualified opinion, adverse opinion and disclaimers of opinion.

Condition	Degree of Materiality or Pervasiveness	Types of opinion
Departures from GAAP	Low	Qualified opinion
Departures from GAAP	High	Adverse opinion
Scope limitations: Client-imposed	High	Disclaimer of opinion
Due to circumstance	Low	Qualified opinion

**8.3 REVIEWING SUBSEQUENT EVENTS**

**Types of Subsequent Events**

Subsequent events are situations or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements and auditor’s report, that have material effect on the financial statements and therefore require adjustment or disclosure in the statements. Subsequent events that occur after the balance sheet date, but before the issuance of the financial statements and the auditor’s report are usually of two categories, viz:

- (a) Those that require the adjustments of account balances; and
- (b) Those that should not be recorded but should be disclosed in the financial statements.

The first type of subsequent event is described as the developments that provide additional evidence with respect to conditions that existed at the balance sheet date, and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the

conditions on which the estimates were based. The financial statements are adjusted for any changes in estimates resulting from the use of such evidence.

The second type of subsequent event is one that provides evidence about conditions that did not exist at the balance sheet date but arose afterwards. These events should be reflected in the financial statements of the year in which they occurred, and should not result in adjustment of the statements of the year being reported on. Some of these events, however, may be significant enough to require disclosure; otherwise the prior-year financial statements would be misleading. They include all transactions and other events and circumstances having significant financial impact. Some examples are business acquisition and casualty losses.

The distinction is often a fine one to make. Deteriorating market conditions subsequent to year-end could be a new condition that merely requires disclosure, or it could be evidence of a condition that was inherent in the inventory at year-end, which calls for adjusting it to net realisable value. Similarly, a subsequent event that reveals that estimated expenses are insufficient because of conditions occurring after the balance sheet date should be disclosed. On the other hand, if the reason for the insufficiency is newly discovered evidence of conditions, that existed at the balance sheet date, that evidence should be reflected in the expense and related asset or liability accounts on the face of the statements.

There is a third type of subsequent event - one occurring after year-end that requires neither adjustment nor disclosure in the financial statements. Events that do not affect the interpretation of financial statements should not be disclosed because describing them in notes could cause misleading or confusing inferences. Since every event may have a financial impact, it is often very difficult to distinguish between events that should and those that should not be disclosed in the financial statements. Strikes, changes in customers or management, and new contracts and agreements are examples of events that ordinarily should not be disclosed in the financial statements, although management may have a responsibility to make public disclosure apart from the financial statements. If the events occur before the annual report to shareholders is printed, the Chairman's letter is often used as a convenient method of communication.

International Standard on Auditing, ISA 560, "*Subsequent Events*" states that "the auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence, that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. These procedures are in addition to procedures which may be applied to specific transactions occurring after period end to obtain audit evidence as to account balances as at period end, for example, the testing of inventory cut-off and payments to creditors.

The auditor is not, however, expected to conduct a continuing review of all matters to which previously applied audit procedures have provided satisfactory conclusions.

The audit procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report. Such audit procedures take into account the auditor's risk assessment and ordinarily include the following:

- (a) Reviewing the procedures that management has established to ensure that subsequent events are identified;
- (b) Reading minutes of the meetings of shareholders, those charged with governance, including established committees such as relevant executive committees and the audit committee, held after period end and inquiring about matters discussed at meetings for which minutes are not yet available;
- (c) Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports;
- (d) Inquiring, or extending previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims;
- (e) Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements. Examples of inquiries of management on specific matters are: the current status of items that were accounted for on the basis of preliminary or inconclusive data;
- (f) Whether new commitments, borrowings or guarantees have been entered into;
- (g) Whether sales or acquisition of assets have occurred or are planned;
- (h) Whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned;
- (i) Whether any assets have been appropriated by Government or destroyed, for example, by fire or flood;
- (j) Whether there have been any developments regarding risk areas and contingencies;
- (k) Whether any unusual accounting adjustments have been made or are contemplated;
- (l) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption; and
- (m) "When a component, such as a division, branch or subsidiary, is audited by another auditor, the auditor would consider the other auditor's procedures regarding events after period end and the need to inform the other auditor of the planned date of the auditor's report."

### **Auditor's Responsibility for Subsequent Events**

The auditor's responsibility for subsequent events depends on whether they occurred before or after the date of his report. Auditors have no responsibility to seek any additional evidence in the period between the date of the auditor's report and the date the financial statements and auditor's report are issued. Nevertheless, many auditors believe that while they have no responsibility to seek additional evidence during that period, they do have a responsibility not to ignore information that comes to their attention.

### **Auditing Procedures in the Subsequent Period**

The auditor has responsibility to determine whether relevant subsequent events have occurred and discuss auditing procedures required to be performed in the subsequent period. That work generally falls into two major categories:

- (a) Procedures performed for the purpose of keeping abreast of events occurring in the subsequent period; and
- (b) Completion of auditing procedures performed for other purposes.

The latter category consists of substantive tests and other auditing procedures that involve reviewing transactions occurring in the subsequent period as part of the audit of year-end account balances. These procedures include tests of the client's cash `cut-offs', sales and purchase `cut-offs', and reviews of collections and payments after year-end. The auditor, however, has no responsibility to carry out any auditing procedures for the period after the report date.

The procedures for keeping abreast of events occurring in the subsequent period may be summarised as follows:

- (a) Read all available information relating to the client's financial affairs: interim financial statements; minutes of meetings of stockholders, directors, and any appropriate committees; pertinent variance and other management reports, and the like. An auditor who understands the client knows which areas are sensitive or volatile and what information about them is likely to be available;
- (b) Make inquiries about such things as financing activities, unusual entries or adjustments in the accounts, and potential problems discovered during the audit. An auditor who has developed a close working relationship with the client can make those inquiries easily and expeditiously;
- (c) Inquire of client's legal counsel concerning litigation, claims, and assessments; and
- (d) Obtain a letter of representation from client officers describing subsequent events or disclaiming knowledge of any.

In addition, as part of the subsequent-period review, the auditor may compare the latest available interim financial statements with the financial statements being reported on, as well as making other comparisons considered appropriate in the circumstances.

It is sometimes necessary in the subsequent period to perform analytical procedures or other substantive tests in a recognised problem area. The purpose is to form an opinion on whether a client has measured the impact of a subsequent event reasonably. Sometimes, however, tests are required to satisfy the auditor that a possible subsequent event did not occur; an example is tests of the net realisable value of inventories due to changed market conditions subsequent to year-end.

### **Responsibilities after Report Date**

Clearly, the auditor is not obligated to keep watch indefinitely; the responsibility ends with the issuance of the financial statements. There is a significant distinction between the discovery of subsequent events before the financial statements are issued and later discovery of facts that existed at the date of auditor's report. The distinction is as follows:

- (a) If the new information refers to:
  - (i) A condition that did not exist at the date of the audit report; or
  - (ii) Final resolutions of contingencies or other matters disclosed in the financial statements or the auditor's report; and
  - (iii) The auditor having no further obligation.
- (b) If the new information:
  - (i) Relates to facts existing at the date of the audit report;
  - (ii) Would have affected the financial statements; or
  - (iii) Would have affected the auditor's report had the auditor been aware of them.

The auditor is obligated to pursue the matter. The obligation exists in those circumstances even if the auditor has resigned or has been discharged.

While the distinction between the two kinds of new information is conceptually clear, in practice it is often difficult to tell, at least initially, whether the new information refers to a new or a pre-existing condition. The auditor should ordinarily discuss the information with the client and request that the client make any necessary investigations. These could be situations in which the auditor would find it desirable to seek the advice of legal counsel.

### **Auditing Procedure in the Subsequent Period**

The auditor is guided on steps to be taken on subsequent events as follows:

- (a) If the information is found to be reliable and to have existed at the date of the auditor's report, the client should be advised to disclose the *facts* and their *effects* on the financial statements;
- (b) Revised financial statements and auditor's report should be issued;
- (c) The reason for the revisions should be described in a note to the financial statements and referred to in the auditor's report; and
- (d) The auditor may include an explanatory paragraph to emphasise the revision.

Where the client's management refuses to make the appropriate disclosures:

- (a) When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and the auditor's report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion;
- (b) When the auditor's report has been released to the entity, the auditor would notify those persons ultimately responsible for the overall direction of the entity, not to issue the financial statements and the auditor's report thereon to third parties. If the financial statements are subsequently released, the auditor needs to take action to prevent reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations;
- (c) The auditor should obtain the advice of legal counsel;
- (d) The auditor should notify each member of the client's board of directors of that refusal;
- (e) The auditor should notify each member of the client's director of the steps the auditor wish to take to prevent future reliance on the auditor's report;
- (f) Unless the auditor's counsel recommends otherwise, the auditor should notify the client that the auditor's report is no longer to be associated with the financial statements;
- (g) Where applicable, the auditor should notify the SEC, stock exchanges, and any other regulatory bodies involved, of the situation and the withdrawal of the report;
- (h) The auditor should request that steps be taken to accomplish the necessary public disclosure/notification; and
- (i) The auditor should also notify any others who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.

The disclosures made by the auditor to regulatory agencies and other parties should, if possible, describe the information and its effect on the financial statements and the auditor's report. The description should be precise and factual and should avoid references to conduct, motives, and the like.

### 8.3.1 Going Concern Status

When forming an opinion as to whether financial statements give a true and fair view, IAS 1, *Presentation of Financial Statements*, stipulates that the auditors are required to consider the entity's ability to continue as a going concern, and any relevant disclosures in the financial statements.

One specific type of uncertainty the auditor must consider is the client's continued existence as a "going concern." The concept that financial statements are prepared on the basis of a going concern is one of the basic tenets of financial accounting. Because the going concern

assumption is so basic, the standard auditor's report does not make reference to it.

SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, responds to the fact that an auditor may detect risk during an audit that can lead to the need to question an entity's ability to continue as a going concern (i.e., have the ability to continue operation and meet obligations). "The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period to time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a reasonable period of time).

The auditor's evaluation is based on his knowledge of relevant conditions and events that exist at or have occurred prior to the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited."

An entity's going concern is in doubt when it can continue in operation and meet its obligations only on condition that:

- (a) It sells substantial amounts of its assets outside the ordinary course of business; and
- (b) its creditors are willing to forgive or restructure its debt.

Doubts about the entity's continued existence should also raise questions about:

- (a) Realisable value of assets;
- (b) The order of payment of liabilities;
- (c) The proper classification and carrying amounts of both; and
- (d) The appropriateness of necessary financial statement disclosures.

### **What Auditor Needs To Do**

If the auditor concludes there is substantial doubt about the entity to continue as a going concern for a reasonable period of time (not to exceed one year from the date of the financial statements), the auditor should:

- (a) Determine that this fact is appropriately disclosed in the financial statements; and
- (b) Reflect that conclusion in explanatory paragraph.

In a properly planned audit, it should not be necessary to design auditing procedures specifically directed at the going concern issue. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. For example, conditions and events that could raise doubts may be identified through some of the following procedures:

- (a) Analytical procedures;
- (b) Review of subsequent events;
- (c) Review of compliance with the terms of debt and loan agreements;
- (d) Reading of minutes of meetings of stockholders, board of directors, and important committees of the board;
- (e) Inquiry of the entity's lawyers about litigation, claims and assessments; and
- (f) Confirmation with related and third parties of the details of arrangements to provide or maintain financial support.

In considering the evidence provided by those procedures, it may be necessary for the auditor to obtain additional information about conditions and events identified that could create substantial doubt about the entity's ability to continue as a going concern. SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, gives the following examples of such conditions and events, some of which are interrelated:

*Negative trends:* These are situations where the following trends are the order of the day:

- (a) Recurring operating losses;
- (b) Working capital deficiencies;
- (c) Negative cash flows from operating activities;
- (d) Adverse key financial ratios.

*Other indications of possible financial difficulties*

These consist of:

- (a) Default on loan or similar agreements;
- (b) Dividends in arrears;
- (c) Denial of usual trade credit from suppliers;
- (d) Restructuring of debt;
- (e) Non-compliance with statutory capital requirements;
- (f) Need to seek new sources or methods of financing or to dispose of substantial assets (outside the course of business).

*Internal matters*

Internal matters may be discussed, as follows:

- (a) Work stoppages or other labour difficulties;
- (b) Substantial dependence on the success of a particular project;
- (c) Uneconomic long-term commitments;
- (d) Need to overhaul operations.

*External matters that have occurred* – Examples are:

- (a) Legal proceedings, legislation, or similar matters that might jeopardise an entity's ability to operate;
- (b) Loss of a key franchise, licence, or patent; loss of a principal customer or supplier;

- (c) Uninsured or underinsured catastrophe such as fire, flood, drought, earthquake;
- (d) If substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, auditors should:
  - (i) Obtain information about management's mitigation plans; and
  - (ii) Assess the likelihood that such plans can be effectively implemented.

Management's mitigation plans might include:

- (a) Plans to dispose of assets, reduce, or
- (b) Delay expenditure, borrow money, or
- (c) Restructure debt, or increase ownership equity.

On the receipt of these plans, the auditor should evaluate them, as follows:

- (a) Consider whether there is adequate evidence supporting management's ability to carry out the plans. For example, plans to dispose of assets could be difficult or impossible to accomplish;
- (b) Ascertain if there are restrictive covenants in loan agreements limiting such disposals;
- (c) Request management to provide information about significant management's plans, and
- (d) Consider whether there is adequate support for the significant assumptions underlying the plans.

If after evaluating management's plans, the auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time; the auditor should then consider:

- (a) The adequacy of financial statement disclosure about the entity's possible inability to continue as a going concern; and
- (b) Include an explanatory paragraph (following the opinion paragraph) in the audit report to reflect that conclusion.

### **Contents of auditors' disclosures**

Auditors' disclosures about the entity's ability to continue as a going concern might include the following information:

- (a) Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time;
- (b) The possible effects of such conditions and events;
- (c) Management's evaluation of the significance of those conditions and events and mitigating factors;
- (d) Possible discontinuance of operations;
- (e) Management's plans, including relevant prospective financial information; and

- (f) Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

An illustration of an explanatory paragraph in the auditor's report relating to going concern is set out below:

*The company's financing arrangements expire and amounts outstanding are payable on March 31, 2005. The company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements and notes thereto do not disclose this fact.*

*In our opinion, except for this omission of information included in the preceding paragraph, the financial statements give a true and fair view of the financial position of the company at June 30, 2005 and the results of its operations and its cash flows for the year then ended in accordance with ...*

If, after considering management's plans, substantial doubt about the entity's ability to continue as a going concern does NOT exist, the auditor should still consider whether the principal conditions and events that initially generated the doubt need to be disclosed. The consideration of disclosure should include the possible effects of those conditions and events and any mitigating factors, including management's plans.

Statement of Accounting Standard No. 59 says, "the auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicate inadequate performance by the auditor. Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern."

### **8.3.2 Management representation**

The auditor is required by SAS 19, *Client Representations*, to obtain a letter of representation from management confirming that they are responsible for the financial statements and have made all pertinent information available to the auditor, and stating their belief in the accuracy and completeness of that information. The representation letter provides written evidence that the auditor has made certain inquiries from management; ordinarily it documents oral responses given to the auditor, thus reducing the possibility of errors or misunderstanding.

A representation letter is a competent evidence, but it is not sufficient on its own, to provide the auditor with a reasonable basis for forming an opinion. In the context of management representations, 'management' includes directors, officers and others who perform senior managerial functions.

### **Written Representations**

An auditor should obtain representation modified to meet the circumstances of the particular engagement and the nature and basis of presentation of the financial statements. For example, if the auditor is reporting on consolidated financial statements, the written representations obtained from the parent company's management should specify that they pertain to the consolidated financial statements. If the auditor is reporting on the parent company's separate financial statements as well, the letter should also extend to them.

Written representations relating to management's knowledge or intent should be obtained when the auditor believes they are necessary to complement other auditing procedures. For example, even if the auditor has performed test for unrecorded liabilities and has not detected any, written representation should be obtained to document that management has no knowledge of any liabilities that have not been recorded. Liabilities known to management but not accrued, through oversight, might be brought to the auditor's attention in this manner. Written representation does not relieve auditor of responsibility for planning the audit to identify material unrecorded liabilities. Information may be omitted or intentionally withheld from the auditor. Accordingly, the auditor should still perform all the usual tests to corroborate representations made by management.

### **ILLUSTRATION OF CLIENT REPRESENTATION LETTER**

#### ***All-Well Black PLC***

*July 30, 2008*

*(to The Auditor)*

*In connection with your audit of the financial statements of All-Well Black PLC for the year ended May 31, 2008 for the purpose of expressing an opinion as to whether the financial statements present a true and fair view of the financial position, results of operations, and cash flows of All-Well Black PLC in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, as at July 29, 2008, the date of your report, the following representations made to you during audit.*

- (a) *We are responsible for the fair presentation in the financial statements, results of operations, and cash flows in conformity with generally accepted accounting principles.*
- (b) *We have made available to you all financial and accounting records and related data and all minutes of the meetings of shareholders, directors, and committees of directors. The most recent meeting held was the July 25, 2008 Board of Directors meeting. We are not aware of any accounts, transactions, or material agreements not fairly described and properly recorded in the financial and accounting records underlying the financial statements.*
- (c) *We are not aware of:*
- (i) *any irregularities involving management or those employees who have significant roles in the internal control structure, or any irregularities involving other employees that could have a material effect on the financial statements, or*
  - (ii) *any violations or possible violations of laws or regulations whose effects would be considered for disclosure in the financial statements or as a basis for recording a loss contingency.*
- (d) *There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices that could have a material effect on the financial statements. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of non-compliance.*
- (e) *All cash and bank accounts and all other properties and assets of the company of which we are aware are included in the financial statements at May 31, 2008. The company has satisfactory title to all owned assets, and all liens, encumbrances, or security interests having any important consequence on any asset of the company are disclosed in the statements or notes thereto.*
- (f) *The receivables in the aggregate gross amount of ₦250,000,000 at May 31, 2008 represent bona fide claims against debtors for sales or other charges arising or before that date and are not subject to discount except for normal cash discounts. These receivables do not include any amounts that are collectible after one year. The amount of ₦800,000 carried as an allowance for uncollectible accounts is sufficient to provide for any losses that may be sustained on realisation of the receivables.*
- (g) *Inventories at May 31, 2008 in the aggregate amount of ₦13,000,000 are stated at the lower of cost or market, cost being determined on the basis FIFO, and consistently with the prior*

year; and provision was made to reduce all slow-moving, obsolete, or unusable inventories to their estimated net realisable values. Inventory quantities at May 31, 2006 were determined from the company's perpetual inventory records, which have been adjusted on the basis of physical inventories taken by competent employees at March 31, 2008. Liability, if unpaid, for all items included in inventories is recorded at May 31, 2005, and all quantities billed to customers at that date are excluded from the inventory balances.

- (h) *All liabilities of the company of which we are aware are included in the financial statements at May 31, 2008. There are no other material liabilities or gain or loss contingencies that ought to be accrued or disclosed and no unasserted claims or assessments that our legal counsel has advised us are probable of assertion and should be disclosed.*
- (i) *Commitments for future purchases are for quantities not in excess of anticipated requirements and at prices that will not result in loss. Provision has been made for any material loss to be sustained in the fulfilment of, or from the inability to fulfil, any sales commitments.*
- (j) *We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.*
- (k) *The financial statements and related notes include all disclosures necessary for a fair presentation of the fanatical position, results of operations, and cash flows of the company in conformity with generally accepted accounting principles, and disclosure otherwise required to be included therein by the laws and regulations to which the company is subject.*

*The following have been properly recorded or disclosed in the financial statements:*

- (a) *Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.*  
*There are no:*
  - (i) *Capital stock repurchases options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.*
  - (ii) *Arrangements with financial institutions involving compensating balances, arrangements involving restrictions on cash balances and lines of credit, or similar arrangements.*
  - (iii) *Agreements to repurchase assets previously sold.*

- (iv) *Guarantees, whether written or oral, under which the company is contingently liable to a bank or other lending institution.*

*No matters or occurrences have come to our attention up to the date of this letter that would materially affect the financial statements and related disclosures for the year ended May 31, 2008 or, although not affecting such financial statements or disclosures, have caused or are likely to cause any material change, adverse or otherwise, in the financial position, results of operations, or cash flow of the company*

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*Finance Director*

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*Chairman/Chief Executive Officer*

### **Dating and Signing**

The representation letter should be addressed to the auditor and dated not earlier than the date of the auditor's report, but not later than the report release date. Both the chief executive and chief financial officer should ordinarily sign representation letters. Other members of management may sign the letter instead if the auditor is satisfied that they are responsible for and knowledgeable about the matters covered by the representations.

### **Scope Limitations**

Management should neither refuse to furnish a written representation that the auditor believes is essential nor refuse to sign the representation letter. Either of the refusals constitutes a limitation on the scope of the audit which may attract a qualified opinion. Auditors should consider whether management's refusal to furnish written representations affect the reliability of their other representations. Executives are expected to understand their legal and ethical responsibilities for financial statement representation. Thus, they should also understand that the representation letter only specifies some of those responsibilities but does not increase them. Refusal to sign the letter should be seen as a 'tell-tale', either of withheld evidence or of inadequately understood responsibilities; either destroys the basis for an unqualified opinion.

### **8.3.3 Truth and Fairness of Financial Statements**

Generally accepted accounting principles provide a consistent frame of reference against which each of management's assertions that are implicit in the financial statements can be evaluated. Obviously, an auditor must be thoroughly familiar with generally accepted accounting principles to comply responsibly with the demands of truth and fairness in the financial statements.

Generally accepted accounting principles can be described as “the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time”, `APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprise*. They are not limited to the principles in pronouncements of authoritative bodies such as the Nigerian Accounting Standards Board (NASB). They also include practices that have achieved acceptance through common usage as well as principles in non-authoritative pronouncements of bodies of recognised statutes. And the auditor’s report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

As a result, accountants over the years have had to contend with specific situations arising in practice and have developed and adopted numerous rules, conventions and doctrines, which are now called principles. Some of those principles have been promulgated formally by authoritative bodies of the profession (such as the NASB). All of those accepted conventions make up the body of GAAP.

The SAS 5, *The Meaning of “Present Fairly in Conformity With Accepted Accounting Principles” in the Independent Auditor’s Report*, enumerated the various judgements that the auditor should make in rendering an unqualified opinion. The auditor’s positive opinion about fair presentation in conformity with generally accepted accounting principles implies a belief that the financial statements have each of the following qualities:

- (a) The accounting principles selected and applied have general acceptance;
- (b) The accounting principles are appropriate in the circumstance;
- (c) The financial statements, including the related notes, are informative on matters that may affect their use, understanding, and interpretation;
- (d) The information presented in the financial statements is classified and summarised in a reasonable manner; that is, neither too detailed nor too condensed; and
- (e) The financial statements reflect the underlying events and transaction in a manner that presents financial position, results of operations, and cashflows stated within a range of acceptable limits i.e., limits that are reasonable and practicable to attain in financial statements.

It should be noted that financial statements will not give a “true and fair view” unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. The concept of “true and fair view” influences accounting standards and other authoritative pronouncements.

## 8.4 AUDITORS' RELATIONSHIP WITH AUDIT COMMITTEES

The Audit Committee is a body established under Section 359 of the Companies and Allied Matters Act., 2004 to which the auditor of a public company will report in addition to the auditor's duty to report to the members of the company in accordance with Section 359 (1) of the Act. The Audit Committee shall consist of equal number of directors and representatives of the shareholders of the public company with a maximum number of six members. Any member of a company may nominate a shareholder as a member of the Audit Committee if a notice is given to the Company Secretary at least 21 days before the Annual General Meeting. The members of the Audit Committee are not entitled to remuneration.

According to Section 359 (4), the Audit Committee shall examine the auditors' report and make recommendations thereon on the Annual General Meeting. Section 359 (6) states that subject to such other additional function and powers that the company's Articles of Association may stipulate, the objectives and functions of the Audit Committee shall be to:

- (a) Ascertain whether the accounting and reporting policies of the company comply with legal requirements and agreed ethical practices;
- (b) Review the scope and planning of audit requirements;
- (c) Review the findings on management letters in conjunction with the external auditor and departmental responses thereon;
- (d) Keep under review the effectiveness of the company's system of accounting and internal control;
- (e) Make recommendations to the Board in regard to the appointment, removal and remuneration of the external auditors of the company;
- (f) Authorise the internal auditor to carry out investigations into any activities of the company, which may be of interest or concern to the Committee.

SAS 61, *Communication with Audit Committees*, requires the auditor to determine that certain matters related to the conduct of and audit are communicated to those who oversee the financial reporting process generally – that is, an Audit Committee or other formally designated group.

This Statement requires the auditor to ensure that the Audit Committee receives additional information regarding the scope and results of the audit that may assist the Committee in overseeing the financial reporting and disclosure process for which management is responsible. Communications can also be made with management or other individuals within the entity who may benefit from such information.

### Items Communicated by the Auditor

Items communicated by the auditor can be written or oral.

- (a) If oral, the communication should be documented in the working papers; and

- (b) Written communication should contain indication that it is intended solely for use by the Audit Committee, board of directors, and, at times, management.

It is important for an Audit Committee to be informed about:

- (a) The level of responsibility the auditor assumes under GAAP for the financial statements and for considering the entity's internal control structure;
- (c) Significant accounting policies that the entity has selected for new or unusual transactions and changes and method used to account for them;
- (d) Management judgements on the process used by management in formulating sensitive accounting estimates and basis for the auditor's conclusion about such estimates;
- (e) Significant audit adjustments - adjustments arising from the audit that could have significant effect on the entity's financial reporting process;
- (f) Other information in documents containing audited financial statements (the auditor should discuss with Audit Committee the responsibility for other information, e.g., annual reports to shareholders, in documents containing audited financial statements);
- (g) Disagreements with management over the application of accounting principles, scope of audit, disclosures and wording of auditor's report;
- (h) Consultation by management with other accountants. Major issues discussed with management prior to retention; and
- (i) Difficulties encountered in performing the audit (in dealing with management, such as unreasonable delays or timetable).

Auditors should at least annually:

- (a) Disclose in writing to the Audit Committee and discuss as appropriate:
  - (i) all relationship that may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and the audit staff;
  - (ii) the related safeguards that are in place; and
- (b) Confirm in writing to the Audit Committee that, in their professional judgement, the firm is independent and the objectivity of the audit engagement partner and audit staff is not impaired.

Audit Committees are formally designated oversight functions of the financial reporting process. The communications required are incidental to the audit; therefore, they need not occur prior to the issuance of the auditor's report on the financial statements. However, they should be made in time and, based on the auditor's judgement, may be given before the report. The communication of recurring matters need not be repeated.

## 8.5 AUDITORS' RELATIONSHIP WITH THIRD PARTIES

### Communication of Audit Matters With Those Charged With Governance

#### Introduction

- (a) *Communication of Audit Matters with Those Charged with Governance*, ISA 260 establishes standards and provides guidance on communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity. These communications relate to audit matters of governance interest as defined hereunder;
- (b) The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity;
- (c) **Governance** is the term used to describe the role of persons entrusted with the supervision, control and direction of an entity. Those who are charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties. Those charged with governance include management only when it performs such functions;
- (d) **Audit matters of governance interest** are those matters that arise from the audit of financial statements and, in the opinion of the auditor, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest.

#### Relevant Persons

The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.

The structures of governance vary from country to country reflecting cultural and legal backgrounds. This diversity makes it difficult to establish a universal identification of the persons who are charged with governance and with whom the auditor communicates audit matters of governance interest. The auditor uses judgement to determine those persons with whom audit matters of governance interest are communicated, taking into account the governance structure of the entity, the circumstances of the engagement and any relevant legislation. The auditor also considers the legal responsibilities of those persons. The relevant persons in entities with supervisory boards or with audit committees, could be those bodies.

When the entity's governance structure is not well defined, and/or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, the auditor comes to an agreement with the entity about whom to communicate audit matters of governance interest with. Examples of such entities include some owner-managed entities, some not for profit organisations, and some government agencies. To avoid misunderstandings, an audit engagement letter should explain that the auditor will communicate only those matters of governance interest, that come to attention as a result of the performance of an audit and that the auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest. The engagement letter may also:

- (a) Describe the form in which any communications on audit matters of governance interest will be made;
- (b) Identify the relevant persons with whom such communications will be made; and
- (c) Identify any specific audit matters of governance interest which it has been agreed are to be communicated.

The effectiveness of communication is enhanced by developing a constructive working relationship between the auditor and those charged with governance. This relationship is developed while maintaining an attitude of professional independence and objectivity.

### **Audit Matters of Governance Interest to be Communicated**

The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance. Such matters include the following:

- (a) The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- (b) The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- (c) The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- (d) Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entity's financial statements;
- (e) Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- (f) Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. This communication include consideration of whether the matter has, or has not, been resolved and the significance of the matter;

- (g) Expected modifications to the auditor's report;
- (h) Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management; and
- (i) Any other matters agreed upon in the terms of the audit engagement.

All uncorrected mis-statements aggregated by the auditor during the audit that were determined by management to be immaterial to the financial statements taken as a whole, should be communicated to those charged with governance. The uncorrected misstatement communicated to those charged with governance need not include the misstatement below a designated amount.

As part of the auditor's communication, those charged with governance are informed that:

- (a) The auditor's communication of matters include only those audit matters of governance interest that have come to the attention of the auditor as a result of the performance of the audit; and
- (b) An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Accordingly, the audit does not ordinarily identify all such matters.

### **Timing of Communication**

The auditor should communicate audit matters of governance interest on a timely basis. This enables those charged with governance to take appropriate action. In order to achieve timely communication, the auditor discusses with those charged with governance the basis and timing of such communication. In certain cases, because of the nature of the matter, the auditor may communicate that matter sooner than previously agreed.

### **Forms of Communication**

The auditor's communication with those charged with governance may be made orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as the following:

- (a) The size, operating structure, legal structure, and communication processes of the entity being audited;
- (b) The nature, sensitivity and significance of the audit matters of governance interest to be communicated; and
- (c) The arrangements made with respect to periodic meetings or reporting of audit matters of governance interest.

When audit matters of governance interest are communicated orally, the auditor documents in the working papers the matters communicated and any responses to those matters. This documentation may take the form of a copy of the minutes of the auditor's discussion with those charged with governance. In certain circumstances, depending on the nature, sensitivity, and significance of the matter, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communication on audit matters of governance interest. Ordinarily, the auditor initially discusses audit matters of governance interest with management, except where those matters relate to questions of management competence or integrity. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communication, provided that the auditor is satisfied that such communications has effectively and appropriately been made.

### **Confidentiality**

The requirements of The Institute of Chartered Accountants of Nigeria (ICAN) and/or other regulations may impose obligations of confidentiality that restrict the auditor's communication of audit matters with third parties. The auditor should refer to such requirements, laws and regulations before communicating with those charged with such third parties. In some circumstances, the potential conflicts with the auditor's ethical and legal obligations of confidentiality and reporting may be complex. In these cases, the auditor may wish to consult with legal counsel.

## **8.6 NON-STATUTORY AUDIT**

The audit of small business is influenced by a number of special considerations, which are due to:

- (a) The intrinsic characteristics of small businesses;
- (b) The nature of the professional relationship between such businesses and their auditors; and
- (c) Other factor, such as the small size of the audit team and any special legal consideration affecting small businesses.

The impact of these considerations on the conduct of the audit can vary; some can often be beneficial, resulting in increased efficiency and effectiveness of the audit and, in turn, savings of cost to the client. In particular, the assistance with accountancy work normally provided to small businesses by their auditors can often be a source of audit evidence and can significantly reduce the extent of the work necessary purely for the sake of the audit.

Auditors of small businesses can provide a cost-effective audit service to their clients by planning their work to take full advantage of the opportunities afforded by such engagements to obtain the audit evidence they require in the most appropriate and economical manner.

### **Professional Relationship Between Small Businesses and their Auditors**

The owner-manager of a small business often needs professional advice and assistance on a wide range of accounting and related financial and business issues which are not available 'in-house'. The accounting firm appointed to act as auditors is therefore usually also engaged to provide other services, such as:

- (a) Accounting
  - (i) assisting with the keeping of accounting records;
  - (ii) advising on the selection and application of accounting policies; and
  - (iii) assisting with the preparation of financial statements.
- (b) Systems-advising on accounting systems and internal control procedures:
  - (i) advising on computer systems
- (c) Taxation
  - (i) assisting with the preparation of income and corporation tax returns;
  - (ii) computations and preparation of VAT returns; and
  - (iii) general tax advice and tax planning advice.
- (d) Other matters - advising on business and share valuations;
  - (i) advising on the owner-manager's responsibilities as company director;
  - (ii) assisting with preparation of budgets and forecasts;
  - (iii) assisting with obtaining finance; and
  - (iv) providing management consultancy services.

It is common for auditors to provide some or all of these services to a small business. This can enable them to obtain useful information about the business and about its owner-manager's aims, management style and ethos. The auditors also have the opportunity to keep up-to-date their knowledge of the business, which will help them to plan and conduct audit.

### **Fraud and Error**

Certain conditions or events may increase the risk of fraud or error. One of the examples given is "... management dominated by one person (or a small group) and no effective oversight board or committee." Although this situation applies in virtually all small businesses, the guidance in the SAS 110, *Fraud and Error*, is not intended to imply that all small businesses are to be regarded by their auditors as necessarily involving a higher inherent risk of fraud or error than larger businesses.

Accordingly, whilst the presence of a dominant owner-manager is an important factor in the overall control environment, the auditors' assessment of its impact is conditioned by their knowledge of the particular small business and of its owner-manager. The owner-manager's attitude to control can have a significant influence on the auditors' approach.

Examples of conditions or events, which may increase the risk of fraud or error, include:

- (a) The owner-manager has a specific identifiable motive to distort the financial statements, combined with the opportunity to do so;
- (b) The owner-manger makes no distinction between personal and business transaction;
- (c) The owner-manager's life-style is materially inconsistent with the level of his or her remuneration;
- (d) The owner-manager or key personnel have not taken annual leave for a long period of time;
- (e) Frequent changes of professional advisers;
- (f) The start-date for the audit has been repeatedly delayed;
- (g) Unexplained demands to prepare the accounts and complete the audit in an unreasonable short period of time;
- (h) Limitations placed on the scope of the audit, particularly if these appear to be unreasonable or illogical;
- (i) A significant level of cash transactions without adequate documentation;
- (j) Numerous unexplained aspects of audit evidence (such as difference between the accounting records and third-party confirmation, or unexpected results of analytical procedures);
- (k) Inappropriate use of accounting estimates;
- (l) Unusual transactions around the year-end which have a material effect on profit;
- (m) Unusual related party transactions; and
- (n) Payments of fees or commissions to agents and consultants which appear excessive.

## 8.7 SUMMARY OF AUDITOR'S RESPONSIBILITIES

All entities have the same basic audit requirements; the difference is just in matters of degree. Hence auditors' responsibilities as regards the objective and general principles governing statutory audit of financial statements prevail.

Auditors should:

- (a) Obtain engagement letter.
- (b) Obtain knowledge about the entity in sufficient quantity.
- (c) Consider the law and regulations governing the entity. These are:
  - (i) Law and regulations which relate directly to the preparation of the financial statements.
  - (ii) Laws and regulations which provide a framework for the conduct of the business.

- (iii) Other laws and regulations.
- (d) The going concern basis in financial statements.
- (e) Review subsequent events.
- (f) Consider other information contained in the financial statements.
- (g) Degree of accuracy in preparing financial statements and materiality in the audit.
- (h) Evidence the work done by use of working papers.
- (i) Ensure proper quality control of the audit work.
- (j) Obtain representations by management as part of audit evidence.

## 8.8 SUMMARY AND CONCLUSIONS

The chapter has covered in fair detail, the structure and framework of statutory audit reports as well as the incidence of non-statutory audit reports.

It also addressed the need or otherwise for Qualified Audit reports, after due consideration of issues bordering on materiality, Inconsistencies, Client-imposed Restrictions, observed departures from Generally Accepted Accounting Principles (GAAP), Subsequent Events, and the Going Concern factor.

Finally the chapter briefly discusses the auditor's relationship with Audit Committees of Corporate Clients, and other stakeholders.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

## 8.9 REVISION QUESTIONS

### 8.9.1 MULTIPLE CHOICE QUESTION

1. "Subsequent events" for reporting purposes are defined as events that occur subsequent to the
  - (A) Balance sheet date
  - (B) Date of the auditor's report
  - (C) Balance sheet date but prior to the date of the auditor's report
  - (D) Date of the auditor's report and concern contingencies that are not reflected in the financial statements
  - (E) Incorporation date.
  
2. A written undertaking between the auditor and client concerning the auditor's responsibility for discovering illegal acts is usually set forth in a (an)
  - (A) Client representation letter
  - (B) Management letter
  - (C) Letter of inquiry
  - (D) Engagement letter
  - (E) Disengagement Letter.

3. When obtaining evidence regarding litigation against a client, ICAN would be least interested in determining
  - (A) An estimate of when the matter will be resolved.
  - (B) The period in which the underlying cause of the litigation occurred.
  - (C) The probability of an unfavourable outcome.
  - (D) An estimate of the potential loss
  - (E) All the above.
  
4. In the course of an audit exercise, the auditor decides that modification of the standard report is not adequate to indicate deficiencies in the financial statements taken as a whole, and the client is not willing to correct the deficiencies. The auditor should therefore
  - (A) Perform a review of the financial statements
  - (B) Issue a special report
  - (C) Withdraw from the engagement
  - (D) Express an adverse opinion
  - (E) Do nothing.
  
5. In an audit of contingent liabilities, which of the following procedure would be least effective
  - (A) Reviewing a bank confirmation letter
  - (B) Examining customer confirmation
  - (C) Examination of invoices for professional services
  - (D) Reading the minutes of the board of directors
  - (E) Reviewing Assets Verification Procedure.

### 8.9.2 SHORT ANSWER QUESTIONS

1. Explain the classification of potential losses due to uncertainties as “probable,” “reasonably possible,” or “remote.”
2. What matters are usually covered in a representation letter? When, and by whom, is it signed?
3. Name and describe the different types of subsequent events auditors must consider in the audit of a client’s financial statements.
4. What procedures must the auditor follow where he intends to use the work of an “expert”?
  - (a) Give the definition of an “expert” in relation to an audit?
  - (b) Under what circumstances will an auditor use the work of an “expert”?
  - (c) What factors determine the need to use the work of an “expert”?
5. There are circumstances in which auditors should qualify their opinions in reporting on financial statements and other circumstances in which they should disclaim an opinion on the financial statements. Explain the general nature of the circumstances that would make each course necessary.

*Refer to suggested Solutions in Appendix I on page 301.*

# ***INTRODUCTION TO ASSURANCE SERVICES***

## **9.0 LEARNING OBJECTIVES**

After studying this chapter, readers should be able to:

- ◆ Understand the difference between assurance and other professional services.
- ◆ Appreciate steps involved in carrying out an assurance service.
- ◆ Understand the basics of an assurance report.
- ◆ Understand the meaning of due diligence.
- ◆ Identify how to carry out a due diligence review.
- ◆ Understand the meaning of forensic audit and steps for carrying out a forensic audit.

## **9.1 DEFINITION AND SCOPE OF ASSURANCE SERVICES**

### **Definition**

Assurance has been defined as Independent Professional Services that improve information quality or its context for decision makers. This broad concept includes audit and attestation services and is distinct from consulting because, it focuses primarily on improving information rather than on providing advice. Assurance services reduce the information risk; risk that the information provided is incorrect, on more than just financial data. The major purpose of assurance services is to provide independent and professional opinions that improve the quality of information to management as well as other decision makers within a given firm. Audits can be considered a type of assurance service. However audits are only designed to test the validity of the financial statement. Under an assurance service, accountants can provide a variety of services ranging from information systems, security reviews to customer satisfaction surveys. Unlike audit and attestation services, that are often highly structured, assurance services tend to be customised and implemented when performed for a smaller group of decision makers within the firm. Often, organisations should make decisions on matters which they have incomplete or inaccurate data for, and decisions made on such data may be incorrect and increase the overall business risk. In this respect, assurance services can be very helpful in reducing such risk and help managers or decision makers to take more confident decisions within a given organisation. Assurance services can test financial and non-financial information; due to this, assurance services

are sometimes classified as consulting services. However, assurance services are not consulting because in consulting services generally accountants use their professional knowledge to make recommendations for a future event or a procedure. In contrast, assurance services are designed to test the validity of past data of the business cycles.

Assurance services are intended to enhance the credibility of information about a subject matter, by evaluating whether the subject matter conforms in all material respects with suitable criteria. The International Standard on Assurance Services issued by the International Auditing and Assurance Standards Board, describes the objectives and elements of assurance services to provide either a high or a moderate level of assurance. The International Auditing and Assurance Standards Board has also issued specific standards for certain assurance services. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (moderate level assurance) of financial statements.

## 9.2 SCOPE OF ASSURANCE SERVICES

Whether a particular service is an assurance service or not will depend upon exhibiting all the following elements:

- (a) A three-party relationship involving:
  - (i) A professional accountant;
  - (ii) A client; and
  - (iii) An intended user;
- (b) A subject matter;
- (c) Suitable criteria;
- (d) A service process; and
- (e) A conclusion.

The client and the intended user will often be from separate organisations but need not be. A client and an intended user may both be within the same organisation. The relationship between the client and the intended user needs to be viewed within the context of a specific assurance service.

There is a broad range of services to provide a high or moderate level of assurance. Such services may include:

- (a) Services to report on a broad range of subject matters covering financial and non-financial information;
- (b) Attest and direct reporting services;
- (c) Services to report internally and externally; and
- (d) Services in the private and public sector.

The subject matter of an assurance service may take many forms, such as the following:

- (a) Data (for example, historical or prospective financial information, statistical information, performance indicators).

- (b) Systems and processes (for example, internal controls).
- (c) Behaviour (for example, corporate governance, compliance with regulation, human resource practices).

Not all services performed by professional accountants are assurance services. Other services frequently performed by professional accountants that are not assurance services include:

- (a) Agreed-upon procedures;
- (b) Compilation of financial or other information;
- (c) Preparation of tax returns when no conclusion is expressed, and tax consulting;
- (d) Management consulting; and
- (e) Other advisory services.

### 9.3 DEFINITION AND OBJECTIVE OF AN ASSURANCE SERVICE

“Assurance Service” means a service in which a professional accountant expresses a conclusion designed to enhance the degree of confidence of the intended users other than the client about the outcome of the evaluation or measurement of a subject matter against criteria.

The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:

The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards (criteria) to an entity’s financial position, financial performance and cash flows (subject matter).

In this section, the term “subject matter information” will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the professional accountant gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be mis-stated, potentially to a material extent. This occurs when the subject matter information does not properly reflect the application of the criteria to the subject matter, for example, when an organisation’s financial statements do not give a true and fair view of its financial position, financial performance and cash flows, in accordance with International Financial Reporting Standards, or when an entity’s assertion that its internal control is effective is not fairly stated.

In some assurance services, the evaluation or measurement of the subject matter is performed by the client, and the subject matter information is in the form of an assertion by the client that is made available to the intended users.

These services are called “assertion-based services.” In other assurance services, the professional accountant either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the client that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These assurance services are called “direct reporting assurance services.”

There are two types of assurance services a professional accountant can render a reasonable assurance service and a limited assurance service. The objective of a reasonable assurance service is a reduction in assurance service risk to an acceptably low level in the circumstances of the service as the basis for a positive form of expression of the professional accountant’s conclusion. The objective of a limited assurance service is a reduction in assurance service risk to a level that is acceptable in the circumstances of the service, but where that risk is greater than for a reasonable assurance service, as the basis for a negative form of expression of the professional accountant’s conclusion.

### **Acceptance of an Assurance Service By a Professional Accountant**

A professional accountant can only accept an assurance service only where his preliminary knowledge of the service circumstances indicates that:

- (a) Relevant ethical requirements, such as independence and professional competence will be satisfied; and
- (b) The service exhibits all of the following characteristics:
  - (i) The subject matter is appropriate;
  - (ii) The criteria to be used are suitable and are available to the intended users;
  - (iii) The professional accountant has access to sufficient appropriate evidence to support the his conclusion;
  - (iv) The professional accountant’s conclusion, in the form appropriate to either a reasonable assurance service or a limited assurance service, is to be contained in a written report; and
  - (v) The professional accountant is satisfied that there is a rational purpose for the service. If there is a significant limitation on the scope of the accountants’ work, it may be unlikely that the service has a rational purpose. Also, a professional accountant may believe the client intends to associate the professional accountant’s name with the subject matter in an inappropriate manner.

### **Elements of an Assurance Service**

The following elements of an assurance service are discussed in this section:

- (a) A three party relationship involving a professional accountant, a client, and intended users;
- (b) An appropriate subject matter;
- (c) Suitable criteria;
- (d) Sufficient appropriate evidence; and

- (e) A written assurance report in the form appropriate to a reasonable assurance service or a limited assurance service.

### **Three-party Relationship**

Assurance services involve three separate parties: a professional accountant, a client and intended users.

The client and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the management board of that entity.

The relationship between the client and the intended users needs to be viewed within the context of a specific service and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a professional accountant to perform an assurance service on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the client), but for which the senior management is ultimately responsible.

### **Professional Accountant**

The term "professional accountant" as used in this chapter is broader than the term "auditor" as used in ISAs and ISREs, which relates only to professional accountants performing audit or review services with respect to historical financial information. A professional accountant may be requested to perform assurance services on a wide range of subject matters. Some subject matters may require specialised skills and knowledge beyond those ordinarily possessed by an individual professional accountant. A professional accountant does not accept a service, if preliminary knowledge of the service circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases this requirement can be satisfied by the professional accountant using the work of persons from other professional disciplines, referred to as experts. In such cases, the professional accountant is satisfied that those persons carrying out the service collectively possess the requisite skills and knowledge, and that the professional accountant has an adequate level of involvement in the service and understanding of the work for which any expert is used.

### **Client**

The client is the person (or persons) who:

- (a) In a direct reporting service, is responsible for the subject matter; or  
 (b) In an assertion-based service, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the client is responsible for both the subject matter information, and the subject matter, is when an entity engages a professional accountant to perform an assurance service regarding a report it has prepared about its own sustainability practices. An example

of when the client is responsible for the subject matter information but not the subject matter, is when a government organisation engages a professional accountant to perform an assurance service regarding a report about a private company's sustainability practices that the organisation has prepared and is to distribute to intended users. The client may or may not be the party who engages the professional accountant (the engaging party).

The client ordinarily provides the professional accountant with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting service, the professional accountant may not be able to obtain such a representation when the engaging party is different from the client.

### **Intended Users**

The intended users are the person, persons or class of persons for whom the professional accountant prepares the assurance report. The client can be one of the intended users, but not the only one.

Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users. The professional accountant may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the professional accountant and the client or engaging party, or by law.

Whenever practical, intended users or their representatives are involved with the professional accountant and the client (and the engaging party if different) in determining the requirements of the service. Regardless of the involvement of others however, and unlike an agreed-upon procedures service (which involves reporting findings based upon the procedures, rather than a conclusion):

- (a) The professional accountant is responsible for determining the nature, timing and extent of procedures; and
- (b) The professional accountant is required to pursue any matter he becomes aware of, that leads him to question whether a material modification should be made to the subject matter information.

In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the client (or the engaging party if different) to arrange for, an assurance service to be performed for a specific purpose. When services are designed for specified intended users or a specific purpose, the professional accountant considers including a restriction in the assurance report that limits its use to those users or that purpose.

## Subject Matter

The subject matter, and subject matter information, of an assurance service can take many forms, such as:

- (a) Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements;
- (b) Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness;
- (c) Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specification document;
- (d) Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness; and
- (e) Behaviour (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

Subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:

- (a) Precision with which the subject matter can be evaluated or measured against criteria; and
- (b) The persuasiveness of available evidence.

The assurance report notes characteristics of particular relevance to the intended users. An appropriate subject matter is:

- (a) Identifiable, and capable of consistent evaluation or measurement against the identified criteria; and
- (b) Such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

## Criteria

Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal, for example in the preparation of financial statements, the criteria may be International Financial Reporting Standards or International Public

Sector Accounting Standards: when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the service; and when reporting on compliance, the criteria may be the applicable law, regulation or contract.

Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).

Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the assurance service circumstances. Even for the same subject matter, there can be different criteria. For example, one client might select the number of customer complaints resolved to the acknowledged satisfaction of the customer for the subject matter of customer satisfaction; another client might select the number of repeat purchases in the three months following the initial purchase.

**Suitable Criteria Exhibit the Following Characteristics:**

- (a) **Relevance:** relevant criteria contribute to conclusions that assist decision-making by the intended users.
- (b) **Completeness:** criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the assurance service circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
- (c) **Reliability:** reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified professional accountants.
- (d) **Neutrality:** neutral criteria contribute to conclusions that are free from bias.
- (e) **Understandability:** understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

The evaluation or measurement of a subject matter on the basis of the professional accountant's own expectations, judgments and individual experience would not constitute suitable criteria.

The professional accountant assesses the suitability of criteria for a particular service by considering whether they reflect the above characteristics. The relative importance of each characteristic to a particular service is a matter of judgment. Criteria can either be established or specifically developed.

Established criteria are those embodied in laws or regulations, or issued by authorised or recognised bodies of experts that follow a transparent due process. Specifically developed criteria, are those designed for the purpose of the assurance service. Whether criteria are established or specifically developed affects the work that the professional accountant carries out to assess their suitability for a particular assurance service.

Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. Criteria are made available to the intended users in one or more of the following ways:

- (a) Publicly;
- (b) Through inclusion in a clear manner in the presentation of the subject matter information;
- (c) Through inclusion in a clear manner in the assurance report; and
- (d) By general understanding, for example the criterion for measuring time in hours and minutes.

Criteria may also be available only to specific intended users, for example the terms of a contract, or criteria issued by an industry association that are available only to those in the industry. When identified criteria are available only to specific intended users, or are relevant only to a specific purpose, use of the assurance report is restricted to those users or for that purpose.

### **Evidence**

The professional accountant plans and performs an assurance service with an attitude of professional scepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material mis-statement. The professional accountant considers materiality, assurance service risk, and the quantity and quality of available evidence when planning and performing the service, in particular when determining the nature, timing and extent of evidence-gathering procedures.

### **Professional Scepticism**

The professional accountant plans and performs an assurance service with an attitude of professional scepticism recognising that circumstances may exist that cause the subject matter information to be materially misstated. An attitude of professional scepticism means the professional accountant makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the client. For example, an attitude of professional scepticism is necessary throughout the assurance service process for the professional accountant to reduce the risk of overlooking suspicious circumstances, of over generalising when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence gathering procedures and evaluating the results thereof. An assurance service rarely involves the authentication of documentation, nor is the professional accountant trained as or expected to be an expert in such authentication. However, the professional accountant considers the reliability of the information to be used as evidence, for example photocopies, facsimiles, filmed, digitised or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

**Materiality**

Materiality is relevant when the professional accountant determines the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of mis-statement. When considering materiality, the professional accountant understands and assesses what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the professional accountant considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular assurance service are matters for the professional accountant's judgment.

**Assurance Service Risk**

Assurance service risk is the risk that the professional accountant expresses an inappropriate conclusion when the subject matter information is materially mis-stated. In a reasonable assurance service, the professional accountant reduces assurance service risk to an acceptably low level in the circumstances of the service to obtain reasonable assurance as the basis for a positive form of expression of the professional accountant's conclusion. The level of assurance service risk is higher in a limited assurance service than in a reasonable assurance service because of the different nature, timing or extent of evidence-gathering procedures. However in a limited assurance service, the combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the professional accountant to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained by the professional accountant is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

In general, assurance service risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance services:

- (a) The risk that the subject matter information is materially misstated, which in turn consists of:
  - (i) Inherent risk: the susceptibility of the subject matter information to a material mis-statement, assuming that there are no related controls;
  - (ii) Control risk: the risk that a material mis-statement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and

- (b) Detection risk: the risk that the professional accountant will not detect a material mis-statement that exists. The degree to which the professional accountant considers each of these components is affected by the service circumstances, in particular by the nature of the subject matter and whether a reasonable assurance or a limited assurance service is being performed.

### **Nature, Timing and Extent of Evidence-gathering Procedures**

The exact nature, timing and extent of evidence-gathering procedures will vary from one assurance service to the another. In theory, infinite variations in evidence gathering procedures are possible. In practice, however, these are difficult to communicate clearly and unambiguously. The professional accountant attempts to communicate them clearly and unambiguously and uses the form appropriate to a reasonable assurance service or a limited assurance service.

“Reasonable assurance” is a concept relating to accumulating evidence necessary for the professional accountant to conclude in relation to the subject matter information taken as a whole. To be in a position to express a conclusion in the positive form required in a reasonable assurance service, it is necessary for the professional accountant to obtain sufficient appropriate evidence as part of an iterative, systematic service process involving:

- (a) Obtaining an understanding of the subject matter and other assurance service circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;
- (b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;
- (c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;
- (d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the client, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and
- (e) Evaluating the sufficiency and appropriateness of evidence.

“Reasonable assurance” is less than absolute assurance. Reducing assurance service risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- (a) The use of selective testing;
- (b) The inherent limitations of internal control;
- (c) The fact that much of the evidence available to the professional accountant is persuasive rather than conclusive;
- (d) The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence; and

- (e) In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

Both reasonable assurance and limited assurance services require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic service process that includes obtaining an understanding of the subject matter and other service circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance service are, however, deliberately limited relative to a reasonable assurance service. For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance service. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the service, in particular, the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance services, if the professional accountant becomes aware of a matter that leads the professional accountant to question whether a material modification should be made to the subject matter information, he pursues the matter by performing other procedures sufficient to enable him to report.

### **Quantity and Quality of Available Evidence**

The quantity or quality of available evidence is affected by:

- (a) The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when information about the subject matter is future oriented rather than historical; and
- (b) Circumstances of the service other than the characteristics of the subject matter, when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the professional accountant's appointment, an entity's document retention policy, or a restriction imposed by the client. Ordinarily, available evidence will be persuasive rather than conclusive.

An unqualified conclusion is not appropriate for either type of assurance service in the case of a material limitation on the scope of the professional accountant's work, that is, when:

- (a) Circumstances prevent the professional accountant from obtaining evidence required to reduce assurance service risk to the appropriate level; or
- (b) The client or the engaging party imposes a restriction that prevents the professional accountant from obtaining evidence required to reduce assurance service risk to the appropriate level.

### Assurance Report

The professional accountant provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. ISAs, ISREs and ISAEs establish basic elements for assurance reports. In addition, the professional accountant considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.

In an assertion-based service, the professional accountant's conclusion can be worded either:

- (a) In terms of the client's assertion (for example: "In our opinion the client's assertion that internal control is effective, in all material respects, based on XYZ criteria, is fairly stated"); or
- (b) Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria"). In a direct reporting service, the professional accountant's conclusion is worded directly in terms of the subject matter and the criteria.

In a reasonable assurance service, the professional accountant expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria." This form of expression conveys "reasonable assurance." Having performed evidence-gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant service circumstances described in the assurance report, the professional accountant has obtained sufficient appropriate evidence to reduce assurance service risk to an acceptably low level.

In a limited assurance service, the professional accountant expresses the conclusion in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria." This form of expression conveys a level of "limited assurance" that is proportional to the level of the professional accountant's evidence-gathering procedures given the characteristics of the subject matter and other service circumstances described in the assurance report.

A professional accountant does not express an unqualified conclusion for either type of assurance service when the following circumstances exist and, in the professional accountant's judgment, the effect of the matter is or may be material:

- (a) There is a limitation on the scope of the professional accountant's work. The professional accountant expresses a qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the limitation is. In some cases the professional accountant considers withdrawing from the service.

- (b) In those cases where:
  - (i) The professional accountant's conclusion is worded in terms of the client's assertion, and that assertion is not fairly stated, in all material respects; or
  - (ii) The professional accountant's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated, he expresses a qualified or adverse conclusion depending on how material or pervasive the matter is.
- (c) When it is discovered after the service has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance service. The professional accountant expresses:
  - (i) A qualified conclusion or adverse conclusion depending on how material or pervasive the matter is, when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or
  - (ii) A qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the matter is, in other cases. In some cases the professional accountant considers withdrawing from the service.

### **Inappropriate Use of the Professional Accountant's Name**

A professional accountant is associated with a subject matter when the professional accountant's reports on information about that subject matter or consents to the use of his name in a professional connection with that subject matter. If he is not associated in this manner, third parties can assume no responsibility of the professional accountant. If the professional accountant learns that a party is inappropriately using his name in association with a subject matter, he requires the party to cease doing so. The professional accountant also considers what other steps may be needed, such as informing any known third party users, of the inappropriate use of the professional accountant's name or seeking legal advice.

## **9.4 DUE DILIGENCE**

### **Definition of Due Diligence**

Due Diligence is a term used for a number of concepts involving either the performance of an investigation of a business or person, or the performance of an act with a certain standard of care. It can be a legal obligation, but the term will more commonly apply to voluntary investigations. A common example of due diligence in various industries is the process through which a potential acquirer evaluates a target company or its assets for acquisition.

In business transactions, the due diligence process varies for different types of companies. The relevant areas of concern may include the financial, legal, labour, tax, IT, environment and market/commercial situation of the company.

Other areas include intellectual property, real and personal property, insurance and liability coverage, debt instrument review, employee benefits and labour matters, immigration, and international transactions.

In the perspective of private-sector world of business and finance, the term due diligence refers to the process through which an investor researches an organisation's financial and organisational health to guide an investment decision. The decision to fund or not to fund is based upon a balance of objective data analysis, insight into the general state of organisational health and stability, and intuition. A due diligence review is the process through which all the factors that make up that equation are uncovered and understood. It is the process in which a program officer seeks the truth about an organisation.

Due diligence in civil litigation, is the effort made by an ordinarily prudent or reasonable party to avoid harm to another party. Failure to make this effort may be considered negligence. This is conceptually distinct from investigative due diligence, involving a general obligation to meet a standard of behaviour. Quite often a contract will specify that a party is required to provide due diligence. Due care should not be confused with Due diligence. Due care should be spelt out in full as duty of care. It is a legal concept by itself. Duty of care may be very wide, far reaching, and also a grey area subject to argument. When read carefully, care is the passive mode; diligence is the active mode. First the duty of care (due care) arises, making it a requirement. In order to fulfil this duty, due diligence is exercised. The flow may be continuous, but these two concepts are different. When due diligence is called for, then there will be a set of demands to be complied with, depending on the context.

In criminal law, due diligence is the only available defence to a crime that is one of strict liability. Once the criminal offence is proven, the defendant should prove beyond a reasonable doubt that they did everything possible to prevent the act from happening. It is not enough that they took the normal standard of care in their industry - they should show that they took every reasonable precaution.

Information security due diligence is often undertaken during the information technology procurement process to ensure risks are known and managed, and during mergers and acquisitions due diligence reviews to identify and assess the business risks.

Due diligence is a somewhat technical phrase used to describe a range of assignments, legal obligations, reports and investigations which take place in business, manufacturing and law. Its most frequently heard version is the one pertaining to business, where due diligence refers to the steps taken by venture capitalists before investing a round of capital in a start-up, the ongoing investigation as to how the funds are being distributed, or the precautionary steps taken by a larger company in deciding to acquire a smaller company.

In venture capitalism, due diligence involves looking into the past and present of the people and structure of a company requesting venture funding. For instance, venture capitalists are cautious of investing in companies that lack people with credentials or a proven track record. Depending on the overall level of caution in the investment environment at the time, a due diligence investigation may be more or less stringent. Typically a venture capital firm will have a dozen or more investigators whose task is to research specific details of the personal history of people in the company. Of course, due diligence is not a magic potion against investment failures. Even a company made up of well-educated high achievers can falter due to unpredictable market conditions, unforeseen competition, or technical setbacks. Due diligence generally refers to the background checks conducted after a venture partner has already made a decision about the company.

In law, due diligence refers to precautions that are supposed to be taken by a person or company in some context. For example, did the company thoroughly check its product beforehand to ensure it was non-toxic or was not a strangulation hazard? If the company did not and bad results came of the negligence, it can be held criminally liable

### **Objectives of Due Diligence**

The first step in planning a due diligence program is to define its objectives. There may be different interest groups with different objectives in the given investments. However some of the more common objectives are:

- (a) Verification that the business is essentially what it seems to be. Determining this, by means of interviews, document study and on-site inspections, is the fundamental objective of due diligence.
- (b) Verification that the investment complies with investors' criteria. Many investors have vital criteria for businesses in which they will invest. These criteria may involve historical earnings, financial ratios, projected earning potential, tangible book value in relation to price, quality of management and type of business. The criteria reflect what investors hope to get for their money

The objective of the due diligence process should be to quantify major items and monetary values, not simply to identify assets, liabilities, defects or problems.

### **Responsibility of Professionals**

Accountants, attorneys, investment bankers, loan officers and other professionals involved in securities transactions have an obligation to conduct independent due diligence. Full disclosure is not just their clients' responsibility. Accountants may be required to provide formal opinion letters regarding the business. Investment bankers and others routinely write "fairness opinions" outlining their view of the transaction. Their objective is not just to provide competent professional service to their clients but to establish a record demonstrating they conducted adequate due diligence under the circumstances.

### **Scope of Due Diligence Programme**

While planning the scope and nature of a due diligence program, an investor should determine the degree of business and legal risk he will accept. Scope in this context consists of the depth of questioning on any subject and the quantity of original documents to be reviewed. A comprehensive and systematic due diligence program is absolutely necessary because risk multiplies when all aspects of a business are not objectively reviewed. One should however balance the amount of due diligence against the resources available in terms of time and cost.

An intense, well-run due diligence program cannot guarantee success for the investor, but it can most certainly reduce the chances of incurring losses. Conversely, no amount of information appraisal will totally eliminate risk or generate certainty that the contemplated transaction will succeed; however, that is no excuse for carrying out less work in a due diligence engagement.

### **What can be Considered Adequate Due Diligence?**

There can actually never be enough due diligence in evaluating an investment, but there are certain essentials that can lessen the investor's risk and possibly justify reducing the scope of due diligence. They include the following:

- (a) Stable and proven management;
- (b) Audited financial statements with short, easily understood notes;
- (c) History of consistent earnings;
- (d) Few subsidiaries, divisions or joint ventures;
- (e) Strong market position;
- (f) Absence of material litigation;
- (g) No real estate or operations with potential environmental problems;
- (h) Earnings primarily from operations;
- (i) Not dependent upon one or few customers or clients;
- (j) No intangible assets;
- (k) No intercompany transactions;
- (l) No discontinued operations or restructuring;
- (m) Little or no extraordinary income or expenses;
- (n) Strong internal controls; and
- (o) Few and readily accessible locations.

The absence of the above list will increase the signal for maximum due diligence. It would be necessary to conduct extensive due diligence if a number of significant adverse risk factors arose. Reducing its scope of due diligence can possibly be justified if key elements of the business are in favourable condition.

### **Constructing a Due Diligence Questionnaire**

On commencement of a due diligence programme, a list of information and documents that eventually may be required should be compiled. Such a large quantity of information on so many subjects is needed that an effort should be made to avoid matters of little importance or those that are irrelevant. The objective of data collection is to obtain enough information to make an informed

business decision. An exact amount of information cannot be recommended, but the following questions can help develop a due diligence questionnaire:

- (a) Is the information necessary to understand the business?
- (b) Is it necessary for negotiations and to write the contracts to conclude the deal?
- (c) If the information is not requested now, will it be needed at a later date?
- (d) Could mistakes be avoided by obtaining the information?
- (e) Is the information necessary to affect a smooth transition and for those managing the investment to be effective?
- (f) Since it is impossible to predict which subject or document will prove to be of great importance, it is better to include a subject than to delete it.

A due diligence checklist records answers and identifies what is missing. The checklist should ask questions to cover the following areas of the proposed investment;

- ◆ Capital structure
- ◆ Management
- ◆ R & D and Technology
- ◆ Real Estate facilities
- ◆ Markets, competitions and customers
- ◆ Marketing
- ◆ Pricing
- ◆ Advertising and public relations
- ◆ Purchasing
- ◆ Human resources
- ◆ Employees
- ◆ Compensations and benefits
- ◆ Corporate Culture
- ◆ Legal
- ◆ Information system
- ◆ Budgeting and Planning
- ◆ Insurance and bonding
- ◆ Environmental issues
- ◆ Debt and Banking
- ◆ Investments and Cash Management
- ◆ Taxes
- ◆ Accounting general questions
- ◆ Accounting policies
- ◆ Cash
- ◆ Accounts and notes receivables
- ◆ Inventories
- ◆ Fixed and other assets
- ◆ Liabilities
- ◆ Backlog and Income Recognition
- ◆ Cost of Sales, Selling and Administrative Expenses
- ◆ Intercompany transactions
- ◆ Investment Questions and Issues.

## 9.5 FORENSIC AUDIT

Forensic audit is the specialty practice area of accountancy that describes services which result from actual or anticipated disputes or litigation. Forensic means suitable for use in a court of law, and it is to that standard and potential outcome that forensic auditors generally have to work. Forensic auditors, also referred to as forensic accountants or investigative auditors, often have to give expert evidence at the eventual trial. It includes the audit of accounting records to prove or disprove a fraud. Includes the interview process of all related parties to a fraud, when applicable. It also includes the act of serving as an expert witness when matters are brought up in court. The term forensic in the accounting profession deals with the use or application of financial data in resolving allegations of fraud. Forensic audit evidence is oriented to a court of law.

The need of forensic audit is almost always reactive; this distinguishes it from fraud audit, which is actively involved in prevention and detection in corporate or regulatory environment. Forensic auditors are engaged to react to complaints arising in criminal matters, statements of claims arising in civil litigations, and rumours and inquiries arising in corporate investigations.

In contrast to financial audit, forensic audit put things together rather than taking them apart. The process of forensic auditing sometimes is more intuitive than deductive, although intuition and deduction play important roles. Forensic auditing is less procedural as it is intended to work more effectively in detecting fraud. Professional scepticism is the basic mindset for forensic audit.

### Need for Forensic Auditing

Complexities in business and changes in social and legal expectations have enhanced the need for forensic auditing. Wherever a potential loss, real financial loss, or risk of loss is perceived, a forensic audit may be commissioned. It can be applied in the following areas

- (a) **Corporate Investigations:** Organisations frequently are faced with circumstances of possible wrongdoings that may require investigations. The forensic auditor assists in investigating allegations ranging from kickbacks and wrongful dismissals to internal situations involving allegations of management or employee wrongdoing.
- (b) **Litigation Support:** In cases of loss of profit, construction claims, product liability, shareholder disputes, bankruptcies and breach of contracts, forensic auditors assist counsel in investigating and assessing the integrity and amount relating to such cases.
- (c) **Criminal Matters:** In criminal matters, forensic auditors as expert witnesses are increasingly important in court cases in variety of situations such as arson, scams, fraud, vendor frauds, customer frauds, investment scams, and stock market manipulations.
- (d) **Insurance claims:** To assess the integrity and the quantum of claim, the assistance of the forensic auditor is often required.

- (e) **Government:** Forensic accountants assist Governments to achieve regulatory compliance by ensuring that companies follow the appropriate legislation.

### **Qualities of a Forensic Auditor**

Most aspects of forensic audit fall outside the normal training of financial auditors. The following qualities are necessary to perform adequately as a forensic auditor:

- (a) Ability to identify fraud with minimal initial information;
- (b) Identification of financial issues. When confronted with situations arising from a complain, allegation, rumour, etc., he should be able to quickly identify the financial issues significant to the matter;
- (c) Knowledge of investigation techniques;
- (d) Knowledge of evidence. He should understand what constitutes evidence. For example, the meaning of “best” and “primary” evidence, the rules of evidence in court, and what constitute evidence in court;
- (e) Interpretation of financial information;
- (f) Presentation of financial findings. He should have the ability to communicate in findings in a language that is understandable by a lay person and without any ambiguity;
- (g) Investigative skills. Investigative skills are needed for litigation support;
- (h) Investigative mentality. The forensic auditor should, along with accounting skills, develop an investigative mentality that allows him to go beyond the limits established in generally accepted auditing standards;
- (i) Scope is not restricted as a result of materiality;
- (j) Sampling is not recommended; and
- (k) Non-assumption of integrity of management.

### **Steps in Forensic Auditing**

The following steps are adopted by the forensic auditor in performing an audit:

- (a) Verify compliance with regulatory, legal and evidential matters;
- (b) Review documents related to legal and general business functions;
- (c) Test the organisation’s motivational and ethical climate;
- (d) Document management, administrative, and organisational policies, procedures, and practices;
- (e) Gather and preserve evidence to corroborate asset losses, fraudulent transactions;
- (f) Establish accounting, audit, and internal control;
- (g) Conduct a review of internal controls;
- (h) Assess the strengths and weaknesses of those controls;
- (i) Design scenarios of potential fraud losses based on identified weaknesses in internal controls;
- (j) Identify questionable and exceptional transactions;
- (k) Identify questionable and exceptional account balances and variations;
- (l) Distinguish between simple and human errors and omissions in entries and fraudulent entries;

- (m) Follow the flow of funds that support documents;
- (n) Follow the flow of funds into and out of an organisation's bank account;
- (o) Search for underlying support documents for questionable transactions;
- (p) Review such documents for peculiarities; examples are fake billings, destruction of data, improper account classification, irregularities in financial data, substitution of copies of documents for the original; and
- (q) Document and report fraud loss for criminal, civil, or insurance claims.

### **Differences Between Forensic Audit and Financial Audit**

The procedure for financial audits are designed to detect material mis-statements, not material frauds. Financial auditors depend on a sample and rely on examination of audit trail instead of the examination of the events and activities behind the documents. Financial audit procedures are based on uncovering material deviations in financial data and significant variances from acceptable accounting and auditing standards. Forensic auditors look behind and beyond the transactions and audit trail to focus on substance of the transactions instead. Unlike the financial auditor, the forensic auditor asks the following questions:

- (a) Where are the weakest links in the system chain of controls?
- (b) How are offline transactions handled, and who authorises them?
- (c) What possible deviations can occur in the system different from conventional good accounting practice?
- (d) What simple way exists to compromise the system?
- (e) What is the nature of work environment in the organisation?
- (f) How can higher management bypass the control systems in the organisation?

Forensic audit has the following peculiar characteristics:

- (a) It is more a mindset than a mythology;
- (b) Forensic audit approach is different from financial audit approach;
- (c) Forensic audit is learned from experience not from text books; and
- (d) Forensic audit views fraud as an intentional misrepresentation of material financial facts; financial audit views fraud as an intentional misrepresentation of financial fact of a material nature.

## **9.6 SUMMARY AND CONCLUSIONS**

The chapter makes an introduction to assurance services. Elements and scope of assurance services were discussed, including the various forms of assurance reports. Issues on due diligence as an aspect of audit and assurance, were covered.

Similarly forensic services as distinct from financial audit was explained, with steps required for an effective forensic investigation, provided.

*Refer to Comprehensive Questions and Suggested Solutions in Appendix II, on page 321.*

**9.7 REVISION QUESTIONS****9.7.1 MULTIPLE CHOICE QUESTIONS**

1. The various elements which are peculiar to an assurance engagement do not include the following:
  - (A) Existence of a three party relationship involving the practitioner the responsible party and the intended user
  - (B) Non-existence of suitable criteria
  - (C) Identification of the subject matter
  - (D) Written assurance report in appropriate form to include appropriate conclusion
  - (E) Availability of sufficient appropriate evidence.
  
2. Which of the following is not an example of assurance engagements
  - (A) A statutory audit
  - (B) Reports and statements of Accounting Policies
  - (C) Reports on Corporate Social Responsibility Performance
  - (D) Reports on Environmental Performance
  - (E) Report for Lenders and Other Investors.
  
3. One of the following is not a peculiar characteristics of forensic audit
  - (A) It is more a mind set than a mythology
  - (B) Forensic audit approach is different from financial audit approach
  - (C) Forensic audit is learned from experience not from text books
  - (D) Forensic audit is the same as assurance service
  - (E) Forensic audit views fraud as an intentional misrepresentation of material financial facts; financial audit views fraud as an intentional misrepresentation of financial fact of a material nature.
  
4. One of the following questions is not necessary in developing a due diligence questionnaire
  - (A) Is the information necessary to understand the business
  - (B) Is it necessary for negotiations and to write the contracts to conclude the deal
  - (C) If the information is not requested now, will it be needed at a later date
  - (D) Could mistakes be avoided by obtaining the information
  - (E) The academic qualifications of management staff.

**9.7.2 SHORT ANSWER QUESTIONS**

5. It is noted that there can actually be enough due diligence when evaluating an investment, however there are certain essentials that can lessen the investor's risk and possibly reduce the scope of due diligence. List these essentials.
  
6. The term "Due Diligence" may mean different things in different professions and industries; what do you understand by the term Due Diligence in the perspective of private sector world of business and finance.
  
7. Complexities in business and changes in social and legal expectations have enhanced the need for forensic auditing. What are the areas where forensic audit can be applied?

8. What are the qualities that are required of a good forensic auditor?
9. List the steps necessary by a forensic auditor to perform a forensic audit.

*Refer to suggested solution in Appendix I on page 301.*

# ***APPENDICES***

# APPENDIX I

## SUGGESTED SOLUTIONS TO REVISION QUESTIONS

### CHAPTER 1

1. A
2. C
3. D
4. C
5. D

### SHORT ANSWER SOLUTIONS

1. Fundamental principles of independent auditing:  
The Auditors' Code, published by APB, prescribes nine fundamental principles of independent auditing as follows:
  - (a) **Accountability**  
Auditors act in the interests of primary stakeholders, whilst having regard to the wider public interest. The identity of primary stakeholders is determined by reference to the statute or agreement requiring an audit: in the case of companies, the primary stakeholder is the general body of shareholders.
  - (b) **Integrity**  
Auditors act with integrity, fulfilling their responsibilities with honesty, fairness and truthfulness.  
Confidential information obtained in the course of the audit is disclosed only when required in the public interest, or by operation of law.
  - (c) **Objectivity and independence**  
Auditors are objective. They express opinions independently of the entity and its directors.
  - (d) **Competence**  
Auditors act with professional skill, derived from their qualification, training and practical experience.  
This demands an understanding of financial reporting and business issues, together with expertise in accumulating and assessing the evidence necessary to form an opinion.
  - (e) **Rigour**  
Auditors approach their work with thoroughness and with an attitude of professional scepticism. They assess critically the information and explanations obtained in the course of their work and such additional evidence as they consider necessary for the purposes of their audit.
  - (f) **Judgement**  
Auditors apply professional judgement taking account of materiality in the context of the matters on which they are reporting.
  - (g) **Clear Communication**  
Auditors' reports contain clear expressions of opinion and set out information necessary for a proper understanding of that opinion.

- (h) **Association**  
Auditors allow their reports to be included in documents containing other information only if they consider that the additional information is not in conflict with the matters covered by their report and they have no cause to believe it to be misleading.
- (i) **Providing Value**  
Auditors add to the reliability and quality of financial reporting; they provide to directors and officers constructive observations arising from the audit process; and thereby contribute to the effective operation of business, capital markets and the public sector.

2. **Scope**

The auditor considers the following matters in determining the scope of work:

- (a) the relevant statements of accounting standards,
- (b) the auditing standards,
- (c) the requirements of relevant professional bodies,
- (d) legislation and regulations and
- (e) the terms of the audit engagement

3. **Ethical principles**

In the conduct of any audit of financial statements auditors should comply with the ethical guidance issued by their relevant professional bodies.

The ethical principles which govern auditors' professional responsibilities include:

- (a) integrity;
- (b) objectivity;
- (c) independence;
- (d) professional competence and due care;
- (e) professional behaviour; and
- (f) confidentiality.

In Nigeria, the auditor should comply with the 'Rules of Professional Conduct for Members issued by the Institute of Chartered Accountants of Nigeria and accounting standards issued by the Nigerian Accounting Standards Board. The 'Rules of Professional Conduct for Members' covers the following matters:

- (a) fundamental principles
- (b) integrity, objectivity and independence
- (c) conflicts of interest
- (d) confidentiality
- (e) changes in professional appointment
- (f) consultancy
- (g) association with non-members
- (h) fees
- (i) obtaining professional work
- (j) the names and letterheads of practicing firms
- (k) second and other opinions
- (l) members in business
- (m) enforcement of ethical standards

4. **Independence of mind:**

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

5. Matters which should be considered in determining whether confidential information may be disclosed are as follows:
- (a) When disclosure is authorised. When authorisation to disclose is given by the client or the employer the interests of all the parties including those third parties whose interests might be affected should be considered.
  - (b) When disclosure is required by law. Examples of when a professional accountant is required by law to disclose confidential information are:
  - (c) To produce documents or to give evidence in the course of legal proceedings; and
  - (d) To disclose to the appropriate public authorities infringements of the law which come to light.

When there is a professional duty or right to disclose:

- (a) To comply with technical standards and ethics requirements; such disclosure is not contrary to this section;
- (b) To protect the professional interests of a professional accountant in legal proceedings;
- (c) To comply with the quality (or peer) review of a member body or professional body; and
- (d) To respond to an inquiry or investigation by a member body or regulatory body.

When the professional accountant has determined that confidential information can be disclosed, the following points should be considered:

- (a) Whether or not all the relevant facts are known and substantiated, to the extent it is practicable to do so; when the situation involves unsubstantiated fact or opinion, professional judgement should be used in determining the type of disclosure to be made, if any;
- (b) What type of communication is expected and the addressee; in particular, the professional accountant should be satisfied that the parties to whom the communication is addressed are appropriate recipients and have the responsibility to act on it; and
- (c) Whether or not the professional accountant would incur any legal liability having made a communication and the consequences thereof.

In all such situations, the professional accountants should consider the need to consult legal counsel and/or the professional organisation(s) concerned. The 'Rules of Professional Conduct for Members' issued by the Institute of Chartered Accountants of Nigeria provides, in relation to confidentiality, that:

- ◆ information confidential to a client or employer acquired in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper source, or where there is a legal right or duty to disclose.
- ◆ Where a legal right or duty of disclosure does exist, the client or employer should normally be notified in advance of the disclosure being made.

## CHAPTER 2

1. C
2. A
3. A
4. A
5. E

## SHORT ANSWER SOLUTIONS

1. Remuneration of auditors
  - (a) The remuneration of the auditors of a company-
    - (i) in the case of an auditor appointed by the directors, may be fixed by the directors; or
    - (ii) shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.
  - (b) “Remuneration” includes sums paid by the company in respect of the auditors’ expenses. (Section 361).
  
2. Liability of auditors for negligence
  - (a) A company’s auditor shall in the performance of his duties, exercise all such care, diligence and skill as is reasonably necessary in each particular circumstance.
  - (b) Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him the auditor shall be liable for negligence and the directors may institute an action for negligence against him in the court.
  - (c) If the directors fail to institute an action against the auditor any member may do so after the expiration of 30 days’ notice to the company of his intention to institute such action. (Section 368)
  
3. Any person:
  - (a) having any interest in a bank otherwise than as a depositor; or
  - (b) who is a director, officer or agent of a bank; or
  - (c) which is a firm in which a director of a bank has any interest as partner or director; or
  - (d) who is indebted to a bank, shall not be eligible for appointment as the approved auditor for that bank;
  - (e) and a person appointed as such auditor who subsequently – acquires such interest; or becomes a director, officer or agent of the bank; or becomes indebted to a partner in a firm in which a director of a bank is interested as partner or director, shall cease to be such auditor.
  
4. NASB Act 2003 prescribes stiff penalties for non-compliance with accounting standards issued by the NASB. These include
  - (a) Fines at the discretion of the Board
  - (b) 5 million fine
  - (c) One year imprisonment, or both, on conviction
  - (d) Proscription or delisting of the firm of accountants
  
5. Family and Personal Relationships
 

The Code of Ethics for Professional Accountants issued by the International Federation of Accountants further provides that “Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual’s responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level”.

When an immediate family member of a member of the assurance team is

- (a) a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, or
- (b) in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level.

If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence on the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.

When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- (a) The position the close family member holds with the client; and
- (b) The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- (a) Removing the individual from the assurance team;
- (b) Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- (c) Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

### CHAPTER 3

- 1. E
- 2. A
- 3. E
- 4. C
- 5. C

### SHORT ANSWER SOLUTIONS

- 1. The scope and objectives of internal audit vary widely and depend on the size and structure of the entity and the requirements of its management and directors. Generally, internal audit activities include one or more of the following:
  - (a) review of the accounting and internal control systems: the establishment of adequate accounting and internal control systems is a responsibility of management and the directors which demands proper attention on a continuous basis. Often internal audit is assigned specific responsibility for reviewing the design of the systems, monitoring their operation and recommending improvements thereto.

- (b) Examination of financial and operating information: this may include review of the means used to identify, measure, classify and report such information and specific enquiry into individual items including detailed testing of transactions, balances and procedures;
  - (c) Review of the economy, efficiency and effectiveness of operations including non financial controls of an organisation;  
Review of compliance with laws, regulations and other external requirements and with internal policies and directives and other requirements including appropriate authorisation of transactions; and
  - (d) Special investigations into particular areas, for example suspected fraud.
2. The internal audit function's objectives vary
- (a) according to the requirements of management and the directors and,
  - (b) generally, less emphasis is placed on materiality consideration.
3. In some cases, after considering the activities of internal audit, the external auditors may decide that internal audit work will have no effect on external audit procedures. Nevertheless, external auditors normally find it helpful to be aware of conclusions drawn by internal audit.

In the event that the external auditors conclude that the internal audit work is not adequate for their purposes,

- (a) they should extend their procedures beyond those original planned and
  - (b) ensure that sufficient appropriate audit evidence is obtained to support the conclusions reached.
4. To assess inherent risk
- (a) Auditors use their professional judgement to evaluate numerous factors
  - (b) Having regard to their experience of the entity from previous audits
  - (c) Any controls established by management to compensate for a high level of inherent risk and
  - (d) Their knowledge of any significant changes which have taken place.

Examples of the factors are:

At the entity level

- (a) The integrity of directors and management
  - (b) Management experience and knowledge and changes in management during the period,
  - (c) Unusual pressures on directors or management, such as tight reporting deadlines, market expectations or other circumstances might predispose them to misstate the financial statements,
  - (d) The nature of the entity's business
  - (e) Factors affecting the industry in which the entity operates
5. Control risk in the small business
- (a) Auditors must obtain an appropriate level of audit evidence to support their audit opinion regardless of the size of the entity.
  - (b) However, many internal controls relevant to large entities are not practical in the small business; for example, in small businesses accounting procedures may be performed by few persons who may have both operating and custodial responsibilities and, consequently, segregation of duties may be severely limited.
  - (c) Inadequate segregation of duties may, in some cases, be offset by other control procedures and close involvement of an owner or manager in strong supervisory controls where they have direct personal knowledge of the

- entity and involvement in transactions though this in itself may introduce other risks.
- (d) In circumstances where segregation of duties is limited and evidence of supervisory controls is lacking, the audit evidence necessary to support the auditors' opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures and any audit work carried out in the course of preparing the financial statements.

#### CHAPTER 4

1. A
2. E
3. E
4. F
5. E

#### SHORT ANSWER SOLUTIONS

1. Planning the work  
 Planning is necessary for audits of entities of all sizes. The objectives of planning the audit work, which takes place before the detailed audit work begins, include:
  - (a) Ensuring that appropriate attention is devoted to the different areas of the audit;
  - (b) Ensuring that potential problems are identified; and
  - (c) Facilitating review.

Planning also assists

- (a) in the proper assignment of work to members of the audit team and their briefing, and
- (b) in the co-ordination of work done by other auditors and experts, so that the audit may be performed in an efficient and timely manner.
- (d) In obtaining an understanding of the entity's affairs and,
- (e) all members of the audit team in understanding the nature and scope of the work they are to carry out before the audit field work starts.

Obtaining knowledge of the entity's business is required as an important part of planning the work. The auditors' experience with the entity and knowledge of its business assist in the identification of events, transactions and practices which may have a material effect on the financial statements.

Planning varies according to the size of the entity and the complexity of the audit.

2. Auditors need to discuss elements of the overall audit plan and certain audit procedures with
  - (a) the entity's management and staff, and
  - (b) with any audit committee in order to improve the effectiveness of the audit and to co-ordinate audit procedures with work of the entity's personnel, including internal auditors.

The overall audit plan and the detailed audit procedures to be performed, however, remain the auditors' responsibility. When such discussions occur, care is required not to compromise the independence and validity of the audit.

3. Work performed by audit staff is reviewed by other more senior audit staff or the audit engagement partner. Reviewers consider whether:
- (a) the work has been performed in accordance with the firm's procedures and in accordance with the audit programme.
  - (b) The work performed is adequate in light of the results obtained and has been adequately documented;
  - (c) Significant audit matters have been raised for further consideration;
  - (d) Appropriate consultations have taken place and the results of such consultations have been documented;
  - (e) The objectives of the audit procedures have been achieved; and
  - (f) The conclusions are consistent with the results of the work performed.

Audit engagement partners perform an overall review of working papers. The review is sufficient for them to be satisfied that the working papers contain sufficient appropriate evidence to support the conclusions reached and for the auditors' report to be issued.

Although the review may not cover all working papers, it covers:

- (a) all critical areas of judgement, especially any relating to difficult or contentious matters identified during the audit.
- (b) audit evidence relating to high risk areas;
- (c) any other areas which the audit engagement partner considers important.

Audit engagement partners document the extent of their review and its timing so as to demonstrate that it was completed before the auditors' report was signed. Review notes recording questions or points raised in the course of the audit need not be retained at the end of the audit provided that the working papers have been updated thereto and, in particular, record the reasoning on all significant matters which require the exercise of judgement.

#### 4. **Monitoring**

Firms should appoint a senior audit partner to take responsibility for monitoring the time aspects of audits carried out by the firm.

The responsibility for monitoring the time aspects of audit performance is different from the responsibility for the establishment of quality control policy and processes. Wherever possible, the two responsibilities are undertaken by different senior audit partners.

The objective of monitoring time and costs to provide an independent assessment of:

- (a) the appropriateness of the time cost, billing and recovery of costs on audit;
- (b) whether the firm's own time and cost policy and processes have been applied.

The senior audit partner responsible for the monitoring process

- (a) develops procedures for the systematic review of time cost, billing and recovery on completed audit engagements.
- (b) develops appropriate course of action where significant variances between estimated time cost and actual cost are identified. Courses of action may involve communication of the findings within the firm and additional training.
- (c) ensures changes to the firm's policies and procedures and disciplinary action against those who repeatedly fail to comply with the firm's standards.

5. Auditors should apply analytical procedures at the planning stage to assist in:
- understanding the entity's business,
  - identifying areas of potential audit risk and
  - planning the nature, timing and extent of other audit procedures.

Analytical procedures at this stage are usually based on interim financial information, budgets and management accounts. Discussions with management, focused on identifying significant changes in the business since the prior financial period, may also be useful.

Application of analytical procedures may indicate

- aspects of the entity's business of which the auditors were previously unaware and
- assist in determining the nature, timing and extent of other audit procedures.

## CHAPTER 5

- D
- B
- C
- D
- E

## SHORT ANSWER SOLUTIONS

1. (a) The auditor should keep in mind the objectives of observing a physical inventory, namely:
- To ascertain that the inventory exists.
  - To observe that the count are accurate.
  - Ensure the description of the inventory are accurate; and
  - Its condition properly recorded.

The auditor makes and records test counts of inventory for the following purposes:

- Confirm the accuracy of the client's counting and
- Record evidence to corroborate the existence of the inventory for later tracing to the inventory summary sheet.
- Random selection, independent counting and comparison with quantities recorded by the clients, provide evidence that all items on hand are accurately included in the client's recorded counts.

If the auditor's test counts disclose an unacceptable number of errors in a particular location, the client would ordinarily perform a recount of the inventory.

2. The factors that would influence the timing of the inventory are:
- When the inventory is subject to significant volatility of movement of quantities, or if the control procedures for accounting for movement are ineffective, it should be counted at year-end;
  - If those procedures are effective, the count can be taken before year-end or, if the client used cycle counts, on a staggered basis throughout the year;
  - If the inventory is taken at one time, both client and auditor usually prefer a month in the last quarter of the fiscal year.

3. “Goodwill is the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets”. Separable net assets are those assets (and liabilities) which can be identified and sold (or discharged) separately without necessarily disposing of the business as a whole. They include identifiable intangibles. Other Definitions Include:
  - (a) The value attributable to a company’s average strength in areas such as technical skill and knowledge;
  - (b) The value of the business community’s attitudes to the entity;
  - (c) That part of the value of a business which arises from all its advantageous circumstances which generate earnings above an assumed norm (super profits).
  
4. Auditors should consider the following factors before observing the year-end inventories:
  - (a) Timing of inventories at various locations,
  - (b) Difficulty of observing them, and
  - (c) Number of counting teams the client provides.

The auditor should also observe inventory exercise so as to ascertain:

- (a) Whether supervisory personnel are present,
- (b) How planned recounting procedures are executed,
- (c) Whether cut-off procedures are performed,
- (d) How inventory count documents are controlled,
- (e) How individual areas or departments are controlled and cleared, and
- (f) Whether instructions are followed.

The auditor’s assessment of how effective the client’s reconciliations are would determine the nature, timing, and extent of many of the substantive tests of cash. Other factors are:

- (a) The adequacy of the accounting system,
- (b) The competence of employees conducting the reconciliations, and
- (c) The segregation of duties.

The more effective the auditor finds the client’s reconciliations to be, that is, the lower the assessed level of control risk, the less detailed the auditor’s reconciliation procedures have to be. Those procedures may range from simply reviewing the client’s reconciliations at year-end, if control risk has been assessed as low, to performing independent reconciliations covering the entire year using the proof of cash form. Generally, performing proof of cash reconciliation for the entire year is considered necessary only in special situations, such as when a defalcation is believed to have occurred. Between those two extremes falls the auditor’s judgmental discretion.

5. Kiting is a way of concealing cash shortages caused by a defalcation, such as misappropriating cash receipts that were perpetrated previously. It involves the careful and deliberate use of the “float” (the time necessary for a cheque to clear the bank it was drawn on). Drawing a cheque on one bank, depositing it in another bank just before year-end, so that deposit appears on the bank statement and the recording of the transfer in the receipts is not done until after year-end amounts to kiting. The float period will cause the cheque not to clear the bank it was drawn on until after year-end, and the amount transferred is included in the balances of both bank accounts. Since the transfer is not recorded as a receipt or a disbursement until the following year, it will not appear as an outstanding cheque or a deposit in transit on the reconciliation of either bank account. The effect is to increase receipts per the bank statement; if the misappropriation of cash receipts and the kiting take

place in the same period, receipts per the bank statement will agree with receipt per the cash receipts journal at the date of the bank reconciliation. (If the misappropriation of cash receipts takes place in the period before the kiting, a proof of cash may also reveal the kiting). Kiting requires that the transfer process be repeated continually until the misappropriated funds have been restored. Kiting could have a wider meaning to encompass writing cheques against inadequate funds with the intent of depositing sufficient funds later, but before the cheques clear the book.

## CHAPTER 6

1. C
2. E
3. A
4. D
5. B

## SHORT ANSWER SOLUTIONS

1. Internal control
2. Online
3. Roles
4. Information Technology General Controls or IT General Controls or ITGC
5. Completeness check control

## CHAPTER 7

1. C
2. D
3. D
4. D

## SHORT ANSWER SOLUTIONS

1. The Auditor-General for the Federation is appointed by the President on the recommendation of the Federal Civil Service Commission subject to confirmation by the Senate. He is appointed in accordance with the provision of Sec 86 of the Constitution of Federal Republic of Nigeria.
2. A person shall act in the office of the Auditor-General for a period not exceeding six months. Any extension of the acting period must be with the sanction of a resolution of the Senate.
3. Public Accounts Committee is empowered to:
  - (a) Examine such audited accounts of the Federation and of all offices and courts of the Federation and the Auditor-General report thereon as may be referred to it.

- (b) Examine:
  - (i) The Accounts and reports of ministries and Departments of the Government of the Federation.
  - (ii) The Audited Accounts of statutory corporations, boards and such other government bodies.
  - (iii) The causes which led to, or might have led to, any excess over approved appropriations.

In the performance of the above-named functions, the PAC is further empowered to:

- (a) Procure all such evidence, oral or written and examine such persons as it may deem necessary or desirable.
- (b) Require any person to produce any books, documents or records, as it may deem necessary and desirable.

The composition of PAC is geared towards functioning like a court of enquiry empowered to look into civil and criminal cases as regards allocation and disbursement and use of public funds by public officers who have been entrusted with the responsibility of judiciously using the funds, carrying out government programmes, and recommending appropriate actions against officers fund wanton in carrying out his duties.

#### 4. **Value-for-money audit**

This is also known as Performance Audit by British classification. It is also called Economy and Efficiency Audit. The essence is to determine whether an entity is acquiring, managing or utilizing its resources (staff, building materials space etc.) in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices. Value for Money Audit is defined as an objective professional and systematic assessment of:

- (a) The nature and function of an authority's managerial systems and procedures.
- (b) The economy and efficiency with which its services are processed.
- (c) The effectiveness of its performance in achieving objectives.

#### **Phases of value-for-money audit**

- (a) Proposal Phase which aims at justifying the study of a particular area, authorise, initial resources and determine further considered initial analysis of financial statistics, audit costs and other performance indicators.
- (b) The Scooping Phase, which aims at gathering sufficient details. It embraces, gathering working information, studying related legislations, testing controls act. At this stage there will be comprehensive management systems and objective review.
- (c) Planning Phase, aims at planning to fully develop identified potentials. The planning and control processes are properly analysed and methods of reviewing operating results are examined through analysis of control and reporting systems.
- (d) Implementation Phase: aims at reporting the audit results to those responsible for receiving or acting on them.
- (e) Evaluation Phase: is to evaluate the audit result, methodology and performance of the audit staff. The focus here will be assessment of efficiency and effectiveness review. Value-for-money audit aims to identify ineffectiveness in the system and underutilisation of resources.

5. An internal auditor in the public sector is responsible for:
- (a) Reviewing, evaluating and reporting on the adequacy or otherwise of the controls installed and operated and the extent to which they assure propriety, security, completeness and accuracy of operations of the establishment;
  - (b) Performing the responsibility imposed by the Civil Service Reforms. The Reforms state that he shall carry out complete and continuous audit of accounts and records of revenue and expenditure, plant stores and assume the duty of Stock Verifier where none exists in an establishment;
  - (c) Confirmation of reliability and accuracy of extracted financial information to management.

## CHAPTER 8

1. C
2. D
3. D
4. D
5. C

## SHORT ANSWER SOLUTIONS

1. Accounting Standards require that potential losses due to uncertainties be classified as “probable,” “reasonably possible,” or “remote.”:
  - (a) If a loss is probable, management must provide for it in the financial statements, either by accruing it if the amount is susceptible to reasonable determination or by disclosing it if the amount cannot be reasonably estimated. No explanatory language is needed in the auditor’s standard report if the auditor agrees that the provision or disclosure is appropriate; if the amount cannot be reasonably estimated, however, the auditor should add an explanatory paragraph to the report because of the uncertainty.
  - (b) Likewise, a “remote” uncertainty would not require an explanatory paragraph in the standard report.
  - (c) If a material loss is “reasonably possible,” however, management is required to disclose the uncertainty in the notes to the financial statements, including an estimate of the amount, and the auditor would normally add an explanatory paragraph to the report.

For instance, if the outcome of a matter having an impact on the financial statements depends on the decisions of others, it may be impossible for management and the auditor to reach a valid conclusion about it because competent evidential matter simply does not exist. The most common events of that kind are lawsuits and tax disputes. The mere existence of an unresolved question does not relieve management or the auditor of the responsibility for forming a judgement about the outcome.

The outcome of many tax disputes, for instance, can be reasonably determined by an informed analysis. In some cases, however, the best possible efforts result in a judgement that no valid conclusion can be formed. In that event, the auditor should describe the uncertainty in a separate explanatory paragraph following the opinion paragraph of the report, along with an indication that its outcome cannot presently be determined. The separate paragraph may be shortened to refer to disclosures made in a note to the financial statements.

2. When Required

The representation letter should be addressed to the auditor and should be dated no earlier than the date of the auditor's report, but no later than the report release date. Both the chief executive and chief financial officers should ordinarily sign representation letters. Other members of management may sign the letter instead, however, if the auditor is satisfied that they are responsible for and knowledgeable about the matters covered by the representations.

3. Subsequent Events an Auditor Must Consider

After the financial statements and audit report have been issued an auditor may become aware of new information regarding the client. If the new information refers to:

- (a) A condition that did not exist at the date of the audit report, or
- (b) Final resolutions of contingencies or other matters disclosed in the financial statements or in the auditor's report, then the auditor has no further obligation.

If, however, the new information:

- (i) Relates to facts existing at the date of the audit report; and
- (ii) Would have affected the financial statements or
- (iii) Would have affected the auditor's report had the auditor been aware of them, the auditor is obligated to pursue the matter.

The auditor has obligation in those circumstances even if he has resigned or has been discharged.

While the distinction between the two kinds of new information is conceptually clear, in practice it is often difficult to tell, at least initially, whether the new information refers to a new or a pre-existing condition. The auditor should ordinarily discuss the information with the client and request that the client make any necessary investigations.

4. Definition of an Expert

An expert is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing. An expert is synonymous with a "specialist". The expert may be engaged by the client or by the auditor.

- (a) Circumstances under which the Auditor may use the work of an Expert, (any four):
  - (i) Where the auditor has difficulty in ascertaining the value of certain assets; e.g. land and buildings, plant and machinery, works of art, precious stones and other solid minerals.
  - (ii) Where the auditor is unable to determine qualities or physical conditions of assets e.g. minerals in stockpiles, underground mineral and petroleum resources and the remaining useful life of plant and machinery.
  - (iii) Where determination of values of certain assets is by means of special techniques or methods outside the training of the auditor e.g. an actuarial valuation.
  - (iv) Where there is need for measurement of work completed and work in progress for the purpose of revenue recognition and the techniques for measurement are outside the accounting profession.
  - (v) Where the auditor is unable to interpret legal documents such as agreements, statutes and regulations.

A general outline of the specific items the auditor expects the expert's report to cover

- ◆ the intended use of the expert's work by the auditor including the possible communication to the client of the expert's identify and extent of involvement.
  - ◆ documentation or further information required as audit evidence.
- (vi) Evaluation of the work of the expert: the auditor should ensure that the expert's work constitutes appropriate audit evidence in support of the financial information. In this regard, he should consider:
- ◆ The source of the data – To ensure it is appropriate in the circumstances
  - ◆ The assumptions and methods used – to ensure their consistency with prior period. The results of the expert's work – in the light of the auditor's overall knowledge of the business and of the result of his audit procedures.
- (vii) Audit Reporting: The auditor should satisfy himself that the substance of the Expert's findings, advice or opinion is properly reflected in the financial statements.
- (b) Factors determining the need for an expert
- (i) The materiality of the item being examined in relation to the financial information as a whole. The persuasion to use the work of an expert will be greater where the item is material.
  - (ii) The nature and complexity of the item including the risk of error therein.
  - (iii) The availability of other audit evidence available with respect to the item.
  - (iv) The time and cost of obtaining the expert advice in relation to the value to be derived.
  - (v) The skills and competence of the expert – the expert's professional certification, license or membership of appropriate professional body and the experience and reputation of the expert in the relevant field.
  - (vi) the objectivity of the expert – the risk that an expert's objectivity will be impaired increases when the expert is employed by the client or is related in some other manner to the client. For example, by being financially dependent on the client or having an investment in the client organisation.
- (c) Procedures to be followed by the auditor when the works of others is required
- (i) Communication with the Expert: If while planning the audit, the auditor intends to use the work of an expert, he should communicate with the expert to confirm the terms of the expert's engagement. In particular, the auditor should ascertain the following:
    - ◆ The scope and objective of the expert's work
    - ◆ The expert's relationship, if any, with the client
    - ◆ The extent of the expert's access to appropriate records and files.
    - ◆ The assumptions and methods intended to be used by the expert and if appropriate their consistency with those used in a prior period.
    - ◆ The auditor should also provide the expert with the following relevant information.

5. Circumstances for departure from unqualified opinions  
 SAS 58, *Reports on Audited Financial Statements*, classifies departures from the standard unqualified report as qualified opinions, adverse opinions, and disclaimers of opinion. These departures are:

Qualified opinions

There are two basic reasons for qualifying an opinion, viz:

- (a) Limitations on the scope of the audit and
- (b) Departures from GAAP.

Scope limitations

An audit can be limited:

- (a) by circumstances beyond the client's control that preclude the auditor from employing the auditing procedures that would otherwise be considered necessary, or
- (b) by client-imposed restrictions.

Circumstances precluding necessary auditing procedures

Sometimes an auditor is not able to carry out procedures that customarily are considered necessary in the circumstances as a basis for rendering unqualified opinion. In most instances, the auditor is able to design and perform alternative

procedures that provide sufficient assurance that the relevant audit objectives procedures have been achieved. Those common instances in which the auditor might not be able to perform alternative procedures are when conditions make it impracticable or impossible to confirm accounts receivable or observe inventories. If an auditor cannot obtain satisfaction by means of alternative auditing procedures, the auditor should:

- (a) describe the problem and
- (b) modify the standard report, or
- (c) if the auditor decides to express a qualified opinion (rather than disclaim an opinion), the problem should be described in a separate paragraph and referred to in both the scope paragraph and the opinion paragraph.

Client-Imposed restrictions

The most common client-imposed restrictions are imitations preventing observation of physical inventories, confirmation of accounts receivable, or examination of a subsidiary. Usually, if scope is limited by client-imposed restrictions, auditors should disclaim an opinion because the client's election to limit the auditor's scope implies also an election to limit the auditor's responsibility. On rare occasions, if a client-imposed scope limitation applies to an isolated transaction or a single account, a qualified opinion may be acceptable.

8. Auditor's evaluation of doubt about a client going concern status  
 If the auditor concludes there is substantial doubt about the entity to continue as a going concern for a reasonable period of time the auditor should:

- (a) determine that this fact is appropriately disclosed in the financial statements, and
- (b) reflect that conclusion in explanatory paragraph.

In a properly planned audit, it should not be necessary to design auditing procedures specifically directed at the going concern issue. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

For example, conditions and events that could raise doubts may be identified through some of the following procedures:

- (a) analytical procedures;
- (b) review of subsequent events;
- (c) review of compliance with the terms of debt and loan agreements;
- (d) reading of minutes of meetings of stockholders, board of directors, and important committees of the board;
- (e) inquiry of the entity's lawyers about litigation, claims and assessments; and
- (f) confirmation with related and third parties of the details of arrangements to provide or maintain financial support.

In considering the evidence provided by those procedures, it may be necessary for the auditor to obtain additional information about conditions and events identified that could create substantial doubt about the entity's ability to continue as a going concern. SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, gives the following examples of such conditions and events, some of which are interrelated:

*Negative trends:* Characterised by recurring operating losses, working capital deficiencies, negative cash flows from operating activities and adverse key financial ratios are the order of the day.

*Other indications of possible financial difficulties* – Examples are: default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, non-compliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets (outside the course of business).

*Internal matters* – Examples: work stoppages or other labour difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, needs to overhaul operations.

*External matters that have occurred* –

Examples are:

Legal proceedings, legislation, or similar matters that might jeopardise an entity's ability to operate,

- (a) loss of a key franchise, license, or patent; loss of a principal customer or supplier;
- (b) uninsured or underinsured catastrophe such as fire, flood, drought, earthquake.
- (c) If substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, auditors should:
- (d) obtain information about management's mitigation plans and
- (e) assess the likelihood that such plans can be effectively implemented.

Management's plans might include:

- (a) plans to dispose of assets, reduce or
- (b) delay expenditures, borrow money or
- (c) restructure debt, or increase ownership equity.

The auditor should:

- (a) evaluate those plans;
- (b) consider whether there is adequate evidence supporting management's ability to carry out the plans. For example, plans to dispose of assets could be difficult or impossible to accomplish;

- (c) ascertain if there are restrictive covenants in loan agreements limiting such disposals;
- (d) request management to provide information about significant management's plans and
- (e) consider whether there is adequate support for the significant assumptions underlying the plans.

After evaluating management's plans, auditor should conclude whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time.

If the auditor concludes there is substantial doubt, he or she should then consider

- (a) the adequacy of financial statement disclosure about the entity's possible inability to continue as a going concern and
- (b) include an explanatory paragraph (following the opinion paragraph) in the audit report to reflect that conclusion.

## CHAPTER 9

1. B
2. B
3. (a) An assertion based engagement  
(b) A direct reporting engagement.
4. D
5. E.
6. There can actually never be enough due diligence in evaluating an investment, but there are certain essentials that can lessen the investor's risk and possibly justify reducing the scope of due diligence. They include the following:
  - (a) Stable and proven management.
  - (b) Audited financial statements with short, easily understood notes.
  - (c) History of consistent earnings.
  - (d) Few subsidiaries, divisions or joint ventures.
  - (e) Strong market position.
  - (f) Absence of material litigation.
  - (g) No real estate or operations with potential environmental problems.
  - (h) Earnings primarily from operations.
  - (i) Not dependent upon one or few customers or clients.
  - (j) No intangible assets.
  - (k) No inter-company transactions.
  - (l) No discontinued operations or restructuring.
  - (m) Little or no extraordinary income or expenses.
  - (n) Strong internal controls.
  - (o) Few and readily accessible locations.

The absence of the above list will increase the signal for maximum due diligence.

7. In the perspective of private-sector world of business and finance, the term "due diligence" refers to the process through which an investor researches an organisation's financial and organisational health to guide an investment decision. The decision to fund or not to fund is based upon a balance of objective data analysis, insight into the general state of organisational health and stability, and intuition. A due diligence review is the process through which all the factors that make up that equation are uncovered and understood. It is the process in which a program officer seeks the truth about an organisation.

Due diligence is a somewhat technical phrase used to describe a range of assignments, legal obligations, reports and investigations which take place in business, manufacturing and law. Its most frequently heard version is the one pertaining to business, where due diligence refers to the steps taken by venture capitalists before investing a round of capital in a start-up, the ongoing investigation as to how the funds are being distributed, or the precautionary steps taken by a larger company in deciding to acquire a smaller company.

8. Complexities in business and changes in social and legal expectations have enhanced the need for forensic auditing. Wherever a potential loss, real financial loss, or risk of loss is perceived, a forensic audit may be commissioned. It can be applied in the following areas;
  - (a) Corporate investigations. Organisations frequently are faced with circumstances of possible wrongdoings that may require investigations. The forensic auditor assists in investigating allegations ranging from kickbacks and wrongful dismissals to internal situations involving allegations of management or employee wrongdoing.
  - (b) Litigation Support. In cases of loss of profit, construction claims, product liability, shareholder disputes, bankruptcies and breach of contracts, forensic auditors assist counsel in investigating and assessing the integrity and amount relating to such cases.
  - (c) Criminal matters. In criminal matters, forensic auditors as expert witnesses are increasingly important in court cases in verity of situations such as arson, scams, fraud, vendor frauds, customer frauds, investment scams, and stock market manipulations.
  - (d) Insurance claims. To assess the integrity and the quantum of claim, the assistance of the forensic auditor is often required.
  - (e) Government. Forensic accountants assist governments to achieve regulatory compliance by ensuring that companies follow the appropriate legislation.
  
9. Most aspects of forensic audit fall outside the normal training of financial auditors. The following qualities are necessary to perform adequately as a forensic auditor.
  - (a) Ability to identify fraud with minimal initial information.
  - (b) Identification of financial issues. When confronted with situations arising from a complain, allegation, rumour, etc., he should be able to quickly identify the financial issues significant to the matter.
  - (c) Knowledge of investigation techniques.
  - (d) Knowledge of evidence. He must understand what constitute evidence. For example the meaning of “best” and “primary” evidence, the rules of evidence in court, and what constitute evidence in court.
  - (e) Interpretation of financial information.
  - (f) Presentation of financial findings. He must have the ability to communicate findings in a language that must be understandable by a layperson and without any ambiguity.
  - (g) Investigative skills. Investigative skills are needed for litigation support.
  - (h) Investigative mentality. The forensic auditor must, along with accounting skill, develop an investigative mentality that allows him to go beyond the limits established generally accepted auditing standards. For example;
    - (i) Scope is not restricted as a result of materiality.
    - (ii) Sampling is not recommended.
    - (iii) Non assumption of integrity of management.

10. The following steps are adopted by the forensic auditor in performing an audit:
- (a) Verify compliance with regulatory, legal and evidential matters;
  - (b) Review documents related to legal and general business functions;
  - (c) Test the organisation's motivational and ethical climate;
  - (d) Document management, administrative, and organisational policies, procedures, and practices;
  - (e) Gather and preserve evidence to corroborate asset losses, fraudulent transactions;
  - (f) Establish accounting, audit, and internal control;
  - (g) Conduct a review of internal controls;  
Assess the strengths and weaknesses of those controls;
  - (h) Design scenarios of potential fraud losses based on identified weaknesses in internal controls;
  - (i) Identify questionable and exceptional transactions;
  - (j) Identify questionable and exceptional account balances and variations;
  - (k) Distinguish between simple and human errors and omissions in entries and fraudulent entries;
  - (l) Follow the flow of funds that support documents;
  - (m) Follow the flow of funds into and out of an organisation's bank account;
  - (n) Search for underlying support documents for questionable transactions;
  - (o) Review such documents for peculiarities, examples are fake billings, destruction of data, improper account classification, irregularities in financial data, substitution of copies of documents for the original; and
  - (p) Document and report fraud loss for criminal, civil, or insurance claims.

## **APPENDIX II**

# **COMPREHENSIVE QUESTIONS AND SUGGESTED SOLUTIONS**

### **MULTIPLE CHOICE QUESTIONS AND SOLUTIONS**

#### **SECTION A: Multiple-choice questions**

Candidates are required to choose the single most appropriate answer from the following:

- (1) The responsibility for the fairness of the representations made in financial statements is that of
- (a) Independent auditor
  - (b) Audit committee
  - (c) Client's management
  - (d) External auditor.

Answer **c**

- (2) An auditor, while performing an audit, strives to achieve independence in appearance in order to
- (a) Maintain public confidence in the profession
  - (b) Comply with the generally accepted standards of field work
  - (c) Become independent in fact
  - (d) Reduce audit risk and liability.

Answer **b**

- (3) An independent auditor must act without bias in relation to the financial statements of a client in order to
- (a) Comply with the Companies and Allied Matters Act
  - (b) Attain the impartiality necessary for an expression of the auditor's opinion
  - (c) Maintain the appearance of separate interests on the part of the auditor and the client
  - (d) Avoid criticism and possible litigation from creditors and stockholders.

Answer **b**

- (4) Prior to accepting an audit engagement, an incoming auditor should make specific inquiries of the outgoing auditor regarding the outgoing auditor's
- (a) Understanding as to the reasons why the audit appointment should not be accepted
  - (b) Understanding of all matters of continuing accounting significance
  - (c) Awareness of departure in the application of generally accepted accounting principles over time
  - (d) Update of any subsequent events since the outgoing audit report was issued.

Answer **a**

- (5) In relation to maintaining its quality-control objectives on assigning personnel to engagements, a firm of independent auditors may use policies and procedures such as
- (a) Having for new entrants a recruitment policy that includes minimum standards of academic preparation and accomplishment
  - (b) Retaining senior qualified personnel to provide advice on accounting or auditing questions for the entire duration of the engagement
  - (c) Making available to auditing personnel current accounting and auditing literature for research and reference purposes throughout the engagement
  - (d) Requiring timely identification of the staffing requirements of specific engagements so that appropriate levels of qualified personnel can be allocated.

Answer **d**

- (6) Roberts & Co., a large international accounting firm, is to have an “external peer review.” The peer review will most likely be performed by
- (a) Audit review staff of the Institute of Chartered Accountants of Nigeria
  - (b) Employees and partners of Roberts & Co., who are not associated with the particular audits being reviewed
  - (c) Employees and partners of another firm of chartered accountants
  - (d) Audit review staff of the Securities and Exchange Commission.

Answer **c**

- (7) It is the responsibility of an independent auditor to design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. Which of the following, if material, constitutes an irregularity as defined in Statements on Auditing Standards
- (a) Mistakes in the application of accounting principles
  - (b) Clerical mistakes in the accounting data underlying the financial statements
  - (c) Misappropriation of an asset or groups of assets during the period covered by the audit
  - (d) Misinterpretation of facts that existed when the financial statements were prepared.

Answer **a**

- (8) There have been regular discussions on the auditor’s responsibility in relation to material errors and irregularities. Which of the following statements best describes the auditor’s responsibility regarding the detection of material errors and irregularities
- (a) The auditor needs to extend auditing procedures to detect material errors and irregularities if the audit indicates that they may exist
  - (b) The auditor may be held responsible for the failure to detect material errors and irregularities only when such failure results from the non-application of generally accepted accounting principles
  - (c) The auditor needs to extend auditing procedures to detect unrecorded transactions even if there is no evidence that material errors and irregularities may exist
  - (d) The auditor may be held responsible for the failure to detect material errors and irregularities only when the auditor fails to confirm receivables or observe inventories.

Answer **a**

- (9) If in the course of an audit, an auditor believes that the client may have committed illegal acts, which of the following actions should be taken immediately by the auditor
- Extend the planned auditing procedures to ascertain whether the suspected illegal acts may have a material effect on the financial statements
  - Communicate the findings to members of the audit committee of the board of directors of the nature of the acts and request that they give guidance with respect to the approach to be taken by the auditor
  - Obtain the client's counsel and the auditor's counsel to determine how the suspected illegal acts will be communicated to the stockholders and other interested parties
  - Communicate with the client's management and consult with the client's legal counsel or other specialists, as necessary, to obtain an understanding of the nature of the acts and their possible effects on the financial statements.

Answer **a**

- (10) An auditor would most likely withdraw from an engagement where the client has committed an illegal act when the
- Illegal act has material financial statement implications
  - Illegal act has received widespread publicity
  - Illegal act affects the auditor's ability to rely on management representations
  - The auditor cannot reasonably estimate the effect of the illegal act on the financial statements.

Answer **d**

- (11) In the course of an audit, audit evidence may come in different forms with different degrees of persuasiveness. Which of the following audit evidences is the least persuasive type of evidence
- Vendor's invoice
  - Bank statement obtained from the client
  - Computations made by the auditor
  - Pre numbered sales invoice of client

Answer **b**

- (12) Which of the following statements is generally correct about the competence of evidential matter
- Accounting data alone may be considered sufficient competent evidential matter for the auditor to issue an unqualified opinion on financial statements
  - In order to be competent, evidential matter must be either valid or relevant, but need not be both
  - The auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly from independent outside sources
  - Competence of evidential matter refers to the amount of corroborative evidence to be obtained.

Answer **d**

- (13) Which of the following procedures would an auditor most likely rely on to verify management's assertion of completeness
- Compare a sample of vendors' invoices with related purchase orders
  - Compare a sample of shipping documents with related sales invoices
  - Observe the client's distribution of payroll checks
  - Confirm a sample of recorded receivables by direct communication with the debtors.

Answer **d**

- (14) An example of an analytical procedure is the comparison of
- (a) Computer generated data with similar data generated by a manual accounting system
  - (b) Financial information with similar information regarding the industry in which the entity operates
  - (c) Results of a statistical sample with the expected characteristics of the actual population
  - (d) Recorded amounts of major disbursements with appropriate invoices.

Answer **b**

- (15) The auditor's working paper that reflects the major components of an amount reported in the financial statements is referred to as
- (a) Extended trial balance
  - (b) Audit control workbook
  - (c) Lead schedule
  - (d) Supporting schedule.

Answer **c**

- (16) Working papers which record the procedures used by the auditor to gather evidence should be
- (a) Designed to meet the circumstances of the particular engagement
  - (b) Considered the primary support for the financial statements being audited
  - (c) Destroyed when the audited entity ceases to be a client
  - (d) Viewed as the connecting link between the books of account and the financial statements.

Answer **a**

- (17) The independent auditor's principal reason for understanding the internal control structure is
- (a) To maintain a state of independence in mental attitude in all matters relating to the audit
  - (b) To obtain a measure of assurance of management's efficiency
  - (c) To comply with generally accepted accounting principles
  - (d) To determine the nature, timing, and extent of tests to be performed.

Answer **d**

- (18) Which of the following might, in itself, not form a valid basis for an auditor to decide to omit a test
- (a) Difficulty and expense involved in testing a particular item
  - (b) Auditor's assessment of control risk
  - (c) Relative risk involved
  - (d) Relationship between the cost of obtaining evidence and its usefulness.

Answer **a**

- (19) Which of the following is not a typical analytical procedure
- (a) Study of relationships for the financial information with relevant non financial information
  - (b) Comparison of the financial information with similar information regarding the industry in which the entity operates
  - (c) Comparison of recorded amounts of major disbursements with appropriate invoices
  - (d) Comparison of the financial information with budgeted amounts.

Answer **c**

- (20) A basic premise underlying analytical procedures is that
- (a) These procedures can not replace tests of balances and transactions
  - (b) Statistical test of financial information may lead to the discovery of material misstatements in the financial statements
  - (c) The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations
  - (d) Relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.

Answer **b**

## SECTION B

Some of the questions in this section are reproduced or adapted from past examinations of the Institute of Chartered Accountants of Nigeria, as indicated.

### QUESTION 1

Tee & Co., an internationally affiliated firm of Chartered Accountants, act as a firm of auditors to two major insurance companies, which are in cut-throat competition with each other.

#### Required:

- (a) Comment on the above scenario in line with the rules of professional conduct of members as regards conflict of interest. (9 Marks)
- (b) State in detail what your opinion would be if it were discovered that the engagement partner had 20,000 ordinary shares in one of the companies. These shares were acquired before the firm commenced the audit of the company. The partner also held a life assurance policy taken out before the audit engagement. (5 Marks)

**(Total 14 Marks) – May 2002 QUESTION**

### ANSWER TO QUESTION 1

- (a) The Chartered Accountant should, according to the rules of professional conduct of members, take all reasonable steps to manage any possible conflict of interest of the two clients thereby avoiding any adverse circumstances. Meanwhile sufficient disclosure should be made to the two clients of safeguards proposed to avoid the interest of one client adversely affecting that of the other. Some of the safeguards include:
  - (i) Use of different partners and staff for different engagements.
  - (ii) Standing instructions and other steps necessary to prevent the leakage of confidential information between different teams and sections within the firm.
  - (iii) Regular review of the audits by a senior partner not personally involved with either client audit.

It is believed that nothing per se is wrong with Tee & Co being the auditors to the two Insurance Companies but where the continuance of the engagement would, even with safeguards, materially prejudice the interest of any or the two clients, the engagement of one or both should be discontinued.

On the other hand, the clients themselves may make an informed decision of retaining the firm considering the disclosure or safeguards. But where adequate disclosure is not possible, mainly by reason of constraints or confidentiality the firm should discontinue with one or both engagements.

- (b) Apart from the fact that if the information about the shareholding comes to the knowledge of the competing company, there is bound to be belief of conflict of interest and undue advantage, holding shares in a client company would amount to insider dealing or a “related party transaction”. But since the shares had been required before the audit engagement the shares should be disposed of by the engagement partner otherwise it would also constitute an “insurmountable self interest threat”

In similar manner since the partner held the life insurance policy before the commencement of the engagement, it is believed that there is nothing wrong with him continuing to hold the policy if it is in the normal course of business and on normal commercial terms. The engagement partner cannot take out a new policy with such a client. This will be unethical.

## QUESTION 2

- (a) Clients have an undisputable right to appoint their auditors or choose their professional advisers. They may seek professional advice from even more than one professional accounting firm, as required. However, there are legitimate professional reasons why a professional accounting firm might not wish to accept an appointment as Auditors to a prospective client. Enumerate these reasons. (6 Marks).
- (b) Hamzat, Chukwu & Co. a big auditing firm has been appointed Joint auditors to a commercial bank. Some years later, the bank decided to maintain Hamzat, Chukwu & Co as the sole firm of auditors. State the professional duty required of Hamzat, Chukwu & Co. before accepting the appointment on each occasion. (4 Marks)
- (c) Section 360 (3) of the Companies and Allied Matters Act 1990 confers on the auditors the right to require from the officers of a company any information and explanations deemed necessary for the performance of the audit. In addition, the auditor can obtain third party certificates to complement evidence he has obtained.

### Required:

- (i) What are third party certificates? (2 Marks)
- (ii) Briefly state reasons why certificates are obtained from third parties. (2 Marks)
- (iii) Describe three types of third party certificates. (6 Marks)
- (Total 20 Marks) – May 2003 QUESTION 1)**

## ANSWER TO QUESTION 2

- (a) **Acceptance of new appointment as auditors**

It has been established that in the interest of the investing public and professional practice, prospective auditors should communicate with the existing auditors whether there is any consideration, which may affect his decision to take up appointment as the new auditors or advisers.

The reasons why a professional firm may decide not to accept appointment as auditor include.

- (i) If permission is refused by the client for communication with the existing auditor.
- (ii) If the existing auditor informs the prospective firm that he is not authorised to discuss the client’s affairs with him.
- (iii) The reasons for the change as highlighted by the client are not in accordance with the facts.

- (iv) The proposal to replace the existing auditor arose because he has carried out his duties in the face of opposition or the existence of important difference of principle, or practice between him and the client.
- (v) The client, its directors or employees might have been guilty of some unlawful act or default, or that any aspect of their conduct which is relevant to the carrying out of the audit assignment ought in the opinion of the existing auditor, to be investigated further by an appropriate authority.
- (vi) The prospective auditor has serious doubts regarding the integrity of the directors and/or senior managers of the company.
- (vii) The client's directors or staff had deliberately hindered the performance of the existing auditor or limited or attempted to limit the scope of the audit.
- (viii) If any partner, staff or close relation of the new firm has financial and/or any beneficial interest in the prospective client.
- (ix) The client's directors and staff had defrauded or attempted to defraud government departments e.g. the Federal Inland Revenue Services, the Nigerian Customs Service etc. and wanted to cover up by changing the existing auditor.

(b) **Addition to or change of Auditors**

With the appointment of Messrs Hamzat, Chukwu & Co. as joint auditors, the first professional duty required of them is to formally communicate with the existing auditors (joint auditors) seeking information which could influence their decision as to whether or not they may accept the appointment as if they have been nominated to "take over" an existing audit assignment.

If a joint audit appointment becomes a sole appointment, the surviving auditor should communicate formally with the other joint auditor as in the case of a new appointment.

(c) **Third Party Certificates**

(i) Third party certificate is external audit evidence obtained by the auditor from an independent outside source. It is normal practice for the auditor to accept certificates in respect of certain classes of assets, liabilities and other representations made by management in respect of the affairs of a company. These certificates provide more assurance in respect of verification work.

(ii) **Reasons why third party certificates are obtained**

The auditor obtains third party certificates to complement/corroborate evidence he has obtained because evidence obtained from independent third party is more reliable. By the auditor's operational standards, he is required to obtain relevant, reliable and sufficient evidence to enable him draw valid conclusion relating to the audit.

(iii) **Types of Certificates**

(a) **Bankers' Certificates**

Bankers' certificates of balances are usually obtained in respect of all bank balances and other commitments of the client. These certificates confirm the existence and ownership of the account balances as well as confirm the right of the company to draw from the account and the limit of any overdraft facilities and other commitments. Bank certificates must be sent directly to the auditor by the bank, stating clearly the date in respect of which they were issued.

(b) **Stock Certificates**

The problems inherent in stocks make it very difficult for the auditor to form a conclusive opinion as to the value at which stock was stated. Hence when stocks are held with third party the auditor often requires the holder

to confirm in writing that stocks are held by them and under what condition such stocks are held.

(c) **Certificate of Investment**

Investment certificates and other vital documents of title are often lodged with bankers or other third parties for direct evidence of the existence of such investments. It is therefore, the usual practice for the auditor to accept the banker's or holder's certificate to the effect that the investment certificates are held on behalf of the client and are free from any charges/lien whatsoever.

(e) **Solicitor's Certificate**

Sometimes companies are engaged in one type of litigation or another as at the balance sheet date. This may give rise to a contingent liability which might be difficult to ascertain. The auditor therefore obtains a solicitor's certificate which would contain details of the possible outcome of the litigation and the extent, if any of the costs that may arise there from.

(f) **Valuers' Certificates**

Certificates are at times required from architects, estate valuers, engineers and other professional experts to confirm completion level of construction work in progress, machinery installation, research and development project, special products work in progress, jewellery and other solid mineral products etc.

### QUESTION 3

Auditing firms do not always describe themselves as auditors. They describe themselves as "Chartered Accountants" because apart from auditing, they also render other services to their clients.

Describe FIVE other services, which audit firms provide for their clients in addition to auditing.  
**(16 Marks) - November 2003 QUESTION 1)**

### ANSWER TO QUESTION 3

Candidates should consider the latest pronouncements on conflicts of interest in situations where auditors provide services to their clients.

The other services which an audit firm may render, provided the issue of conflict of interest is properly considered, include any five of the following:

(a) **Taxation**

- (i) Preparation of tax and capital allowances computations
- (ii) Rendition of advisory services regarding tax matters e.g. minimization of taxes payable and tax planning.
- (iii) Filing of tax returns and collection of tax clearance certificates on behalf of clients.
- (iv) Investigation of PAYE, VAT and corporation tax frauds on behalf of tax authorities.

(b) **Financial Consulting**

- (i) Advising on investment options and optimum returns.
- (ii) Monitoring liquidity management and budgetary control for clients
- (iii) Reorganisation and restructuring.

(c) **Receivership, Liquidation and Trusteeship**

- (i) Handling the winding up of companies to settle creditors and shareholders.

- (ii) Receivership for debenture holders and other creditors of a company in insolvency situations.
- (iii) Acting as trustees.

**(d) Investigation**

- (i) Investigating alleged frauds.
- (ii) Valuation of shares and businesses.
- (iii) Preparing prospectus reports for public issues.
- (iv) Reporting on profit forecasts.
- (v) Due diligence

**(e) Accounting Services**

- (i) Writing up books of accounts from source documents
- (ii) preparing financial statements from books of accounts
- (iii) Advising on:
  - ◆ Accounting and internal control systems,
  - ◆ Budgeting,
  - ◆ Costing,
  - ◆ Computerisation,
  - ◆ Internal audit set up, and
  - ◆ Financial management.

**(f) Manpower Planning, Recruitment and Training**

- (i) Audit firms help their clients in planning manpower development strategies.
- (ii) They also function in the area of staff recruitment, training and retraining

**NB:** Where chartered accountants provide secretarial and registrar services, they offer such services under corporate umbrellas different and distinct from the firm of chartered accountants.

**QUESTION 4**

An auditor is expected to be independent, competent and of high integrity.

- (a) Write short notes on each of the above qualities.
- (b) List FIVE factors that may impair the independence of an auditor.

**(15Marks) - November 2003 QUESTION 2)**

**ANSWER TO QUESTION 4**

**(a) Qualities required of an auditor**

**(i) Independence**

Professional independence is fundamental to the accountancy profession. An auditor cannot give an unbiased opinion unless he is independent of all the parties involved. Not only must the auditor be independent, he must also be seen to be independent. He must ensure that there are no circumstances that can reduce the degree of the exercise of his independence. As a guide, he must avoid financial dependence, financial involvement, close personal relationship and conflict of interest.

**(ii) Competence**

An auditor must be properly trained and must have acquired competence before he can sign an audit report. The Companies and Allied Matters Act, 2004 states that, to be qualified for appointment as an auditor of a company, a person must be a member of a body of accountants recognised for that purpose by the Act.

These bodies ensure that their members pass requisite examinations that will make them competent. They also need to acquire practical experience before they can be issued with licence to practice. In addition, they should also ensure that they attend Mandatory Continuing Professional Education (MCPE) programmes to update their knowledge and experience.

Furthermore, members have to be familiar with accounting and auditing standards, guidelines and other materials in order to enhance their competence.

(iii) **Integrity**

Chartered Accountants are renowned for their honesty, discretion and tactfulness. In ICAN rules of professional conduct to members, it is a fundamental requirement that a member should exhibit a high level of integrity in all professional and business relationships. Integrity implies not merely honesty but also fair dealing and truthfulness.

The auditor should conduct himself or herself with courtesy and consideration towards all with whom he/she comes into contact during the course of performing his/her work.

**Factors that may impair the independence of the auditor include:**

- (i) Where the fee is material in relation to total fee his total fee income.
- (ii) Where the auditor provides other services to the client which may lead to conflict of interest.
- (iii) If the auditor owns material shares in the client company.
- (iv) If the auditor receives loans from the company
- (v) If the auditor is in partnership with an officer of the company.
- (vi) If the auditor is related to management staff of the company (by blood or marriage)
- (vii) If the auditor is employed by the company or employs an employee of the company.
- (viii) If the auditor receives material gifts or gratification from the company.

**N.B.** any five of the above will satisfy the requirements of the question.

**QUESTION 5**

The auditing guidelines “Audit evidence” suggests that techniques of audit testing fall into some broad categories.

**Required:**

List and discuss FOUR of these categories giving TWO examples of each.

*(12 Marks) - November 2003 QUESTION 4)*

**ANSWER TO QUESTION 5**

The categories of audit evidence (only four required)

(a) **Inspection**

Inspection as a technique of audit test involves reviewing or examining of records, documents or tangible assets.

**Examples of inspection include (only two required):**

- (i) Review of tangible assets to ascertain their existence and service condition though not necessarily their ownership, cost or value.
- (ii) Examination of records and other documents to ensure evidence of Board authorisation and approval for assets acquisition and/or disposal.
- (iii) Review of minutes of board meetings will provide evidence of existence of capital commitments and/or contingent liabilities.

(b) **Observation**

Observation involves witnessing an operation or procedure being performed by others with a view to determining the manner of its performance at a point in time. Examples are:

- (i) Observing stock-counts in action.
- (ii) Attending wages payout in progress
- (iii) Observing receipt of goods into the warehouse
- (iv) Witnessing physical cash count.

(c) **Enquiry**

The auditor ensures that the accounting system and the related system of internal controls are effective in operation. This may be done by

- (i) the auditor enquiring from knowledgeable persons in the organisation either formally or informally, orally or in written form.
- (ii) Due to unclear nature of audit evidence in some situations, enquiry will be necessary to ascertain strength of such evidence.
- (iii) Enquiries can also be from third parties.

**Examples are:**

- ◆ Letter of confirmation of balances from the bank or debtors/creditors
- ◆ Confirmation of goods held by third parties on behalf of the client.

The degree of reliability that the auditor attaches to the evidence obtained is dependent on his opinion of the competence, experience, independence and integrity of the respondent.

(d) **Computations**

There may be a necessity for the auditor to establish evidence by undertaking computations and re-computations of data provided by the client.

**Examples are:**

- (i) Payroll deductions
- (ii) Sales men's commission
- (iii) Interest and dividend payable
- (iv) Withholding taxes.

(e) **Analytical review**

The auditor reviews figures and ratio and financial statements to check the fairness of the items or the need for additional explanation for unusual features in the accounts.

**QUESTION 6**

"Audit evidence" refers to the information obtained by the auditor and used in arriving at the conclusion on which he bases his opinion on the financial statements.

**Required:**

List and describe FIVE sources of audit evidence.

*(12 Marks) - November 2003 QUESTION 5*

**ANSWER TO QUESTION 6**

**Sources of audit evidence (only five required)**

- (a) Observation
- (b) Confirmation by independent parties
- (c) Authoritative external documents
- (d) Authoritative internal documents

- (e) Testimony from directors and officers of the company
  - (f) Calculations performed by the auditor
  - (g) Subsequent events
  - (h) Expected Relationships
  - (i) External events.
- (a) **Observation**  
This consists of:
- (i) Observation of the internal control system and book-keeping procedures.
  - (ii) Witnessing of processing of transaction to ensure that book keeping and internal control procedures are effectively carried out.
  - (iii) attendance at stock taking/cash counts
  - (iv) Observation of payment procedures of salary/wages on pay days
  - (v) Observation of procedures for receiving into and issuing out of stores
- (b) **Confirmation by Independent Parties**  
This refers to the evidence the auditor can obtain from reliable third parties in confirmation of audit information available within the client organisation e.g. Debtors/Creditors circularisation, bank confirmation letters.
- (c) **Authoritative external documents**  
These are documents issued by other individuals or organisations in evidence of transactions undertaken with client organisation. Examples are: title documents, share and loan certificates, lease and contract agreement and invoices.
- (d) **Authoritative internal documents**  
These are documents raised and authenticated within the organisation by persons with authority in evidence of decision reached or transactions undertaken with third parties e.g. minutes, copy invoices, Board resolutions, journal vouchers, memos and letters.
- (e) Testimony from directors and officers of the company. This may be formal, for example letter of representation, or informal, for example replies to Internal Control Questionnaires (ICQ).
- (f) Calculations performed by the auditor evidence of the correctness of many. Figures can be obtained this way.
- (g) **Subsequent events:**  
The audit is usually performed well after the year end and many assertions can be verified by reference to subsequent events.
- (h) **Expected relationship evidence:**  
Evidence confirming the truth about one item may tend to confirm the truth about another e.g. investment and investment income, loan and loan interest payable.
- (i) **External events:**  
These refer to the events in the external environment of the business being audited which affect the result shown in the financial statements. Knowledge of these events assists the auditor in reaching a more informed conclusion on the figures shown in the financial statements e.g. government restriction, economic recession, industry trends or news analysis and gazettes.

## QUESTION 7

What are the audit objectives applicable to inventories?

**ANSWER TO QUESTION 7**

**The audit objectives applicable to inventories are:**

**Completeness**

- ◆ Inventories represent all raw materials, work-in-progress, and finished goods that the entity owns, including those on hand, in transit or on the premises of others.
- ◆ All shipments of goods during the period covered by the financial statements.

**Accuracy**

- ◆ The detailed perpetual inventory records are correct and agree with the general ledger inventory control account.
- ◆ Costs associated with inventories have been properly classified and accumulated.
- ◆ Cost of sales is based on correct costs and quantities, is properly summarised and posted to the costs of sales and inventory control accounts, and, where appropriate, is credited in the perpetual inventory records.

**Existence/Occurrence**

- ◆ Recorded inventories physically exist in saleable condition and represent property held for sale in the ordinary course of business.
- ◆ Recorded cost of sales represents goods actually shipped during the period covered by the financial statements.

**Cut-off**

- ◆ Production costs incurred and charged to work-in-progress, transfers to finished goods, and cost of sales are recorded in the proper period.

**Valuation**

- ◆ Costs associated with inventories and costs of sales are determined and accumulated using generally accepted accounting principles consistently applied.
- ◆ Inventories are stated at not more than their net realisable value.
- ◆ Rights and Obligation
- ◆ The entity has legal title or ownership rights to the inventory; inventory excludes goods that are the property of others or have been billed to customers.

**Presentation and Disclosure**

- ◆ Inventories and cost of sales are properly described and classified in the financial statements.
- ◆ All encumbrances against inventory are adequately disclosed.  
The auditor achieves these objectives by performing substantive tests or a combination of substantive tests and tests of control structure policies and procedures.

**QUESTION 8**

What alternative procedures should an auditor follow if physical inventory observation is impracticable?

**ANSWER TO QUESTION 8****Alternative procedures when observation is impracticable**

The auditor should not readily accept that the observation of inventories is impracticable or impossible. In a situation where the client does not or cannot take a physical inventory, or if the auditor cannot be present at the inventory-taking, the auditor may be able to form an opinion regarding the reasonableness of inventory quantities by applying any of the following alternative procedures:

**(i) Examining other physical evidence that may be tantamount to observing physical inventories**

If the auditor is engaged after the physical inventory has been taken, subsequent physical tests may be a satisfactory substitute for observing in the inventory-taking. The auditor may also examine written instructions for the inventory-taking, review the original tags or sheets, and make other suitable tests.

In any event, the auditor must:

- ◆ Examine or observe some physical evidence of the existence of the inventory and
- ◆ Make appropriate tests of intervening transactions or control procedures applied to them.

If the auditor is satisfied that inventories are fairly stated; he or she is in a position to express an unqualified opinion. Otherwise, there may be no practicable substitute for observation of inventory-taking, and an auditor may have to express a qualified opinion or disclaimer, depending on the materiality of the inventories and on whether failure to observe was unavoidable or resulted from management's decision to limit the scope of the audit.

**Substantiating through further examination of accounting documents**

Sometimes procedures for substantiating inventories must be based on examining other accounting documents and records. For example, in an initial audit, the auditor generally will not have observed the physical inventory at the previous year-end, which is a principal factor in determining cost of sales for the current year. If reputable independent accountants expressed an unqualified opinion on the prior-year statements, a successor auditor may accept that opinion and perhaps merely review the predecessor auditor's working papers supporting the prior-year balances. If no audit was made for the preceding year, the auditor may have no alternative but to substantially expand the tests of accounting records to attempt to obtain reasonable assurance about the beginning inventories in order to be able to express an opinion on the current year's results of operations.

Those expanded tests may include a detailed examination of physical inventory sheets and summaries, including review and testing of cut-off data, examination of perpetual inventory records and production records, and review of individual product and overall gross profit percentages. In connection with the latter procedures, cost accumulations for

selected inventory items should be tested and significant changes in unit costs directly traced to factors such as technological changes, mass buying economies, changes in labour costs, and changes in overhead rates. Changes in gross profit percentages should be further related to changes in unit sales prices and changes in the profitability of the sales mix, if applicable.

An auditor who is unable to form an opinion on the opening inventory may decide to qualify the audit opinion or disclaim an opinion with respect to results of operations for the year under audit.

**QUESTION 9**

The audit objectives in the verification of liabilities should focus on ascertaining that accrued liabilities are not understated, but not ignoring the possibility of the opposite may occur. What are some possible auditing procedures that would help the auditor address the completeness audit objective for liabilities?

**ANSWER TO QUESTION 9****Verification procedures**

Some of the auditing procedures that would help the auditor address the completeness of audit objectives for liabilities are:

- I. Schedule. Obtain or make detailed schedules of liabilities, showing the movement in each account during the period.
- II. Cut-off. Verify *cut-off*. For example a trade creditor should not be included unless the goods were acquired before the year-end.
- III. Reasonableness. Exercise professional scepticism in determining the reasonableness of the liability.
- IV. Internal control. Determine, evaluate and test internal control procedure. This is particularly important for trade creditors.
- V. Previous date clearance. Consider and review opening balances.
- VI. Review terms and conditions of loans. The auditor should determine that all terms and conditions agreed when accepting a loan have been complied with.
- VII. Authorisation. The authority for all liabilities should be sought. This will be found in the company minutes or directors' minutes and for some items the authority of the Memorandum and Articles may be needed.
- VIII. Description. The auditor must see that the description in the accounts of each liability is adequate.
- IX. Documents. The auditor must examine all relevant documents - invoices, correspondences, debenture deeds etc., according to the type of liability.
- X. Security. Some liabilities are secured in various ways, usually by fixed or floating charges. The auditor must enquire into these and ensure that they have been registered. The Companies Act requires, for secured liabilities, that an indication of the general nature of the security be given and also the aggregate amount of debts included under the item covered by the security.
  - ◆ Vouching. The creation of each liability should be vouched, for example the receipt of a loan.
  - ◆ Accounting policies. The auditor must satisfy himself that appropriate accounting policies have been adopted and applied consistently.
- XI. Letter of representation. Management must explicitly assert the existence, rights and obligations completeness and appropriate presentation and disclosure in the financial statements.
- XII. Interest and other ancillary evidence. Corroborative evidence about the existence of the loan must be obtained, for example, evidence of payments of interest and other activities.
- XIII. Disclosure. All matters, which need to be disclosed, are disclosed, to enable a true and fair view to be expressed on the financial statements. The Companies Act provisions must be complied with.
- XIV. External verification. With many liabilities it is possible to verify the liability directly with the creditor. This action will be taken with short-term loan creditors, bank overdrafts and, by a similar technique to that used with trade debtors and trade creditors.
- XV. Materiality. Materiality is a factor in all accounting and auditing issues.

*Inclusion of All Liabilities*

It is not enough for the auditor to be satisfied that all the liabilities recorded in the books are correct and are incorporated in the financial statements. Auditors must be satisfied that there are no unrecorded liabilities transactions or undisclosed items.

**QUESTION 10**

The auditor's tests of controls help to identify weaknesses which constitute threats to data security, reliability and loss. Discuss.

**ANSWER TO QUESTION 10**

The auditor's tests of controls help to identify weaknesses which constitute threats to data security, reliability, and loss; some of these weaknesses are:

- ◆ Fraud and abuse, including viruses.
- ◆ Error and loss due to negligence.
- ◆ Natural and manmade disasters (tornadoes, floods. Terrorism, etc.)
- ◆ Losses due to poor IT project management.

**Fraud and abuse**

Computer fraud is:

- ◆ Using a computer to steal funds, or
- ◆ Theft of confidential computer files or
- ◆ Unauthorised use of a company computer for private business

Abuse on other hand is the deliberate destruction of computer files or equipment.

**How to prevent fraud and abuse**

This can be effected by:

- ◆ Transfer of disgruntled employees to positions off from the computer area.
- ◆ Change of all locks, passwords, or other entry means available or known to those persons.
- ◆ Strengthening policies regarding the assignment of password privileges.
- ◆ Implementing policies and procedures essential for controlling insider

Computer fraud has become an area of significant concern to all organisations, including governments and their agencies. The increased risk of computer fraud, amongst others, prompted the establishment of Economic and Financial Crime Commission (EFCC). The law establishing the Commission requires all financial institutions operating in Nigeria and other Financial Institutions, to report the discovery of any of the following to their regulatory authority within 30 days of initial discovery:

- ◆ Insider abuse involving any amount.
- ◆ Transactions aggregating ₦50,000 or more that involve potential money laundering or violations of the Bank and Other Financial Institutions Act.

**Error and loss**

Data destruction cannot always be ascribed to malicious attacks. Poorly trained or unmotivated employees and unclear or nonexistent policies and procedures can cause data error and loss. Risk of data problems can be reduced through an effective organisational structure that take cognisance of management's involvement.

**Natural or manmade disasters**

All organisations that require computers to operate and conduct business on a daily basis, or otherwise lose revenue in the event of a computer shutdown, must have disaster-recovery plans that include off-site data storage. A chain of command for notification of a disaster (or pending disaster), agreements for off-site processing during an emergency, and detailed procedures for recovery should be considered.

**Poor IT project management**

Inadequate controls during the design, development, and implementation of IT projects have cost organisations whopping sums in excess project costs. In extreme cases, poorly managed IT projects end up having to be completely abandoned to avoid further losses. IT project management controls should include a strong project leader and project steering committee. There should be detailed project design requirements, milestones and tasks, detailed project budget estimates. Detailed and accurate accounting of costs paid to outside vendors and contractors and of hours spent by all internal staff on the project should be factored into the cost. There should be frequent comparisons of budgeted with actual costs during the life of the project to prevent cost overrun. Quality assurance of completed programming and documentation must be performed, so also is the monitoring of the project to ensure it meets design requirements.

**QUESTION 11**

What are the basic steps to Computer-Assisted Audit Techniques' (CAATs) developments?

**ANSWER TO QUESTION 11**

Basic steps to the development of Computer-Assisted Audit Techniques (CAAT) are:

**Definition of needs**

Fully understanding and documenting the precise audit objectives that the CAAT will test is essential to success. For example, a CAAT-based test of an inventory file could include the following types of objective:

- ◆ Valuation: Recheck or extend the Naira value per item (quantity x price) and select a sample of inventory items for price testing (invoice value to vendor).
- ◆ Summarisation: Foot the re-extended Naira value.
- ◆ Completeness: Compare the gaps in the numeric sequence of an automated count tag against those observed in a physical inventory.

A test of a receivable file could have these types of objectives:

- ◆ Existence: Select a statistical sample of account balances or invoices for confirmation.
- ◆ Valuation; Test the ageing of receivables by recalculating the number of days in receivables using the invoice date.
- ◆ Summarisation: Foot the Naira value of balances.

**Determine feasibility**

An important consideration in performing automated audit techniques is that the equipment is able to process the available types of backup media. Data are stored in different types of backup formats. In many cases, especially in mainframe environments, the auditor must depend on the IT department to initially develop an extract programme to map all auditable fields to an extract database or electronic report. The data can then be downloaded to a file server or PC for use by the auditor.

If IT department help is required, the auditor should be alert to the possibility of data manipulation by unscrupulous IT staff. For this reason, the auditor should always balance the extracted data to the corresponding source system totals when possible. If an extract database of a bank contains all loans with a non-zero balance, for example, the auditor should balance the total amount of loans in the extract database to the total amount of loans in the general ledger. Balancing the count of loans to the source system should also be performed. These controls also help ensure that there was not some other operational problem with the extract programme. Despite these measures, unauthorised changes could still be made that would not affect the total Naira amount or total count of loans. Therefore, auditors should be alert to:

- ◆ IT personnel who have system access capabilities that enable them to perform changes to extract programmes and the associated output.
- ◆ Compensating controls should be in place to monitor the activities of such IT personnel. In this wise, all changes to extract programmes and databases could be logged to a secure location accessible only by IT security personnel.
- ◆ The logs should be reviewed frequently by the IT security staff or designated audit staff.

The timely availability of data is another concern. For example, period closing date requirements affect availability. Coordination may require the input of MIS. MIS cooperation can play a key role in the successful execution of a CAAT, especially when the technique deals with complex data types or has complex programme logic.

Automating procedures for the sake of automation is hardly ever a successful strategy. CAATs are subject to cost/benefit analyses. Although CAATs may improve the effectiveness of a procedure

(e.g., testing 100 percent of a report rather than a sample), or the efficiency of a procedure (e. g, footing a large report using a CAAT rather than an adding machine), they are primarily a tool to improve overall audit effectiveness. In the time it takes to write and test CAATs, obtain and download files, and document the results, many CAATs end up being only marginally more effective than manual procedures in the long-term. In general, CAATs are best used when more than one query is to be performed. If just one query is performed, it may be more cost-effective to simply have the IT staff generate the query. However, if multiple queries and “what if” analyses are to be performed, they best are performed by the auditor. This adds to the independence of results and also frees the IT staff to concentrate on running the IT operations.

### **Plan the work**

#### *Develop the Code.*

It is beneficial to develop a CAAT beforehand, by using a prior period’s data to ensure that the live data will be in a usable format. Programme code that follows a structured format saves time during the debugging and review stages.

#### *Run and Analyse the Results.*

The final results of a CAAT are analysed in terms of the stated audit objectives and whether they meet them. There is a difference between CAATs that have a predictive result, which can be checked against footed totals, extended prices, and market values, for example, and CAATs that produce unpredictable results, such as analytical review reports. Predictive CAATs are always proven out by cross-referencing and reconciling them to expected results.

The accuracy of unpredictable CAATs is checked by:

- ◆ Logic testing, which ensures that the correct results are being achieved.
- ◆ Comparison of them with the original data file on a random basis.

#### *Document the Results.*

Auditor should document evidence of work performed to support CAATs conclusion.

## **QUESTION 12**

What do you understand by audit queries and alarms in the public sector?

### **ANSWER TO QUESTION 12**

Audit queries are observations or points raised by the audit in a particular transaction seeking further clarifications. Such queries raised by Internal Auditor are pre-audit queries while those raised by the Auditor-General are termed post-audit queries.

Queries serve as an important part of the mechanism of financial control as well as valuable means of detecting and preventing errors, fraud etc.

The guidelines on Civil Service Reforms gave prominence to queries by specifying time limit for replying audit queries and possible sanctions for failure to respond.

Offences on which queries may be raised can be classified as:

1. Irregularities resulting in losses to the government due to either fraudulent activity of the functionaries or their negligence or incompetence.
2. Irregularities not directly or immediately resulting in losses to government but which infringe upon budgetary and proper financial management.
3. Irregularities arising through poor or inefficient management and accounting, which may lead to losses to the government.

**QUESTION 13**

What are the contents of auditor's disclosure about the entity's ability to continue as a going concern?

**ANSWER TO QUESTION 13**

Auditors' disclosures about the entity's ability to continue as a going concern might include the following information:

- ◆ Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- ◆ The possible effects of such conditions and events.
- ◆ Management's evaluation of the significance of those conditions and events and mitigating factors.
- ◆ Possible discontinuance of operations.
- ◆ Management's plans (including relevant prospective financial information).
- ◆ Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

If, after considering management's plans, substantial doubt about the entity's ability to continue as a going concern does NOT exist, the auditor should still consider whether the principal conditions and events that initially generated the doubt need to be disclosed. The consideration of disclosure should include the possible effects of those conditions and events and any mitigating factors, including management's plans. It should be noted that:

"The auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicate inadequate performance by the auditor. Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern" (SAS 59).

**QUESTION 14**

If auditor has assessed control risk as low, then merely reviewing the client's reconciliations at year-end may be appropriate. What steps should an auditor take in reviewing a client's bank reconciliation?

**ANSWER TO QUESTION 14**

An auditor should take the following steps in reviewing a client's bank reconciliation:

- ◆ Obtain copies of the client's bank reconciliations and establish their mathematical accuracy.
- ◆ Reconcile the total of the bank balances on the reconciliations to the general ledger balance. This will generally require using a summary of the individual cash account balances in the general ledger account.
- ◆ Scan the bank reconciliation for significant unusual reconciling items and adjustments, and obtain evidence to support them by inquiry or examination of appropriate documents.

In addition to the review procedures the auditor may decide to test the client's reconciliations. The tests may be performed at an interim date, if the auditor has assessed that the client's reconciliations are subject to effective supervisory control procedures. If supervision during the intervening period is not considered effective, the auditor would probably perform the tests at year-end.

The following procedures in addition to the first two steps above are typically performed in testing the client's reconciliations:

- ◆ Determine that paid cheques, deposits, and debit and credit advices appearing on the cut-off bank statements and issued on or before the balance sheet date appear on the year-end reconciliations.
- ◆ Trace to the cash disbursements records outstanding checks listed on bank reconciliations but not returned with the cut-off statements.
- ◆ Trace deposits in transit on the bank reconciliations to the cut-off bank statements and the cash receipts records, and determine whether there are any unusual delays between the date received per the books and the date deposited per the bank statements.
- ◆ Trace other reconciling items to supporting documentation and entries in the cash records.
- ◆ Investigate old or unusual reconciling items. If checks remain uncashed after a specified period of time, the reason should be determined and the amounts either restored to the cash account.
- ◆ Determine the exact nature of items on the year-end bank statements not accounted for by the reconciliation procedures, such as debits or credits followed by offsetting entries of identical amounts that appear to be, or are represented by the client to be, bank errors and corrections not so coded. If information in the client's records is inadequate, clarification should be requested from the bank. In these circumstances, the auditor should consider performing a "proof of cash" reconciliation (described below) if the client's reconciliation process does not include one.

These procedures assume that the testing is performed as of the balance sheet date and that cut-off statements for a reasonable period after the balance sheet date are obtained from the bank.

### QUESTION 15

The Chairman of XYZ LTD, a small scale enterprise has been advised by his accountant to appoint an external auditor, but he disagreed with his accountant that since he has a qualified accountant in his employment, there is no need appointing an external auditor.

As a consultant, explain to the chairman:-

- (a)
  - (i) The difference between auditing and accountancy work;
  - (ii) The objects of an external audit
  - (iii) The advantages of an external audit
- (b) List five essential features of systems audit

**(Total 16 Marks) May 2002)**

### ANSWER TO QUESTION 15

- (a)
  - (i) **Difference Between Auditing and Accounting Work**  
An audit can only commence after the necessary accounting work has been completed. Accountancy work involves keeping proper accounting books from which a trial balance can be extracted and thereafter the preparation of final accounts. It should be clearly understood that the keeping of accounting books and preparation of the financial statements are not part of the audit work.

An audit on the other hand entails the examination of the financial statements by a professionally qualified accountant in his capacity as an external auditor with a view to expressing an independent opinion on the truth and fairness of the state of affairs, the profit or loss, and cash flow of the business entity being reported on.

(ii) **The objects of an External Audit**

There are three main objects viz:

- ◆ To examine and report on financial statements prepared by a client. This is the primary object.
- ◆ To ensure that the correctness of the accounts is not impaired by fraud, error other misstatements that should have been detected in the normal course of the audit.
- ◆ To prevent errors and frauds by the deterrent and moral effect of the audit.

If an audit is well planned and conducted with reasonable skill and care, materials errors and fraud should be discovered in the process of the audit work. The auditor must not be regarded as a detective. He is not expected to carry out on his duties suspecting fraud or error. Nevertheless, if in the course of his examination of the books and records, suspicious circumstances are brought to light, he must do everything that may be reasonably necessary to probe such circumstances in order to either confirm or allay his suspicion.

(iii) **The Advantages of an External Audit**

- ◆ It facilitates the agreement of tax assessments with the Revenue Departments.
- ◆ It facilitates claims for loss profit from an insurance company; including consequential loss.
- ◆ Application to banks and other parties for the purpose of raising finance or credit are greatly enhanced if supported by audited accounts.
- ◆ It helps to reduce fraud and error, through objective review and evaluation of the effectiveness of the internal control system etc.
- ◆ Disputes between partners and other business associates may be avoided especially where complicated profit-sharing arrangements are in force.
- ◆ It enables the client to obtain general and sound financial advice.
- ◆ Users of financial statements would have more confidence in the audited financial statements.

(b) **Essential Features of System Audit**

- (i) To ascertain, record, assess and evaluate the adequacy of the accounting and internal control system on which the auditor wished to place reliance.
- (ii) To test the accounting records and perform compliance tests on the effectiveness of the internal control as basis for determination of other audit procedures.
- (iii) To compare the financial statements with the accounting records in order to ensure that they are in agreement.
- (iv) To carry out a review of the financial statements e.g. by use of analytical review procedures etc.
- (v) To send preliminary report on the financial statements to the management with respect to observed weakness in the system. In compliance with any relevant statutory requirements and professional standards.

**QUESTION 16**

- (a) Explain the term "Audit Committee" considering the provision of the Companies and Allied Matters Act, 1990 (4 Marks)
  - (b) What are the functions of the Audit Committee? (12 Marks)
- (Total 16 Marks) May 2002)**

**ANSWER TO QUESTION 16**

- (a) The Audit Committee is a body established under Section 359 (3) of the Companies and Allied Matters Act, 1990 to which the Auditor of a Public Company will report in addition to the Auditor's duty to report to the members of the company in accordance with Section 359

(1) of the Act. The Audit Committee shall consist of equal number of directors and representatives of the shareholders of the public company with a maximum number of six members. Any member of a Company may nominate a shareholder as a member of the Audit Committee if a notice is given to the Company Secretary at least 21 days before the Annual General Meeting. The members of the Audit Committee are not entitled to remuneration.

- (b) According to Section 359 (4) the Audit Committee shall examine the auditors' report and make recommendations thereon on the Annual General Meeting. Section 359 (6) states that subject to such other additional function and powers that the company's Articles of Association may stipulate, the objectives and functions of the audit Committee shall be to:
- (i) ascertain whether the accounting and reporting policies of the company with legal requirements and agreed ethical practices.
  - (ii) Review the scope and planning of audit requirements.
  - (iii) Review the findings on management letters in conjunction with the external auditor and departmental responses thereon.
  - (iv) Keep under review the effectiveness of the company's system of accounting and internal control.
  - (v) Make recommendations to the Board in regard to the appointment, removal and remuneration of the External Auditors of the company.
  - (vi) Authorise the Internal Auditor to carry out investigations into any activities of the company, which may be of interest or concern to the Committee.

#### QUESTION 17

Your client of over five years – ABC Rubber Products Limited, is proposing to change over to a computer-based accounting system.

- (a) How would this impact on your approach to the audit? (10 Marks)
  - (b) Enumerate the major differences between manual and computer-based accounting system. (10 Marks)
- (Total 20 Marks) May 2002)**

#### ANSWER TO QUESTION 17

(a) **ABC Rubber Products Limited**

The approach of the auditor to a computerised system is considered not fundamentally different from that of the manual system. The auditors' duties and responsibilities actually do not change. The only thing that would change is the method of gathering of relevant, reliable and sufficient audit evidence to support the expression of an opinion by him on the financial statements.

The method of gather audit evidence would change because of special characteristics of processing data on the computer system. Some of the characteristics include:

- ◆ The complex nature of computer system vis-à-vis the manual system.
  - ◆ Centralisation of processing operations in the computer department or section. The auditor has to ascertain, evaluate and test the system to determine if it produces records, which form a reliable basis for the preparation of the financial statements and safeguards the organisation's assets.
- It is important that the auditor takes due cognizance of special computer control problems to aid him in the determination of the audit techniques to be applied.

Some of the control problems include:

- (i) the records and files are in the form of densely packed magnetic media making it difficult to identify their contents visually.
- (ii) Processing is done in the "black box" creating loss of visible processing trail in the course of computer processing.

- (iii) Too much dependence on the electronic data processing department – because of the specialized nature of processing financial data. This results in loss of recording autonomy by user departments.
- (iv) Where auditor is not consulted during planning and installation stages some vital in-built controls could be ignored.
- (v) Programmes reliability can only be inferred indirectly as opposed to being capable of direct observation while functioning.
- (vi) Computer hardware and programmes are vulnerable to atmospheric and environmental conditions, electric and magnetic interference, accidental damage or destruction and human manipulation.
- (vii) Loss of audit trail due to certain records which give no breakdown for checking purpose or for cross-referencing to original documents.
- (viii) There is often a change in documentation on the audit files necessitating the redrafting of standard questionnaire and check-lists to record client data processing documentation and details of major controls included in programmes, systems flow diagrams, etc.

**(b) Differences between manual and computer-based accounting systems**

These include:

- (i) Complexity of the computerised system vis-à-vis the manual system is a major difference. Less skill is required to operate the manual system while operation of a computer-based system requires special skill.
- (ii) In the manual accounting system internal checks which the duty of one officer bears to the duty of the other in the transactions processing chain is absent in a computerised environment.
- (iii) There is lack of visible evidence since records are stored in the hard disc, magnetic disc and tape “files” whereas all records are visible in the manual system consequently errors and frauds could be more difficult to discover in a computerised system.
- (iv) In a computer-based system, organisation may use an outside agency – like a computer service bureau to maintain and process their records. This is hardly often done in a manual system.
- (v) Data processing is faster in a computerised system than a manual system.
- (vi) Even though a computerised system is more expensive to install, in the long run, the benefit derivable outweighs the installation and establishment cost.
- (vii) Information retrieval is faster in a computer-based system than in a manual system.

**QUESTION 18**

It is common practice for auditors to send a letter of engagement to new clients and increasingly to existing clients. Matters usually included range from definition of scope to audit fees.

**Required:**

- (a) Briefly describe an engagement letter. (2 Marks)
- (b) List the purpose of the engagement letter (4 Marks)
- (c) List some of the principal contents of an engagement letter. (10 Marks)

**(Total 16 Marks) November 2003)**

**ANSWER TO QUESTION 18**

- (a) An engagement letter is a letter showing the auditor’s understanding of the agreement between the auditor and his client written before the commencement of any professional work detailing the precise scope and nature of work to be undertaken.

- (b) The purpose of the letter is to:
- (i) define clearly the extent of the auditor's responsibilities
  - (ii) minimise misunderstanding between the auditor and the client
  - (iii) confirm verbal agreement in writing.
  - (iv) confirm details of the auditor's engagement
  - (v) inform and educate the client on what the audit process entails
  - (vi) state client's responsibilities for preparing the financial statements.
  - (vii) state the form and contents of the audit report
  - (viii) state other services the practice firm provides apart from audit.
  - (ix) state basis for computation of audit fees.
- (c) The principal contents of the engagement letter are:
- (i) The Auditor's responsibility to report on the financial statements prepared by the directors.
  - (ii) The scope of the auditor's work based on:
    - ◆ auditing standards and guideline
    - ◆ accounting systems review
    - ◆ collection of audit evidence
    - ◆ test of and reliance on internal control
  - (iii) The letter of weakness to the Management
  - (iv) Special areas such as:
    - ◆ relationship with internal audit, if any
    - ◆ audit of branches
    - ◆ relationship with other auditors, if any
    - ◆ significant reliance on directors' supervision in small companies
  - (v) Need for a letter of representation from the Management.
  - (vi) Any agreement for the auditors to carry out work of a book keeping and accounting nature and the additional charges.
  - (vii) Any agreement for the auditor to provide taxation services – this could be a separate letter.
  - (viii) The fees and the basis on which they are charged.
  - (ix) A request for a letter of acknowledgement signed on behalf of the Board or a direct authentication signature as acceptance of the auditor's letter.

### QUESTION 19

Most large companies have both internal and external auditors.

#### Required:

- (a) Distinguish between the internal audit and external audit. (4 marks)
- (b) Describe the scope and objectives of internal audit. (4 Marks)
- (c) Explain the criteria employed by the external auditor to assess the likely effectiveness and relevance of the internal audit functions (4 Marks)
- (d) State four areas where the Internal Audit function can be of assistance to the External Audit. (3 Marks)

**(Total 15 Marks) - May 2003)**

### ANSWER TO QUESTION 19

- (a) **Internal audit and external audit**  
 Internal audit has been defined as an independent appraisal activity within the organisation for a review of operation as a service to management. It is usually carried out by specially assigned staff of the enterprise known as internal auditors and it primarily involves a continuous review and evaluation of the accounting and internal control systems. External audit on the other hand, is an independent examination of the evidence supporting the

financial statements of an enterprise by a qualified person who is not an officer or servant of the company, with a view to forming and expressing an opinion as to whether the financial statements present a true a fair view of the results for the period in question and the financial position as at the period end.

(b) **Scope and objectives of internal audit**

The scope and objectives of internal audit vary widely and are dependent upon the responsibilities assigned to it by management, the size and structure of the enterprise, and the skills and experience of the internal auditor. Normally, internal audit operates in one or more of the following areas:

- (i) Review of accounting systems and related internal control;
- (ii) Examination of financial and operating statements for management including detailed examination of transactions and balances;
- (iii) Review of the economy, efficiency and effectiveness of operations and of the functioning of non-financial controls;
- (iv) Review of the implementation of corporate policies, plans and procedures;
- (v) Special investigations.

Following the scope of internal audit functions listed above. Objectives of internal audit include:

- (i) the attainment of corporate goal
- (ii) Elimination of waste or avoidable loss
- (iii) Ensuring the effective operation of internal control

(c) **The criteria for assessing effectiveness and relevance**

The criteria employed by the external auditor to assess the likely effectiveness and relevance of the internal audit function include:

- (i) **The degree of independence**  
The external auditor should evaluate the status and reporting responsibilities of the internal auditor and consider any constraints or restrictions placed upon him. Although an internal auditor is an employee of the enterprise and cannot therefore be totally independent of it, he should be able to plan and carry out his work as he wishes and have access to the highest level of management.
- (ii) **The Scope and Objectives of the Internal audit Function**  
The external auditor should examine the internal auditor's formal scope of duties and should ascertain the set objectives of the internal audit function.
- (iii) **Due Professional Care**  
The external auditor should consider whether the work of the internal auditor is properly planned controlled, and comprehensively documented.
- (iv) **Technical Competence**  
The external auditor should ascertain whether the work of the internal audit is performed by persons having adequate training and proficiency as auditors. Indication of technical competence includes membership of relevant professional body and possession of relevant practical experience and skills.
- (v) **Internal Audit Reports**  
The external auditor should consider the quality of reports issued by internal audit and consider the response of and action taken by the management.
- (vi) **Level of Resources Available**  
The external auditor should consider whether the internal audit department has the resources required to do the job effectively.

(d) **Assistance to the external auditor**

The internal audit function can be of assistance to the external audit in the following ways:

- (i) Attendance at stock taking and cash counts of the enterprise where external auditor is not able to do them himself.

- (ii) Conducting compliance tests on accounting controls, on a continuous basis to provide assurance that such controls have operated satisfactorily throughout the period.
- (iii) Documentation of the accounting and internal control systems.
- (iv) Testing of transactions and balances such as sales, purchases, fixed assets and debtors.

**QUESTION 20**

- (a) As the audit manager in charge of an audit of a large multinational company, draw up an audit programme for fixed assets for the use of the field staff. (10 Marks)
  - (b) What are the shortcomings of using standardised audit programmes? (5 Marks)
- (Total 15 Marks) November 2003)**

**ANSWER TO QUESTION 20**

(a)	Audit programme for fixed assets  Details of Work	Auditors		
		W/P. Ref	Initial	Date
	i. Obtain or prepare a summary of Fixed Assets and schedule of each type or category to – (a) reconcile the summary with the figures in the Balance Sheet and the opening figure with the balance brought forward, (b) cast and cross cast summary and the schedules.			
	ii. Obtain or extract schedules of additions during the year for all classes of asset, to-test-vouch items with suppliers invoices or other supporting documents like debit notes, architect’s or surveyor’s certificate and completion statements <ul style="list-style-type: none"> <li>◆ check directors’ minutes and budgets for capital expenditure authorisations and approvals.</li> <li>◆ check appropriateness of capitalisation policy considering effect of accounting standards provisions.</li> </ul>			
	iii. Obtain or extract schedules of disposals to <ul style="list-style-type: none"> <li>◆ check minutes for authority for disposals.</li> <li>◆ test-vouch proceeds of sale with independent external and internal evidence like sales agreement or correspondence as well as receipts.</li> <li>◆ check if assets are scrapped or written off.</li> <li>◆ verify that the original cost (or valuation) and related accumulated depreciation have been eliminated from the fixed assets accounts.</li> <li>◆ check that the profit or loss on disposal agree with the amount in the profit and loss account.</li> </ul>			

	Details of Work	W/P. Ref	Initial	Date
	<p>i v. Obtain and examine certificates of title Deeds And leases of landed properties to</p> <ul style="list-style-type: none"> <li>◆ Confirm that beneficial ownership is in the company.</li> <li>◆ If held by a bank for safekeeping confirm from the bank, the status regarding encumbrance or lien, the bank to confirm directly to the auditors.</li> <li>◆ Confirm directly from other third parties if they hold title documents as a result of charge on properties, details of the liability or indebtedness and nature of the charge.</li> </ul> <p>v. In the case of leasehold properties, to</p> <ul style="list-style-type: none"> <li>◆ verify that provision has been made for dilapidation in accordance with the terms of the lease, and</li> <li>◆ ensure that adequate amortisation is regularly effected.</li> </ul> <p>vi. If assets have been revalued during the year, (a) obtain a copy of the valuation report. If valuation is to be incorporated into the accounts, to:</p> <ul style="list-style-type: none"> <li>◆ verify the independence and qualification of the valuers</li> <li>◆ verify the basis of valuation from the report and ensure that it is acceptable</li> <li>◆ ensure adequate disclosure and agreement with accounting standards.</li> </ul> <p>vii. Reconcile fixed assets register with accounts balances</p> <p>viii. Verify that depreciation rate is as approved by the Board and is consistently applied in accordance with accounting policy.</p> <p>ix Obtain explanation for any change in depreciation rate, test reasonableness and highlight for possible disclosure in the accounts.</p> <p>x Check repairs and maintenance accounts for possible capital expenditure items.</p> <p>xi. Physically inspect material items of all types of assets.</p> <p>xii. Verify adequacy of insurance cover for the assets.</p> <p>xiii. Inspect motor vehicle registration documents.</p> <p>xiv Ascertain if approved user certificates have been obtained from the Inspectorate Division of the Federal Ministry of Industry.</p> <p>xv. Request and obtain representations from management.</p>			

	Details of Work	W/P. Ref	Initial	Date
	xvi Write a conclusion memo on the work done, problems encountered and solutions proffered.			
(b)	<p>The shortcomings of using standardised audit programmes may:</p> <ul style="list-style-type: none"> <li>(i) lead to a perfunctory approach on the part of audit staff and this may lead to poor quality work.</li> <li>(ii) Impair audit staff's spontaneous response to changing situations in client system or management.</li> <li>(iii) Stifle audit staff initiatives.</li> <li>(iv) Encourage speculation of audit procedures by the client's staff.</li> <li>(v) Parts of the audit programme may be executed without due regard to other sections of the assignment.</li> <li>(vi) If changes in client's system and personnel are not taken into consideration when preparing audit programmes certain area of the assignment may be left out</li> </ul>			

**QUESTION 21**

- (a) Define and explain what is meant by analytical review procedures.
  - (b) Mention four types of general analytical review procedures.
  - (c) What is the purpose of performing preliminary analytical review procedures at the audit planning stage?
- (Total 18 Marks) November 2003**

**ANSWER TO QUESTION 21**

- (a) 'Analytical review procedure' is defined as audit procedure which systematically analyses and compares related figures, trends, ratios and other data with the aim of providing evidence to support the audit opinion on the financial statements.  
  
The data used in such examination may be financial or non-financial and may originate from within or outside the client organisation. Analytical review procedures range from simple comparisons such as current with the prior year figures or accounting ratios; to complex analysis using advanced statistical techniques and computer audit programmes.
- (b) Four types of general analytical review procedures:
  - (i) Comparison of current-year account balances to balances for one or more comparable periods.
  - (ii) Comparison of the current year account balances to anticipated results found in the company's budget and forecasts.
  - (iii) Comparison of current year account balances and financial relations (e.g. ratios) with similar information for the industry in which the company operates.
  - (iv) Study of the relationship of current year account balances with relevant non-financial information (e.g. physical production statistics relating to input and out, energy consumption etc.
- (c) Purpose of performing preliminary analytical review procedures in the audit planning stage:  
The main purpose is to discover any misstatement in financial statement presentation, to confirm information supplied, to apply reasonableness test, estimates and judgements and to perform a cursory review of financial statements at the audit planning state. The auditor will endeavour to identify areas of potential risk or new development so that he can plan his other procedures in these areas.

## **APPENDIX III**

# **ESSAY TYPE QUESTIONS AND SOLUTIONS**

### **QUESTION 1**

Mr. Adalat George, the staff Partner of Binitie, George and Co., a firm of Chartered Accountants based in Port Harcourt, is conducting a recruitment interview, as a prelude to the employment of some Audit Staff into his firm.

As one of the applicants, you were requested to come to the interview venue with a report addressed to the staff Partner, detailing the Audit steps necessary, to verify the values appearing for the following assets, in a clients financial statements for an accounting year end.

- (a) Freehold Land and Buildings
- (b) Plant and Machinery
- (c) Motor Vehicles

### **SOLUTION TO QUESTION 1**

The Staff Partner,  
Binitie, George and Co.  
Horsefall Street,  
Port Harcourt.

Date: 16th May 2009

Dear Sir,

#### **AUDIT STEPS TO BE TAKEN, IN VERIFYING LISTED ASSETS**

I write in response to your request that I present a report stating the audit steps necessary to verify the values appearing for the following assets, in a client's Financial Statements, for an accounting year end.

The Steps are as follows:

#### **Freehold land and buildings**

##### **Freehold land**

- ◆ Obtain and examine title documents and costs relating to the land.
- ◆ Ensure that title is registered in the name of the company at the Lands Registry.

##### **Buildings**

- ◆ Agree balance to the General ledger
- ◆ Verify significant additions with relevant Invoices, Architects and Quantity Surveyor's Certificates
- ◆ Check and agree depreciation charges and ensure consistency of rate applied
- ◆ Obtain Board's approval relating to construction handled internally
- ◆ Trace to fixed assets register
- ◆ Verify insurance policy relating thereto
- ◆ In case of revaluation, obtain valuation report done by a professional value

### **Plant and machinery**

- ◆ Agree balance to the general ledger
- ◆ Verify additions by checking related purchase invoices
- ◆ Re-check and agree depreciation figures, and rates applied
- ◆ Check to fixed assets register
- ◆ Verify insurance policies relating thereto
- ◆ If there are disposals, confirm authorisation and proceeds
- ◆ If construction is done internally, check and agree cost sheets
- ◆ Carry out a physical verification of material items

### **Motor vehicles**

- ◆ Agree figures to the general ledger
- ◆ Verify purchase invoices
- ◆ Check that registration of vehicles with the licensing authorities are done in the name of company rather than individuals
- ◆ Check and agree depreciation figures; rates applied and its consistent application.
- ◆ Carry out physical verification of motor vehicles
- ◆ Verify and agree insurance policies relating thereto
- ◆ Check items to fixed assets register
- ◆ Confirm authorisation in respect of disposals where applicable and trace proceeds to bank statement/ cash book.

Once the above steps are followed painstakingly, the authenticity of the values stated against, the listed assets, can either be affirmed or otherwise.

Thanks You,  
Yours faithfully

Mr. O. A. Alainishe.

### **QUESTION 2**

Mr. Yekini Sofola, an Audit Senior in Sekibo Achike Gamba and Co. a firm of Practicing Accountants has recently been commissioned by the Managing Partner of the firm to:

- (a) Briefly outline the nature of the
  - (i) Application controls and
  - (ii) General Controls, expected in a computer-based accounting system
- (b) List and briefly comment on 5 (five) components of audit planning documentation as an important aspect of the audit process.
- (c) You are required to provide what you consider should be the content of Mr. Yekini Sofola's response

### **SOLUTION TO QUESTION 2**

The contents of Mr. Yekini Sofola's response, should include:

- (a) Description of Controls

**(i) Application Controls**

These relate to the transactions and standing data pertaining to each computer-based accounting system and are therefore specific to each such application. The objectives of application controls are to ensure the completeness and accuracy of the accounting records and the validity of the entries made in these records resulting from both manual and programmed processing.

**(ii) General Controls**

These are controls, which relate to the environment within which computer-based accounting systems are developed, maintained and operated and are therefore applicable to all the applications.

The objectives are to ensure the proper development and implementation of applications and the integrity of program as well as data files and computer operations. They may be manual or programmed.

**Five Components of Audit Planning Documentation****Background Information**

- ◆ Meeting with client
- ◆ Brief history of the organisation
- ◆ Nature of Business
- ◆ Organisational Structure
- ◆ Accounting and internal control systems
- ◆ Audit Objectives
- ◆ Terms of engagement
- ◆ Financial Trends

**Audit Strategy**

- ◆ Audit approach
- ◆ Analysis of audit risks
- ◆ Outline of audit emphasis

**Job Administration**

- ◆ Timing of audit work
- ◆ Staff requirement
- ◆ Work Allocation
- ◆ Job review
- ◆ Reporting deadline
- ◆ Interim audit
- ◆ Attendance at stock-taking

**Audit Budget**

- ◆ Time
- ◆ Cost

**Audit Programmes**

- ◆ For all areas of the business

**Audit Briefing (Pre-audit conference)**

- ◆ Date of Meeting
- ◆ Name and level of staff to be briefed
- ◆ Specific matters requiring particular attention such as changes in management structure, technology, etc.

### QUESTION 3

Audit is “An independent examination of and the expression of opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment”.

Required:

- (a) List FIVE types of audit
- (b) State ONE advantage of an audit to each of five different users of the audit report.
- (c) Write short notes on the following:
  - ◆ Compliance tests
  - ◆ Substantive tests
  - ◆ Vouching

### SOLUTION TO QUESTION 3

- (a) **Types of audit are**
  - (i) Final Audit
  - (ii) Management Audit
  - (iii) Interim Audit
  - (iv) Internal Audit
  - (v) Continuous Audit
  - (vi) Environmental Audit
  - (vii) Value for money Audit
  - (viii) Forensic Audit
  - (ix) Social Responsibility Audit.
- (b) **Five advantages of audit are:**
  - (i) To the Tax Authorities, it helps to agree tax assessment with tax authorities
  - (ii) To the insurance underwriters, it facilitates claims for loss of profit or stock from an insurance company, including consequential loss.
  - (iii) To the Banks, it facilitates processing of application for bank facilities
  - (iv) To the Shareholders, it help to prevent or reduce incidents of fraud, error and other misstatements.
  - (v) To the Partnerships, it provides a proper basis for valuation of goodwill on admission, retirement, or death of a partner and helps reduce or settle disputes that may arise from financial statements
- (c) **Short Notes**
  - (i) **COMPLIANCE TESTS**  
These are detailed tests of transactions, which seek to assure the auditor (i.e. provide audit evidence) that the Internal control procedures are being adhered to by the company management.
  - (ii) **SUBSTANTIVE TESTS**  
These are tests of transactions, balances and other procedures such as analytical review, which seek to produce audit evidence regarding completeness, accuracy and validity of balances in the accounting records or financial statements.
  - (iii) **VOUCHING**  
Vouching is the examination of transactions of the business through vetting of documentary and other evidence of sufficient validity to satisfy the auditor that such transactions are in order and have been properly authorised and correctly recorded.

**QUESTION 4**

An Auditor is expected to obtain relevant and reliable audit evidence sufficient to enable him draw measurable conclusions as a basis for his report. You are required to:

- (a) List the factors, which may influence the auditor's judgment in relation to sufficiency of the evidence so collected.
- (b) State the factors that would enable the auditor assess the reliability of such evidence.

**SOLUTION TO QUESTION 4****(a) Sufficiency of Audit Evidence**

The sufficiency of audit evidence will be affected by the following factors:

- (i) The relevance of the evidence collected.
- (ii) The reliability of the evidence collected.
- (iii) The materiality and nature of the item being checked.
- (iv) The auditor's experience of the reliability of management, staff, accounting records as well as the effectiveness of the internal control system.
- (v) The possibility of management bias and the accompanying risk of mis-statements
- (vi) The time and cost of collecting the evidence in relation to the value of the evidence.
- (vii) The auditor's knowledge of the client's business and the operating industry

**(b) Reliability of evidence**

The auditor will consider the following factors when assessing the reliability of the evidence.

- (i) Reliability of the source and his previous experience about that source: the independence, objectivity, qualification, and experience of the provider of evidence.
- (ii) The form of the evidence e.g.
  - ◆ Documentary evidence is more reliable than oral evidence
  - ◆ Externally generated evidence is better than internally generated one
  - ◆ Evidence generated by the auditor through physical inspection, computation or analysis is more reliable than evidence presented by client staff.
- (iii) Whether the evidence agrees or conflicts with other related evidence: for example, if there is a conflict, more evidence will be required to prove the reliability of one source or evidence.

**QUESTION 5**

Penta Ltd. a manufacturing company involved in the production of vegetable oil, has been in business for over five years. Since then, it has been making huge losses. The company accounts are being audited by Babajide and Co., Chartered Accountants.

The company is currently experiencing serious financial difficulties. It has approached the major shareholder to assist it; by granting it a soft loan. Enquiries made by the major shareholder who is the Chairman, revealed that management, with the assistance of some suppliers of the company are defrauding the company, through payment for materials not supplied. The Chairman has approached your firm of Chartered Accountants, Experience and Co, to carry out an investigation into this matter and report your findings to him.

You are aware that Jeje Nig. Ltd, one of your major clients, is one of the major suppliers of Penta Ltd.

- ◆ State, with reasons, whether Experience and Co. (Chartered Accountants) should accept or reject this appointment.
- ◆ If Experience and Co. decides to accept the appointment, what steps should it take before formally accepting?
- ◆ Draw up a programme of work to be undertaken by Experience and Co.

### **SOLUTION TO QUESTION 5**

- (a) Experience and Co. (Chartered Accountants) may not accept the assignment if: He makes a discreet enquiry on his client Jeje Nigeria Ltd. and discovers that the company is one of the suppliers that is assisting the directors of Penta Ltd, to defraud.

The reason for this is that , if he takes the appointment, he will be biased unless he does not mind to lose Jeje and come up clear and plain with the result of his findings.

- (b) If he chooses to accept the appointment, then he must write to the company's auditors – Babajide and Co., informing them of the assignment given to him
- (c) Programme of work to be carried out by Experience and Co.
- (i) Obtain a list of the creditors of Penta Ltd, for the period that the investigation should cover.
  - (ii) Agree totals of the balances to the General Ledger and Trial Balance for each period. (This will help in establishing completeness of the list).
  - (iii) Trace debit entries in the Creditors' ledger to the Bank Cash book and Bank Statements.
  - (iv) Request for original Supplies' invoices, upon which these payments were made.
  - (v) Request for copies of Local Purchase Orders.
  - (vi) Ask for Delivery Notes/Waybills
    - ◆ Trace waybills to Goods Received Notes.
    - ◆ Trace Goods Received Notes to Stock Cards.
    - ◆ Review issues from stock.
    - ◆ Check authorisations to payment vouchers.
    - ◆ Review Bank Reconciliation Statements.

## ***APPENDIX IV***

# ***GLOSSARY OF TERMS***

**Access controls** – procedures designed to restrict access to on-line terminal devices, programmes and data.

**Accounting estimate** – an approximation of the amount of an item in the absence of a precise means of measurement.

**Accounting system** – the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records.

**Adverse opinion** – is expressed when the effect 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.

**Analytical procedures** - consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predictable amounts.

**Annual report** - document issued by an entity on an annual basis, which includes its financial statements together with the audit report thereon.

**Appropriateness** - the measure of the quality or reliability of audit evidence and its relevance to a particular assertion.

**Assertions** – representations by management, explicit or otherwise, that are embodied in the financial statements.

**Attendance** – Attendance consists of being present during all or part of a process being performed by others.

**Audit documentation** - the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations.

**Audit engagement partner** - the partner or other person in the firm who assumes responsibility for the conduct of the audit and for issuing an auditors' report on the financial statements on behalf of the firm.

**Audit evidence** - the information obtained by the auditor in arriving at the conclusions on which the audit opinion is based.

**Audit risk** - the risk that auditors may give an inappropriate audit opinion on financial statements.

**Audit staff** - the personnel involved in an audit other than the audit engagement partner.

**Auditing** - a systematic process of objectively obtaining and evaluating evidence in respect of certain assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and reporting the results to interested parties over a particular period of time.

**Auditor** - the person with final responsibility for the audit. This term is also used to refer to an audit firm.

**Client service partner** - is the partner who takes primary responsibility for coordinating the range of services provided to an audit client.

**Competencies** - the knowledge, skills and abilities of audit engagement partners and audit staff.

**Computer-assisted audit techniques(CAATs)** - application of auditing procedures using the computer as an audit tool.

**Computer information systems (CIS) environment** - exists when a computer of any type or size is involved in the processing of financial information of significance to the audit.

**Confirmation** - a specific type of inquiry that is the process of obtaining representation of information of an existing condition directly from a third party.

**Continuing auditor** - the auditor who audited and reported on the immediate prior period's financial statements and continues as the auditor for the current period.

**Control environment** - the overall attitude, awareness and actions of directors and management regarding internal controls and procedures and their importance in the entity.

**Control risk** - the risk that a misstatement that could occur in an account balance or class of transactions and would not be prevented, or detected and corrected on a timely basis by the accounting and internal control systems.

**Control procedures** - are those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives.

**Date of financial statements** – the date of the end of the latest period covered by the financial statements, which normally is the date of the most recent balance sheet in the financial statements subject to audit.

**Date of approval of the financial statements**—the date on which those with the recognised authority assert that they have prepared the entity’s complete set of financial statements, including the related notes, and that they have taken responsibility for them.

**Date of the auditor’s report**—The date selected by the auditor to date the report on the financial statements. usually after the date of approval of the financial statements.

**Date the financial statements are issued**—The date that the auditor’s report and audited financial statements are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority.

**Database** – collection of data that is shared and used by a number of different users for different purposes.

**Detection risk** - the risk that auditors’ substantive procedures do not detect a misstatement that exists in an account balance or class of transactions that could be material.

**Directors** - the directors of a company, partners, proprietors, or equivalent persons responsible for directing the entity’s operations and preparing its financial statements.

**Disclaimer of opinion** – is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

**Error** – an unintentional mistake in financial statements.

**Errors** - unintentional misstatements or omissions of amounts or disclosures in financial statements.

**External auditor** – independent auditor who is not subject to management controls.

**Financial statements** – the balance sheets, income statements, statements of changes in financial position, notes and other statements and explanatory material which are identified as being part of the financial statements.

**Firm** – sole practitioners, partnerships, limited liability partnerships and other corporate entities engaged in the provision of auditing services.

**Fraud** – refers to an intentional act by one or more individuals among management, employees, or third parties, which results in a misrepresentation of financial statements.

**Going concern assumption** – an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

**Goodwill** - the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets.

**Governance** - describes the role of persons entrusted with the supervision, control and direction of an entity by ensuring that the entity achieves its objectives, financial reporting, and of reporting to interested parties.

**Incoming auditor** – the auditor who is to take over from the current auditor and did not audit the prior period’s financial statements.

**Independent audit** - providing reasonable assurance that published audited financial reports are free from material misstatement and are in accordance with legislation and relevant accounting standards.

**Independent partner** - a partner with sufficient experience and authority who is not engaged in the performance of the audit to perform an ‘independent review’.

**Inherent risk** - the susceptibility of an account balance or class of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes of transactions.

**Intended users** - the person, persons or class of persons for whom the practitioner prepares the assurance report.

**Internal audit** - an appraisal or monitoring activity established by management and the directors for the review of the accounting and internal control systems as a service to the entity.

**Internal control system**- the control environment and control procedures. Which includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective.

**IT environment** – the policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, etc) and application software that it uses to support business operations and achieve business strategies.

**Knowledge of the business** – the auditor’s general knowledge of the economy and the industry within which the entity operates and a more particular knowledge of how the entity operates.

**Limitation on scope** – a restriction on the scope of the auditor’s work which may sometimes be imposed by the entity or by circumstances. It may also arise when, in the opinion of the auditor, the entity’s accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed desirable.

**Local Area Network (LAN)** - a communications network that serves users within a confined geographical area.

**Management** - those persons who may include directors, who have executive responsibility for the conduct of the entity’s operations and the preparation of its financial statements.

**Management** - comprises officers and others who also perform senior managerial functions. Management includes those charged with governance only in those instances when they perform such functions.

**Management fraud** – fraud involving one or more members of management or those charged with governance.

**Management representations** – representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries.

**Material inconsistency** - exists when other information contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor’s opinion on the financial statements.

**Mis-statement** - A mis-statement of the financial statements that can arise from fraud or error (also see Fraud and Error).

**Modified auditor’s report** – An auditor’s report is considered to be modified if either an emphasis of matter paragraph(s) is added to the report or if the opinion is other than unqualified.

**Other auditor** – an auditor, other than the principal, including affiliated firms, whether using the same name or not, and correspondents.

**Predecessor auditor** – the auditor who was previously the auditor of an entity and who has been replaced by an incoming auditor.

**Principal auditor** – the auditor with responsibility for reporting on the financial statements of an entity when those financial statements include financial information of one or more components audited by other auditors.

**Professional scepticism** – an attitude that includes a questioning mind and a critical assessment of evidence.

**Transaction logs** – reports that are designed to create an audit trail for each on-line transaction.

**Uncertainty** – is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

## APPENDIX V

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## APPENDIX VI

# STUDY AND EXAMINATION TECHNIQUES

This appendix contains notes on:

- (a) Using the questions and answers provided in the manual
- (b) Effective study
- (c) Examination technique

### 6.1 Questions and answers

#### Introduction

1. Two types of question are provided in this manual
  - (a) Questions set at the ends of chapters *with answers* provided in Appendix I
  - (b) Questions *with answers* set in Appendix II

#### Questions with Answers

2. These questions are either
  - (a) questions intended to test the understanding of the points arising out of the particular chapter; or
  - (b) examination questions inserted at a stage where it is considered the student will be best able to give a reasonable answer.
3. Most answers are given in outline but some examination answers go a little further in order to provide greater guidance and provide students with the basis for study.
4. When answers are *comprehensive* you could not be expected to write them in the time allowed. *Do not* worry if you feel you could not write such answers; you are not expected to. But you *must* grasp the main points or principles involved which will form the basis for good marks in an examination.
5. Do not worry if your answer differs, there is often more than one approach. You must satisfy yourself however, that it is *only* the approach that differs, and that you have not missed the fundamental principles.
6. Authors' Comments. These have been included to give *additional* points or elaborate on matters arising out of the subject covered by the question to which it is felt you should give some thought.

#### Using the answers

7. Have a shot at each question yourself *before* consulting the answer, you will achieve nothing if you do not do this. Write your answer out in full or jot down the main points. *Do not* hurry to the answer.
8. Look at the answer. (See para 5 in the case of examination answers). Study the particular area *thoroughly* now making sure of your understanding. *Repeat* the process outlined in para 7 and this paragraph after a suitable interval. You *must* do this to get any benefit at all. Make sure the main points *stick*.
9. Just browsing through the answers will really get you *nowhere*. You *must* test yourself by *writing* down your version of the answer.

### 6.2 Introduction

1. These notes are intended for those who are new to studying for examination subjects, although those who are not may also benefit. They have been written in relation to study involving the reading of *textbooks*, and they apply to all subjects. It is often very difficult to pick out the important principles from such books. Careful reading of these notes will be of benefit even in studying the manual.

**General**

2. Study means more than *just reading* a piece of literature. It means *close concentrated reading* with a *notebook* at your side. Unless you are one of a *few* people do not kid yourself you can absorb material by *just one* general read through it, you cannot!
3. Read a small area, *making notes* as you go along. Then ask yourself – what have I just learnt? *Write* down what you think it was all about. Then look again and you may be surprised to find you have missed a *key point* or points – they *must* be down in your notebook and eventually in your head.

**Compilation of notebook**

4. A *well-compiled* NOTEBOOK is a must. Use block capitals or different colour inks to *headline* the main areas and subdivisions of those areas. Notes made during lectures or private study should *not* go straight into your NOTEBOOK. Take them down on a “rough” paper and write them in your NOTEBOOK *as soon as possible* after the lecture or study period, thinking about what you are writing.

**Memory aids**

5. **Mnemonics** are very useful – if the sequence of points in the textbook *is not* significant, *change it* if it makes for a better mnemonic.
6. **Association** of the points with familiar objects which will serve to recall them is also useful.
7. Some people memorise things by *saying* them over and over *out loud*, others have to *write* them down *time after time*.
8. Many students have *small blank cards* and using one side of each card for each study area, put down the main points. They carry the cards everywhere with them and use every opportunity to study them. As they are small they are easily carried. It is surprising how much of your day can be utilized this way.

**Programme**

9. Map out a programme for yourself; set targets and *achieve* them. One thing is certain, studying is not easy but it is *not* too difficult if you go about it in an orderly purposeful way. Many students fail their examinations through *bad preparation*. Tackle your studies as you would a project at work, *systematically*. Allocate a number of hours each week to each subject. Try fixing *specific times* for each subject, then *keep to them* by refusing to let *anything* keep you from your planned task.

**Revision**

10. Revise periodically. The nearer the examination gets, the more you should concentrate on the major headlines in your notebook and less with the supporting details.

**6.3 Examination technique****First impressions**

1. However well prepared you may be, you are still likely to look at the paper on the day and say to yourself, after a quick look at the questions, “There’s not much *there* I can do”.
2. The atmosphere of the exam room has something to do with this. Try to blot everything from your mind other than the job in hand. *Concentrate* hard. If you feel a bit panicky (most people do – despite the apparent looks of serenity around you) grip the table, take a deep breath, and *get on with it*. Remember things are *never* as bad as they seem!

**Time allocation**

3. *Allocate* each question *time* appropriate to the number of marks. At the end of the allotted time for a question *go on to the next* – remember, the *first* 5 or 10 marks on the *new* question are more readily picked up than the *last* 1 or 2 on the *previous* question.
4. The *temptation* will be to say “I’ll write just *one* more sentence”, but before you know where you are you would have written *several* more and probably just managed to scrape another mark, whereas the same time on the next question could have earned 5 or 6 marks. TIME ALLOCATION IS IMPORTANT.
5. If you *are* running out of time write down the *main headings first*, leaving a few lines between each – at least the examiner will see that you had the overall picture. *Then* go back putting in as much supporting detail as you can.

**General approach**

6. Read the *instructions* at the top of the paper
7. Read the question paper once through. Make your choice of questions quickly. Pick the easiest (if one appears so) and *get on with it*.

**Individual question**

8. Read the question again carefully. The question will involve a key principle or set of principles. What are they? It is so easy to make the wrong decision at this stage, so read the question, underlining what appear to be the *key words*. This should help you. Irrelevancy has been heavily criticised by examiners.
9. Do not rush into action with your pen *yet*. Jot down on a piece of scrap paper the *main headings* you will use in your answer. All this will take time – about 5 minutes or more, but the *careful thought* and outline answer represents *marks* already earned.
10. If the question is *set out* in a particular sequence, that is:
  - a. ....
  - b. ....
  - c. .... etc.
 then answer it *in that sequence* or you’ll have a *hostile examiner* to cope with.
11. Use the particular terminology *used in the question*, the examiner can then *link the points* in your answer to the relevant parts of the question.
12. Assumptions are sometimes required (for example because of the lack of standardisation of terminology in this subject). Having stated your assumptions, make sure that what you write is *consistent* with them. Do ensure, however, that your assumptions *are valid* and are *not* just a device for changing the *meaning* of the question to suit your knowledge!

**Layout of answer**

13. Tabulate where appropriate, using block capitals for your main headings and underline subheadings. Underline *words* or phrases which require emphasis. *Use a ruler*.
14. Leave a line *between* your paragraphs and subparagraphs. This makes for a *good* layout. However, do *not* write one very other line within paragraphs, or on one side of the paper only – examiners are waste conscious!
15. The use of different colour pens, where appropriate, is useful but do not overdo it. In fact one black and red felt-tip pen would be sufficient (use the felt-tip pens which have a *fine point*).

### **Charts and diagrams**

16. A descriptive heading or title must be given to each diagram (using the one in the question if indicated).
17. Do not squeeze a diagram into a corner – *spread it out*.
18. Do not clutter your diagram up with too much detail – this defeats the object, which should be clarity.
19. Give a *key* to the symbols and the different lines you've used, and again – use a ruler.

### **End of examination procedure**

20. Have a quick look at each answer, checking for grammatical errors and badly formed letters.
21. Ensure each answer sheet has your *number* on it and *do not* leave any lying on the table.

### **Conclusion**

22. Good technique plays a *large* part in examination success; this is a *fact*. *Refuse* to be panicked, keep your head, and with reasonable preparation you *should* make it.
23. Remember – you do not have to score *100%* to pass.
24. A final point; once you're in the examination room *stay there* and make use of every minute at your disposal.
25. Practice your technique when answering the questions set in the manual.

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